de Nederlandse Orde van Belastingadviseurs
The Dutch Association of Tax Advisers

To the European Commission

January 2, 2018

Subject: European Commission's Public Consultation on 'Fair Taxation of the Digital Economy' (26 October 2017 – 3 January 2018)

Ladies and gentlemen,

The Dutch Association of Tax Advisers ('the Association') has taken interested note of the consultations launched by the European Commission op 26 October 2017 with a view to devising measures for addressing the challenges that the increasingly digitalising economy is posing to EU member states' business income and capital gains tax systems. The European Commission has invited interested parties to respond by completing an online questionnaire on its website (https://ec.europa.eu/info/consultations/fair-taxation-digital-economy_en), while also offering them the opportunity to upload a position paper (max. 1 MB). The Association is pleased to make use of this opportunity in the form of this letter.

The main issues to which the Association wishes to draw attention in this position paper are:

- The digital economy is not a sector that can or should be clearly identified and taxed separately;
- Digitalisation is an accelerator for growth, and taxation should not inhibit this more than it does with traditional businesses;
- The way in which digitalised business models create value needs to be understood, as does the question of whether this differs from the value created by traditional businesses;
- Unilateral actions, and the potential solutions referred to in the consultation, will have a negative overall impact (particularly on growth); and
- Time should be taken to consider the perceived problems, the real challenges, their impact, and potential solutions that could attract multilateral consensus.

The Association examines these issues in this position paper, together with the possible solutions outlined by the European Commission in the online questionnaire.

1 Tax challenges posed by digitalisation; first set the policy and then reflect this in legislation

1.1 General

Our economy is indisputably becoming increasingly digitalised. The evolution in the internet and other telecommunication technologies over the past few decades means these technologies now constitute a fundamental part of the economy and play a vital role in the business models of nearly all sectors in the internal market. This applies both in the case of the well-known tech companies and in more traditional companies, with more and more business now being transacted digitally in almost all industries and sectors. And the importance of the internet and internet-related business activities will become even more important over the coming years, not least for achieving economic growth, attracting investments and creating jobs in the internal market.

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The member states' business income and capital gains tax systems date back to the 1920s and have since been regularly updated and modified, primarily with a view to countering opportunities to avoid taxes. Mention should certainly be made in this respect of the international and historically unprecedented reforms of recent years, including obviously the Base Erosion and Profit Shifting (BEPS) project of the G20/OECD and the implementation of the EU's Anti-Tax Avoidance Directives.

The member states' current corporate tax systems are very much based on the idea of a physical presence in a country, as reflected, for example, in the concept of tax residency and the physical permanent establishment. These days, however, the reality is increasingly frequently at odds with this underlying assumption. Businesses in today's world structure their operating processes on a European or even global level, while commercialising their intangible assets, spreading their production and sales locations across the world for reasons of market efficiency, and often supplying their goods and services remotely. It is the internet above all that has enabled businesses to supply markets without the need for a local presence, either physically or legally. This, in turn, has triggered a historically unprecedented and virtually unlimited ability to upscale digital business models. At the same time, however, these developments are putting pressure on the ways in which taxes are currently levied and have prompted the question of whether the existing tax systems are sufficiently equipped to accommodate today's social and economic reality.

Although the discussion currently seems to be focusing on the well-known tech companies, there would not really seem to be much material difference between 'tech' and 'traditional' (or 'non-tech') businesses, given that more and more traditional industries are becoming increasingly digitalised and using the opportunities offered by telecommunication technologies to achieve sustainable growth and profitability. Indeed, one of the BEPS 1 outcomes was the conclusion, considered correct by the Association, that the digital component of the economy cannot be separated ('ring-fenced') from the rest of the economy.

1.2 Single taxation at the place of value creation

With regard to attributing the rights to tax business profits in an international context, the widely accepted view internationally, including within the EU, is that profits should be subject to single taxation and that this should be in the jurisdiction in which the value is created. The basic assumption in this respect is that profits on transactions between associated enterprises should be attributed in line with the conditions that would have been agreed if the transactions had been entered into between independent parties, as set down in Article 9 of the OECD Model Convention.

However, economic globalisation, which has been accelerated by digitalisation, has enabled – and maybe even encouraged – the supply and demand sides of income production to become geographically separated from each other. This, in turn, has prompted the idea that the existing model for allocating profits is no longer sufficiently equipped to deal with the digital economy, and that alternatives for this model consequently need to be identified. The question here, however, is what exactly the problem is? Is it no longer *technically* possible to allocate profit within the current system of profit allocation, based on the arm's length principle?

1.3 Where is value created?

As indicated earlier, the current transfer pricing model normally attributes the tax base in relationships between associated entities to jurisdictions on the basis of the arm's length principle. When putting this principle into practice, the OECD aligns with the place where relevant functions ('significant people functions performed') and capital ('assets used' and 'risks assumed') are deployed. In this respect, and particularly since the BEPS outcomes on issues raised in transfer pricing (Action Points 8-10) were implemented in the Transfer Pricing Guidelines of 2017, the OECD seems *de facto* to attribute considerable weight to the 'people functions', given that the important factor in the case of 'assets' and 'risks' is where these are used and managed respectively. In the OECD's view, profit is ultimately liable to tax in the place where the enterprise's relevant people perform its relevant activities. In other words,

in the origin jurisdiction, with the demand side of the income generated (i.e. the market) playing no role in this respect. This method of attributing profit reflects the idea that a consumer is a third party who consumes only passively and consequently adds no value to the production process.

