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Stockholm, 2018-04-23

**The European Commission proposals for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM (2018) 147 final and for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM (2018) 148 final**

The Confederation of Swedish Enterprise (CFE) has been given the opportunity to submit its opinion on the Directive proposals. The CFE concurs with what Näringslivets Skattedelegation has stated in the attached position paper.

THE CONFEDERATION OF SWEDISH ENTERPRISE



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**The European Commission proposals for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM (2018) 147 final and for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM (2018) 148 final**

## **Opinion**

Näringslivets skattedelegation (NSD) strongly believes that the tax challenges stemming from the digitalization of the economy is a global issue requiring a global solution.

For this reason, NSD is deeply concerned that the EU Commission jeopardizes the work of the OECD through the introduction of a unilateral regional solution. The interim Digital Services Tax (DST) proposed by the Commission does not tax corporate profits but their turnover. Consequently, also companies that are making losses will be taxed. NSD finds this unacceptable. In addition, the temporary DST runs the risk of becoming permanent, especially since there is no mechanism to ensure its withdrawal when an internationally accepted solution is at hand.

Furthermore, a digital PE definition in an EU Directive creates a parallel system to the OECD. In contrast to recommendations and guidelines stemming from the OECD, interpretations of EU Directives are governed by court decisions from the European Court of Justice (ECJ). Even if the OECD were to adopt the same PE definition as proposed by the Commission, something which seems highly unlikely, over time the two definitions will

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undoubtedly evolve and be interpreted differently, resulting in increased uncertainty, conflicting taxation claims and international double taxation. Since many of the companies having to pay the tax initially are from the US, the proposals increase the risk of aggravating trade and tax tensions across the Atlantic. Such a development would be very harmful to Sweden.

The Commission's proposals open the door to a completely new system for allocating international taxation rights across countries. In addition, it favors countries with big markets at the expense of smaller countries like Sweden.

NSD urges the Swedish government to oppose and reject the proposals by the Commission and instead continue to work closely and actively with the OECD to find a solution to the tax challenges posed by the digitalization of the economy, based on international consensus.

## **Background**

On March 21, 2018 the EU-Commission presented its legislative package for a common reform of the EU's corporate tax rules for digital activities. The package contains two Council Directives: i) a long-term proposal, establishing rules and provisions for a significant digital presence (a digital PE); ii) a short-term proposal, an interim turnover tax on the provision of certain types of digital services.

## **General comments**

### *Fundamental Change of the Corporate Tax System*

The BEPS project was initiated to tackle base eroding activities, not to alter existing international standards on the allocation of taxing rights on cross-border income. The BEPS agreement is now being implemented and to some extent, taxation rights will be reallocated from one country to another. The Commission proposal is not an anti-abuse legislation. It explicitly changes the allocation of tax revenues between countries.

By suggesting to base corporate taxation on the market where products and services are sold rather than on where production, strategic decisions and headquarters are located, the proposals by the Commission constitutes a fundamental change to the international corporate tax system.

### *Income Tax versus VAT*

NSD would like to emphasize the importance of distinguishing between income taxes and consumption taxes (VAT, GST, etc.). In the OECD framework and as a global standard, income tax is based on residence and source. Consumption taxes on the other hand aim at taxing consumption. Levied on the supply of goods and services, VAT/GST are self-declared taxes and businesses serve to collect these taxes for the government. Consequently, the place of consumption is not and should not be a factor when allocating income for income tax purposes. Instead, the place of consumption is relevant for consumption tax purposes such as VAT/GST.

### *The Relevance of Markets*

The traditional division of income based on factors such as functions or R&D, production and marketing, is clearly relevant also for the digital economy. Customers and markets are obviously necessary for any business, irrespective of whether a product is sold over the counter, by mail order through a catalogue or by digital means. A market is a condition of doing business but does not constitute functions, assets, risks or income by itself. Markets with many customers having disposable incomes may provide a business opportunity, but that is all it is: an opportunity. In order to turn those opportunities into income, companies must develop products that customers want to buy, find their customers, and deliver their products. Companies that cannot perform these functions will not earn any income. The income that companies do earn is attributable to the performance of those functions, not the mere existence of the market. If the only thing that happens in the market jurisdiction is customer activity, it is difficult to see how, under traditional notions of income taxation, any income (as opposed to other bases of taxation) can be attributable to the market jurisdiction. This is true both for the digital economy and for the conventional economy.

Thus, the fact that a company provides goods or services to customers in a country does not by itself constitute a right for a jurisdiction to levy income tax. If there is no need for a physical footprint, then the infrastructure of that country is not utilized and, consequently, that jurisdiction should not have a right to tax that income. The country where consumption takes place may, however, levy a consumption tax.

### *Value Creation*

The current corporate tax systems are based on assessing the corporate profit in the jurisdiction. Taxation should be based on where value is created. Since it is not possible to tell where in the value chain profit emerges, there is a need to find universal principles of how to assess where value is created and to what amount. 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.

For obvious reasons these rules need to be revised from time to time as business models evolve over time. The current rules have, through the BEPS project, very recently been revised and are now being implemented. They are expected to substantially reduce the possibility for aggressive tax planning and erosion of tax bases.<sup>1</sup>

### *Level of Taxation*

When assessing the level of taxation