Nowadays, the functions, assets and risks that multinationals deploy or assume in producing their goods and services are increasingly fragmented across the globe, while the goods and services these enterprises produce are also traded on an equally worldwide basis. Although determining an arm's length price in a globalising and digitalising world is likely to become increasingly complex, the Association does not believe that this automatically means it is no longer possible on technical grounds to apply the current principles of international tax law. On the contrary, it is still perfectly possible to apply the transfer pricing model in full to determine the contributions that a multinational's various business units make to the production process.

The question that appears to be emerging in the public discussion on how to tax digital enterprises is whether the new business models operated by tech companies mean that taxation rights (or more taxation rights) should be attributed to the state in which the consumer is resident. The reason that seems to be given in the public debate is that these new business models extract increasing amounts of data from the consumer's residence state, given that anyone buying a book online or using a social media platform provides data in exchange for a lower price for the book or for the right to use the social media platform for free.

The Association has several reservations regarding this line of reasoning:

- It can firstly be questioned whether any value can actually be attributed to the raw data that consumers provide. The data of one individual are of no value to the business collecting such data. And neither are the data of 100 people. But what about 100,000? Where is the value of bundled data? In the raw data themselves? Or is the value in fact created by related activities such as the aggregating or further processing of data?
- Even if we were to conclude that value should be attributed to the raw data as such, a nexus for imposing tax in the consumer's residence state would still seem to be lacking. Consumers are third parties vis-à-vis the online bookstore or the social media platform and may not even be aware that they are supplying data. And even if they are aware of doing so, is the value of the data they supply any different from paying for goods or services in kind? And why should profits generated by these remote sales not be attributed to the country or countries where the enterprise performs relevant activities, deploys assets and assumes risks, just like any other remote sales?
- It should also be pointed out that data collection is nothing new and is not an activity performed solely by digital enterprises. Loyalty programmes, for example, which record personal data and collect data on spending patterns, have been commonplace for decades. There are also other ways, both physical (through surveys and forms) and digital (by tracking website visits and through advertising and newsletters), in which traditional businesses build up databases of market information. In the Association's view, therefore, ring-fencing the digital economy would not only be impossible, but also undesirable.

The Association concludes that the current model of allocating profits continues to be able, from a technical perspective, to apply the usual criteria as the basis for allocating profits, while also acknowledging that this view may not necessarily enjoy support at a political level or in society.

1.4 From origin to destination

If the origin factors of value creation are no longer seen as an appropriate basis for allocating the rights to tax profits generated by tech companies, the question arises as to whether we should instead start focusing on radically reforming the tax system. This applies particularly in view of the recent initiatives moving towards geographically attributing tech companies' profits so as to take more account of where sales are made, as in the case of the taxes recently announced in Italy and the United Kingdom.

The fundamental question arising is whether income should be regarded as being created in the origin jurisdiction or in (or also in) the market jurisdiction? Both jurisdictions are required in order to generate profits, given that profit is the result of supply *and* demand. If no goods and services are produced, there is nothing to sell, while if no market exists, any goods or services produced represent a waste of resources. From that perspective, both labour and capital, as well as the market, could perhaps be regarded as geographical sources of income.

As stated above, production factors and sales of goods and services are now all increasingly fragmented across the globe, both in the case of multinationals operating in the tech sector and in the case of enterprises active in other sectors. In other words, enterprise profits are equally multinational as the multinational enterprises that generate them. This makes it very difficult to devise a suitable apportionment mechanism, with any mechanism essentially seeming somewhat arbitrary. Perhaps, apportionment is ultimately not so much an economic issue, but rather and above all a political matter.

The existing international tax treaties do not seem to provide any clear guidance in this respect as they attribute tax jurisdiction both on the basis of supply side- and demand side-related allocation rules:

- On the one hand, as indicated earlier, the transfer pricing model *de facto* allocates the tax base to the country of origin. The same applies when establishing the tax jurisdiction. Here, too, the primary issue is the business inputs: the place of effective management (labour), the physical permanent establishment (a physical presence: capital), the services permanent establishment (labour) and the dependent agency permanent establishment (performance of representative functions: labour). The transfer pricing model ultimately seeks to apportion the tax base by arriving at a fair market value for each unit of functions. This is most evident in the profit split method, which apportions profit on the basis of the relative contributions of functions performed;
- On the other hand, the tax base in the withholding tax model is *de facto* allocated to the market jurisdiction; in other words, to the demand side and the destination jurisdiction, and thus disregards the supply side. The relevant allocation rules in the tax treaties are applied (Articles 10, 11 and 12 on dividends, interest, royalties and, if applicable, service fees) in order to determine where income derives from. The reference point for establishing the service provider's tax jurisdiction is consistently the location of the party using the service, or at least the place where that party resides or performs business activities (through a permanent establishment).

With regard to the possible solutions suggested in the consultation, it is important to note that when attributing taxation rights to origin countries in international tax law under the transfer pricing model on the one hand and the withholding tax model on the other hand, a distinction is made between *net* and *gross* allocation of the tax base. When the tax base is allocated to origin jurisdictions, under the transfer pricing model, what is being allocated is *profit*; in other words, the allocation is a net allocation, and therefore entails geographical allocation of both business income and business expense. Where, however, the tax base is allocated to destination jurisdictions, under the withholding tax model, what is being allocated is normally *turnover*; in other words, therefore, the allocation is gross, and so only income generated is allocated. The tax base is then the gross turnover, with no costs being eligible for deduction in the origin country and also, therefore, no account being taken of the enterprise's capacity to fund or bear its taxes from profits. This method consequently distorts the market. Analytically, therefore, the withholding tax method is comparable to a turnover tax in a cumulative cascade system ('sales and use tax'), albeit with a tax credit in the residence jurisdiction. This tax credit, however, will normally be on a *net* basis, with – in effect, and from the perspective of the origin state – a geographical cost allocation to the destination jurisdiction and so potentially also a problematic excess credit position for the taxpayer. Where EU law applies, the withholding tax model is also at odds with the EU treaty freedoms if profit taxes in domestic situations are levied on a net basis (for examples of Court of Justice cases involving the gross versus net issue, see *Gerritse*, C-234/01, *Bouanich* C-265/04 and *Brisal*, C-18/15).

1.5 Underlying policy considerations continue to receive too little attention

The Association notes that the debate on taxing the digitalising economy continues to devote too little attention, both internationally and within the EU, to the key issue of the underlying policy on apportioning the tax base. Indeed, neither the possible temporary nor the longer-term solutions referred to in the public consultation provide any explicit guidance in this respect. Instead, the Commission zooms in directly on the various options for taxation, stating in the questionnaire that *'for the digitalised economy, today's rules result in misalignment between taxation and value creation, since many digital business models do not result in a taxable presence or attribute profits to where the digital activities of these businesses takes place.'* This passage presumes it to be possible to identify the place of *'value creation'*, given that it could not otherwise be claimed that there is a '*misalignment between taxation and value creation*'. The problem, however, is precisely that this location has not yet been identified. Indeed, the issue has not even been debated. What is lacking is an answer both to the fundamental question of tax base division and to the question of the policy direction. As a result, the possible options suggested for resolving the problems lack any conceptual basis for policy in either the shorter or longer term. What, after all, is the purpose of conducting a more or less technical discussion of measures to reform tax systems when it is not yet clear what any such measures are intended to achieve?

What is the European Commission seeking to achieve with the measures on which consultation is being sought? Is the issue at stake the approach to dealing with tax avoidance by all types of multinationals, or how we should deal with such behaviour by specific types of multinationals such as tech companies (assuming that these businesses or their activities can actually be isolated from other businesses and activities)? Is the Commission concerned about tax avoidance by multinationals within the existing international tax framework? Or about how to deal with multinationals and, at the same time, how to redistribute the tax base among countries and member states in a manner extending beyond the existing tax frameworks? And, in the latter event, is the Commission seeking to redistribute the profits of *all* multinationals, or only those of specific enterprises, such as tech companies and their tech-related activities? And is it looking to tax these companies' profits, or alternatively (and maybe for the time being) to tax their turnover? What exactly are the proposed measures seeking to achieve, and what is the precise role of the 'digitalising economy and tax' discussion in this respect? The Association would have expected a greater degree clarity in this respect.

If dealing with tax avoidance is the policy objective, it would seem appropriate to wait for the BEPS outcomes of 5 October 2015 to be implemented and, at a certain point, to evaluate their impact. These BEPS outcomes address tax avoidance within the existing international tax framework, based on the three main pillars of substance, coherence and transparency, and the EU is implementing them throughout the EU. Admittedly, the G20/OECD BEPS Project has also failed to discuss the underlying question of exactly where value is created and the resultant issue of apportionment. Indeed it has been said that BEPS treats symptoms rather than underlying causes. Whatever the case, it cannot be denied that measures are currently being introduced on a global scale that have made the well-known and traditional tax avoidance strategies impossible, or would seem to make them impossible in the near future. These measures apply both in respect of multinationals operating in the tech sector and to those active elsewhere. This is simultaneously an argument for not introducing measures exclusively targeting the tech sector, given that digital activities cannot be isolated from non-digital activities. Furthermore, seeking to resolve the problem of tax avoidance within the existing framework allows the underlying issue of apportionment to be disregarded because the recent anti-avoidance measures are being transposed into an existing system. Calls to wait until the BEPS outcomes have been implemented are also being heard at an international level.

If, however, the policy objective is to achieve a more radical redistribution of the tax base among countries and member states *beyond* the existing tax frameworks, the Association believes the fundamental, underlying issue of where value should be seen as being created and the issue of apportioning the tax base should be put onto the agenda and examined in an open and transparent discussion. This could be incorporated into the discussions of the Common Consolidated Corporate Tax Base (CCCTB), for example, or any alternative tax reform proposals that may be launched, however

politically difficult and intractable such discussions may be. Another question to be raised at the same time is whether it is then businesses' turnover that should be taxed or their profits. These aspects need to be resolved before proceeding to proposals of a more technical nature, given that they entail fundamental reform of the tax system and redistribution of tax revenues, along with the related budgetary and macro- and micro-economic effects. Further comments with regard to the CCCTB as a possible solution for taxing the digital economy are set out in section 2.2.2.

Irrespective of the merits of any possible solutions proposed (CCCTB, unitary taxation, destination-based cash flow taxation, and so on), the Association believes that if the latter policy objective is the case, the discussions on taxing the digitalising economy and the Commission's public consultation are being used inappropriately by being reduced to a means, or catalyst, for achieving an objective other than the objective of addressing the challenges that digitalisation presents for tax systems around the world. In reality, we would then be looking at a fundamental reform of how international business profits are taxed, along with the possibility of a simultaneous transfer of member states' autonomy in such matters to the Union. It would then no longer be a case of introducing a tax specifically for the tech sector and aimed at resolving problems related to the taxing of internet businesses. Here, too, it should be emphasised that digital and non-digital activities cannot be separated from each other, which again constitutes an argument for not introducing tax measures targeted solely at the tech sector.

2 Possible solutions for reforming the internal market; an overview and analysis

2.1 Possible solutions; general

The European Commission is considering measures both for the short and the longer term: '*In order to properly address the challenges ahead, the Commission believes that a two-step approach might be needed: first a targeted, temporary solution followed by a comprehensive, long term one.*' The short-term options proposed include various forms of taxes, such as a turnover-related tax on certain digital activities and services, a withholding tax on payments made for goods or services ordered online, and a digital transaction tax to be levied in return for the data collected by a tech company. The long-term options comprise proposals to amend the definition of the permanent establishment and the apportionment formula in the CCCTB draft directive, proposals to redefine the permanent establishment and the transfer pricing model in a new draft directive to be drawn up, and proposals to introduce a destination-based corporate tax, a form of unitary taxation or a residence state tax at the average rate applying in the destination jurisdictions ('residence tax base with destination tax rate'). Any short-term measures to be introduced would need to be accompanied by a 'sunsetting provision' in order to prevent temporary arrangements from acting as long-term solutions.

As mentioned earlier, the anti-BEPS measures implemented to date within the EU have sought to address base erosion and profit shifting strategies within the existing international tax framework, with the outcomes of the BEPS project and the anti-BEPS measures aligning with the existing transfer pricing and withholding tax models. The underlying question of where exactly value is created, along with the question of the country to which the tax base should then be attributed, has not yet been raised within an OECD and G20 context. Indeed, there has been no need for this, given that the anti-BEPS measures are in conformity with the existing tax framework.

The possible solutions proposed with regard to the digital economy, both internationally and within the EU, extend, by contrast, beyond the existing international tax framework. To some degree, all these options, again both within the EU and internationally, involve attributing the tax base to market jurisdictions and would therefore entail a paradigm shift in the way that multinationals' profits are taxed internationally. This also applies to the suggestions, both for the short and longer term, in the European Commission's consultation. Achieving a reform of this nature would require the current transfer pricing model to be modified and/or the withholding tax model expanded. This is because the former generally allocates the profit-related tax base to production jurisdictions, while the latter allocates the turnover-related tax base mainly to destination jurisdictions, with no account yet being taken of 'digital' activities.

The Association would like to re-emphasise at this point that, in view of the far-reaching consequences that such a fundamental reform of profit tax systems would have for the positions both of the member states and the European business sector, the desirability of any move extending beyond the existing international tax frameworks should first be examined on its political and economic merits prior to any discussion of the technical details of how to incorporate it into tax legislation. In this respect, the Association believes that the question of whether it is desirable for some member states already to be considering *ad hoc* measures should be examined, as well as the question of whether a more coordinated set of tax measures at an EU level would be desirable. The Association queries whether a public consultation, based on a questionnaire allowing respondents to mark answers with an 'X' and to fill in text boxes, along with the opportunity to upload a position paper (max. file size: 1 MB), is the most suitable platform for this.

2.2 Possible solutions; details

2.2.1 Common denominator for the short and long term: allocation (or also allocation) to market jurisdictions

As mentioned above, all the possible solutions proposed in the consultation tend towards allocating the tax base to market jurisdictions. However, the new taxes suggested by the Commission specifically for the tech sector ('digi taxes') are all, remarkably, seeking to achieve the impossible: in other words, to ring-fence the digital component of the economy and isolate it from the rest of the economy, which – as we stated before – is simply not possible. In addition, member states unilaterally introducing *ad hoc* measures are likely to further disrupt the process of creating a level playing field within the internal market. A lack of coordination or lack of a systematic approach, both within the EU and in relation to third countries, is fairly likely to lead to arbitrary and multiple taxation, and consequently to differing tax burdens between national and international businesses in the tech and non-tech sectors, as the following example illustrates:

Where should a social media company be taxed on profits generated by sales of marketing data or advertising? In origin country A, where the IP enabling the data to be efficiently collected and distilled has been and will be developed? Or in country B, where the raw data collected by the company's employees from the social media platform are aggregated and converted into a tradeable product? Or in country C, where local platform users make their personal data available for free in exchange for the right to use the platform free of charge? Or what about country D, where the data centres and servers storing and processing all these data are located? Or country E (or also country E), where the buyers of the data processed into products (i.e. the social media company's end customers) are located?

And what are the implications now that the digital component of the economy is increasingly difficult to isolate from the rest of the economy? Should the more traditional economy be taxed (or also be taxed) in the market jurisdiction? Should a car manufacturer that develops and manufactures a car in origin country X and then sells it, increasingly frequently on the internet, to a buyer in destination country Y be taxed (or also taxed) in country Y? Does it make any real difference whether a product or service developed and sold by an enterprise is of a tangible, intangible or virtual nature? While no definitive answer to these questions seems as yet to be available, the European Court of Justice's recent judgment in the *Uber* case (CJ C-434/15), albeit not a tax-related case, clearly illustrates how difficult it is to make a distinction between tech companies and traditional businesses.

2.2.2 Possible solutions for the short term

Separate destination-based and turnover-related taxes

All the short-term options referred to in the consultation are destination-based and turnover-related. This applies to the option for a tax on certain digitalised activities or services ('equalisation levy'), to the withholding tax on digital transactions and to the proposal for a transaction tax on revenues

generated from collecting digital data. Furthermore, all three of these options specifically target business models within the tech sector, and are thus ‘digi taxes’.

In themselves, it would seem possible from a technical perspective to incorporate these short-term options into the existing international tax framework. This is because these options are related to those used in the withholding tax model, particularly if and insofar as the new ‘digi’ withholding taxes to be introduced would be offset by a corporate tax credit in the residence state. However, the tax treaties would need to make provision for this, and this would not generally seem feasible in the near-term future.

Like a withholding tax on outbound dividends, interest or royalty payments, the introduction of ‘digi taxes’ of this nature would result in the tax jurisdiction and tax base being attributed to the market jurisdiction. All other things being equal, such a tax would result in higher tax revenues in the destination state. If the origin state were to grant a credit for taxes paid in the destination state, this would reduce tax revenues in the origin state. Meanwhile if no tax credit were to be available, introducing taxes of this nature would result in the same economic profits becoming liable to multiple taxation.

In the Association’s view, a tax as suggested in the questionnaire as a short-term solution, regardless of whether this comprises a tax on turnover from digitalised activities or services, a withholding tax on digital transactions or a transaction tax on digital data collection, would be highly problematic for the following three reasons:

- Firstly, such a tax would be levied on a gross basis. This would increase the cost price of goods and services supplied digitally and would therefore distort the market in a way comparable to the distortion currently caused by withholding taxes. In contrast to profit-related taxes, turnover-related taxes can transform activities that are profitable before tax into loss-making activities after (double) tax. Such taxes would consequently result in enterprises active in the tech sector unfairly being treated differently from those in other sectors, particularly if the ‘digi taxes’ being considered were no longer eligible (in the tax treaties) for a credit in the taxpayer’s residence state (and that would seem to be the case at present). If no tax credit is available under the tax treaties, the taxes being considered would come close, systematically, to the predecessors of value added tax: in other words, cumulative cascade taxes, but then specifically for tech companies. And there is a good reason why, back in the 1950s, the EU replaced those old-style levies by the current system of value added tax: the former distorted the functioning of the internal market. The unfairness that ‘digi taxes’ could mean for the tech sector, compared with the taxes applying to other enterprises, could then prompt all sorts of EU law questions in cases falling within EU law’s scope of application, possibly including questions concerning the taxes’ compatibility (or incompatibility) with EU treaty freedoms and state aid rules, and not to mention their compatibility (or incompatibility) with international trade treaties and the WTO rules.

- Secondly, taxes such as these imply that it would be analytically and legislatively possible to restrict the scope of application to the tech sector. If enterprises’ internet-related activities are to be specifically targeted, a sufficiently clear distinction between ‘digital taxpayers’ and other taxpayers will first need to be established. The same applies to the taxable ‘digital supplies’ made by these digital taxpayers, and to the ‘digital transactions’ or ‘digital data collection transactions’ they perform. As noted earlier, the fact that it is very difficult, and maybe even impossible, to isolate the digital component of the economy from its non-digital counterpart means the challenge of establishing such a distinction for tax purposes would seem an equally complicated, if not impossible, task. Take the example of a consultant who prepares advice and then sends it to the client, along with the invoice, by post (as a hard copy or digitally on, for example, a USB memory stick), as an e-mail attachment or via an online platform in the ‘cloud’. Which of these transactions is the taxable digital transaction? And which is not? Should it matter? Should it make a difference for tax purposes whether the product sold was, for example,

an old-style paper book or an e-book? Or whether it is a physical LP or CD, or streaming music content? It would not seem inconceivable to expect that any attempt to structure a 'digi tax' will irrevocably lead to delineation problems, manipulation, arbitrary taxation, multiple taxation, market distortions, legal uncertainty and problems of an administrative nature for businesses (compliance) and tax authorities (enforcement) alike. Viewed from this perspective, the short-term solutions referred to in the consultation could easily, and in the equally short term, become highly problematical taxes.

- Lastly, the Association would like to draw attention to the costs of introducing and complying with new taxes. Introducing a new tax imposes a burden on governments and tax authorities in terms of available resources, and also requires businesses to take action to ensure they comply with their tax obligations. These compliance costs could be very high for digital enterprises active in many different countries, while not all companies will necessarily be able to absorb them. The pressure of compliance costs will be all the higher in the case of short-term solutions with a limited horizon and that are intended solely to bridge a perceived gap until longer-term solutions can be found.

The consultation also provides scope to reflect on other possible options. On a broader level, various alternative suggestions have come up in the debate, including the possibility of taxing turnover generated from internet advertising, taxing advertising space or website trafficking, or basing tax on unique visitor numbers, numbers of 'mouse clicks' or 'mouse click-throughs', 'likes', search results and so on. The objections to basing taxes on turnover from digital transactions or activities are comparable to those raised above with regard to the turnover-related taxes mentioned in the consultation (including 'equalisation levies') and withholding taxes (the prospect of double taxation, market distortions and so on). Taxes based on website trafficking, mouse clicks and so on are not much more than 'virtual' variants of the window taxes and head taxes we know from history. Window taxes were levied in Europe until the 19th century, based on the number of windows in wealthy people's homes as a proxy for measuring their economic wealth, while head taxes were levied as a fixed amount per member of a household. Any 'digi tax' based on mouse clicks, visitor numbers or the like would, in effect, do exactly the same as the outdated window and head taxes by resorting to the counting of 'items' as a surrogate for the creation of economic value. Countries long ago abolished window and head taxes for the simple reason that their effect was completely arbitrary. The Association would see little sense, therefore, in seeking to re-introduce such distortive taxes specifically for tech companies, which are precisely the enterprises leading the way in innovation and technological development and operating at the forefront of today's globalising market economy.

2.2.3 Possible long-term solutions

Generic destination-based and profit-related taxes

Just like the short-term options, all the long-term options referred to in the consultation are destination-based. In contrast, however, to the suggestions for possible short-term solutions, they are all profit-related. Moreover, these taxes do not seem to be specifically targeted at the tech sector, but seem structurally to be more of a generic nature.

Revising the permanent establishment rules and the transfer pricing model

The questionnaire suggests the possibility, as a long-term solution, of using a draft directive to revise the definition of the permanent establishment and the way in which the tax base is attributed. Looking at the suggestions in an international context (BEPS 1; OECD/G20), the idea would seem to be to revise the definition of the permanent establishment in the tax treaties (Art. 5) by aligning it with the concept of 'significant economic presence', while the tax jurisdiction would be established by reference to the multinational's intangible or virtual presence in the market jurisdiction. This could, conceivably, be done – by analogy with the 'place of supply' and 'place of performance' rules in VAT – by attributing the tax jurisdiction to the location of the party purchasing the products or services digitally supplied by

the multinational. Consideration could then be given to introducing a quantitative minimum turnover threshold like the *de-minimis* test. In that event, a permanent establishment would be regarded as existing only if the relevant enterprise were to achieve at least a certain level of turnover (amount to be specified) during a certain period (duration to be specified). In effect, this method of establishing tax jurisdiction is comparable to the rules on distance sales in VAT and to the ways in which nexus is determined in some US states (including California) using 'sales factor presence tests'.

From a technical perspective, this proposal would seem, at first sight, to be relatively straightforward to incorporate into tax treaties. In the Association's opinion, however, it is likely to prove far more difficult to proceed along these lines in practice. The current concept of the permanent establishment is highly origin-based. However, introducing a permanent establishment test as referred to above would result in tax jurisdiction also being attributed to the destination jurisdiction. This would irrevocably lead, in turn, to delineation problems and concurrence issues, along with the associated tensions between jurisdictions concerning which country should have jurisdiction in specific cases. As explained above, such a test implies that it is possible to make a distinction, for tax purposes, between remote (digital?) sales on the one hand and other types of economic activities on the other hand. What would happen if, for example, an entity established in country A made a remote sale of its digital products from a physical establishment in country B to a customer in country C? Which country would take precedence when establishing the tax jurisdiction in such a situation? Is it possible, from a tax perspective, for enterprises simultaneously to perform activities from an 'ordinary' permanent establishment and from a 'virtual' permanent establishment? If not, which permanent establishment takes precedence: the ordinary one or the digital one? Underlying this question is the crucial, but as yet unresolved policy issue of which jurisdiction – the origin or the destination jurisdiction – should take precedence in specific situations? In other words, which country should get the first bite of the pie?

Even if it were to prove possible to arrive at a more or less feasible method of establishing jurisdiction, with a new type of destination-based definition of the permanent establishment, the next question of how to allocate a permanent establishment's profits under tax treaties (Art. 7) will give rise to problems of a conceivably even more intractable nature, given that profit currently continues to be allocated on the basis of the origin-based transfer pricing model. As stated earlier, profit is not currently attributed to the customer's location. The point in the digitalising economy, as outlined above, is that the supply and demand sides have become geographically separated. Functions can easily be performed in one country, while the digital products created by these functions can equally easily be sold in another country. If the transfer pricing model is not simultaneously modified, the outcome of the above will be all sorts of new permanent establishments to which no profit can be attributed. The issue here is comparable to that of allocating profit to the new BEPS 7 permanent establishments (involving commissionaire arrangements and so on). In the absence of functions in the market jurisdictions – because of the products being sold remotely or through an intermediary receiving a commercial remuneration – scarcely any additional profit can be attributed to these permanent establishments unless the transfer pricing model is modified.

If consideration were to be given to revising the transfer pricing model and then proceeding to allocate (or re-allocate) part of enterprise profits to the market jurisdiction – and this seems to be something the European Commission is considering – the next question would be what proportion of an enterprise's profit should be re-allocated: 30%, 70%, 50%? And that brings us back to precisely the same unresolved question mentioned earlier: at which location is value created, and how and in what ratio should a multinational's profits be apportioned between jurisdictions for tax purposes? Revising the method used to allocate permanent establishment profits (Art. 7) without any simultaneous change in the way in which transfer pricing on transactions between associated enterprises is determined (Art. 9) would also create an unfair difference between the treatment of permanent establishments for tax purposes and the way in which group companies are treated. This, in turn, would distort enterprises' choice of legal form and irrevocably lead to all sorts of Union-law questions, within EU law's sphere of application, on the measure's compatibility or otherwise with EU treaty freedoms and so on (cf. CJ 270/83 *Avoir Fiscal* and C-307/97 *Saint Gobain*).

Modifying the permanent establishment rules and the apportionment formula in the CCCTB draft directive

An alternative approach, put forward as a second possible long-term solution in the questionnaire, would be to modify the permanent establishment rules and the apportionment formula in the CCCTB draft directive. The Association does not regard this consultation as the appropriate place for further detailed comments on the CCCTB draft directive, while nevertheless noting with regard to the current discussions and consultation that this draft directive is politically highly sensitive in various EU member states, particularly in view of the budgetary and macro-economic effects of the apportionment formula. This formula apportions a multinational's consolidated European profits among the member states by applying three equally weighted factors: a payroll factor and an assets factor on the supply side, and a sales factor on the demand side.

The Association notes that the EU has not yet reached political agreement on the apportionment formula – and so has also not yet reached agreement on the underlying apportionment of the tax base. Furthermore, the consolidated tax base could be potentially vulnerable to traditional base erosion and profit shifting strategies. The scope of the apportionment formula in the CCCTB draft directive is limited to apportioning the profits that multinationals generate from economic activities within the EU (the 'water's edge limitation'). Given, however, the number of multinationals operating on a worldwide basis, this consolidated European profit is just as vulnerable to base erosion and profit shifting as it would be under any currently existing form of corporate tax. Moreover, certain design faults in the apportionment formula create a vulnerability to intra-EU profit shifting via factor manipulation strategies. Under the CCCTB, tax planning within the EU would consequently be arranged in two phases: firstly (i) erosion of the consolidated tax base, using classical BEPS strategies, followed by (ii) factor manipulation strategies to shift the eroded consolidated profit to the EU member state imposing the lowest rate of tax.

In the Association's view, introducing a modified definition of the permanent establishment into the CCCTB draft directive as outlined above would result in the same delineation and concurrence problems as referred to earlier. Similarly, suggestions for specific changes to the apportionment formula will, in the Association's opinion, trigger exactly the same discussion as in the case of the CCCTB draft directive: specifically, how should the tax base be apportioned among the member states? The Association's impression is that, under the CCCTB, the only way to avoid any remaining BEPS strategies from a technical perspective – and so irrespective of whether member states have the political will to proceed – is by ending the water's edge limitation and thus introducing an effective worldwide unitary taxation model (see 'unitary taxation' below). Any such move, however, will first require a broad-ranging political discussion in society about apportioning the tax base and whether any measures should go beyond the confines of the existing international tax framework. The Association's view is that the way to avoid factor manipulation strategies is by properly structuring the apportionment formula in the CCCTB draft directive.

Introducing the destination principle into corporate profit taxation

A third long-term option mentioned in the questionnaire is to '*introduce the destination-principle to corporate taxation, according to which the jurisdiction to tax is based on the location of the consumer.*' The Association was surprised to see this tax included as a separate option in the questionnaire and fails to understand the reason for this, given that *all* the options put forward in the questionnaire, both for the long and the short term, are destination-based. The idea of introducing the destination principle into EU member states' profit tax systems is implicit in all the possible solutions proposed in the questionnaire. Consequently everything stated earlier in this position paper on establishing tax jurisdiction in the destination country and attributing the tax base to the same country applies in full to the suggestion in the questionnaire to introduce the destination principle into EU member states' profit tax systems. The European Commission may have meant to refer to a 'destination-based cash flow tax'. The Association notes that if such a variant were to be considered, the technical overlap with VAT would have to be examined in more detail. However, as this variant is not specifically mentioned in the

questionnaire and any attempt to anticipate the European Commission's intentions in this respect would be purely speculative, it is not discussed in any further detail here.

Introducing 'unitary taxation'

The fourth option mentioned in the questionnaire is unitary taxation; in other words, the option to '*introduce a tax on a share of the world profit of digital companies which would be attributed to each country on the basis of the percentage of revenue earned in that country.'* The unitary tax model proposed in the questionnaire is analytically akin to the CCCTB, albeit with the following significant differences between the proposed model and the CCCTB draft directive in its current form:

(i) The unitary taxation model suggested would apply across the world, both for the purposes of establishing the tax base ('worldwide unitary combination') and for apportioning it ('global formulary apportionment'). Consequently, and in contrast to the CCCTB, it would not be limited to the territory of the EU (i.e., no 'water's edge limitation');

(ii) The unitary taxation model suggested would also attribute the tax base entirely to the demand side of income production instead of using the three-factor formula in the CCCTB draft directive as it currently stands ('global formulary apportionment' or 'global sales-only apportionment').

Whether it would be desirable to introduce such a model is a policy issue, with the micro-economic, macro-economic and budgetary implications all having an important role to play in the discussions. On this occasion, therefore, the Association has limited itself to the following comments of a general nature.

If the EU were to proceed to introduce a unitary taxation model as referred to here, it could lead, all other things being equal, to multinationals being liable for double taxation and also double non-taxation. Enterprises producing outside the EU and selling their products and services within the EU would face double taxation (i.e., taxation in the EU destination country *and* in the non-EU origin country), while enterprises producing within the EU and selling their products and services outside the EU would enjoy double non-taxation. All other things being equal and providing the technical aspects of the model are correctly designed, enterprises in the latter situation would then have an incentive to move investments to the EU. Other countries and regions, in turn, would have an incentive to oppose such measures politically or an incentive (possibly encouraged by the international business community) also to switch to sales-only apportionment. In that way, a politically successful introduction of such a model in the internal market could conceivably boost the European investment climate and economic growth, while also encouraging job creation. It is worth noting in this respect that, driven by their own economic interests, the US states using formulary systems are moving towards sales-only apportionment.

Introducing taxation in the residence state at the average rate of the countries where turnover is generated

The fifth and final option proposed in the questionnaire is the 'residence tax base with destination tax rate'. In other words, '*a system where profits of a company are declared and taxed in the Member State of establishment (as is the case today), but the applicable rate is the turnover-weighted average of the tax rates of the countries where the turnover is generated.'* This would mean taxes being levied in the residence state at the turnover-weighted average rate for the relevant jurisdictions, with enterprise profits being determined in the same way as at present and allocated on the basis of the transfer pricing model. The important difference, however, is that the tax rate – and, therefore, the tax burden – would not be determined by the relevant origin countries. Instead, it would be determined by looking at the effective tax rates applying in the jurisdictions in which the enterprise sells its products and services. The tax would therefore be an origin-based tax levied at a destination-based rate. It is not clear from the information provided, however, as to whether the rate set would take account only of European sales or of an enterprise's total worldwide sales.

The Association would not be in favour of a tax reform along these lines. In its view, such a reform would impose an unfair restriction on EU member states' autonomy, given that they would lose their

freedom to set their tax rates and so also their freedom to determine the share of profit taxes that they wish to include in their tax mix and budgets. This is because, under this model, the rate in the origin member state would be determined pro rata, taking account of the rates applying in all the jurisdictions where an enterprise generates turnover from its sales of products and services. Countries operating such a model would consequently no longer be able to reduce their tax rates as a means of attracting investments. Member states implementing such a model would then also lose their autonomy to use corporate tax as an instrument for achieving a competitive investment climate. Furthermore, only those countries applying this model would lose this instrument. The Association recognises that such a model could in itself provide a counterweight to the much-discussed 'race to the bottom'. Nevertheless this would be the case only if such a system were to be introduced on a worldwide basis. Insofar as this would not be the case, the EU member states signing up to such a system would *de facto* lose not only their autonomy, but at the same time would also limit their tax competitiveness compared with countries choosing not to adopt such a system. The ultimate effect of this could be to trigger an outbound flow of investments from the EU member states applying this model and directed towards the countries choosing not to apply it. That could act as a brake on investments in the internal market and, therefore, hold back economic growth and employment. The Association would regard this as undesirable.

The Association notes that, unlike the previous options discussed, this fifth and final option would not result in any actual shift of the tax base towards the destination jurisdictions. The tax base would continue to be fully attributed to the same tax jurisdictions as in the current transfer pricing model. In that respect, such an option would be very comparable to the existing international tax framework. As mentioned above, however, there would nevertheless be one significant difference: the setting of the applicable rate. Under the model suggested, this would be set at the turnover-weighted average, based on the proportions of sales in the market jurisdictions. In effect, therefore, two analyses would have to be performed. Firstly, an analysis in line with the existing tax framework so as to determine the origin-based apportionment of the tax base. Then, secondly, an analysis enabling the average rate for the destination jurisdictions to be determined. Not only would a two-step model such as this restrict member states' autonomy, but it would also create additional (primarily technical and administrative) complexity, compared to the current system. Given the restrictions that such a tax model would impose on autonomy and the increased complexity it would create, the Association is not in favour of introducing such a model in the internal market.

3 Closing comments; fundamental reform or no reform

It would not seem easy to achieve a short-term solution to the challenges that the ever-increasing digitalisation of the economy is posing to EU member states' profit tax systems. In a digitalising market environment it is extremely complicated, if not impossible, to identify a meaningful way of isolating the digital component of the economy – for tax purposes – from the rest of the economy. If tech and non-tech cannot be separated from each other, it would not then seem sensible to seek to achieve such a separation for tax purposes. It is strange, therefore, that this is precisely what the proposed short-term options seek to achieve. All the options specified require 'digital' taxpayers and/or their 'digital' services to be defined in a way that distinguishes them from their non-digital equivalents. The Association believes that this will irrevocably lead to delineation and concurrence problems and, therefore, to the risks of arbitrary taxation, manipulation, multiple taxation, market distortion, legal uncertainty and problems of an administrative nature, both for businesses and tax authorities alike.

Solutions for the problems that have been identified demand measures going beyond the existing international framework, as well as the ending of the status quo in aspects of the ways in which international profits are taxed. The EU has not yet been able to reach agreement on the need for this. Indeed, agreement has not even been reached on the true nature of the problems. Is the Commission seeking to combat tax avoidance, assuming the current international tax framework, in itself, to be 'correct'? Or do the concerns instead reflect a wish (apparent or otherwise) to reconsider this framework and to examine the possibility of radically reforming the tax system? In view of the possible solutions put forward, the Association has the impression that the actual issue on which the European Commission is seeking to consult is not so much the taxation of internet companies, but rather the

structuring of member states' company tax systems, along with the necessary preliminary question of how multinationals' profits should be apportioned among countries for tax purposes.

If the real political aim of the EU is to pursue fundamental reform of the tax system, the Association believes that this should be preceded by a frank and open discussion on how corporate income tax bases should be divided across tax jurisdictions. Looking at the possible solutions proposed for the longer term, not all these options would seem to be equally suitable for this purpose. Various alternatives have, however, been put forward in the international tax literature, including:

- Origin-based 'global (residual) profit-splitting systems', which are analytically related to the transfer pricing model, but without the problems involving separate accounting and comparability analysis;
- Origin- or destination-based unitary systems ('global formulary apportionment'), and even
- Destination-based cash flow taxation.

Consequently the real question (or preliminary question) that the Association believes should be examined is whether the EU wants *fundamental tax reform or no reform?*

Yours sincerely,
The Dutch Association of Tax Advisors

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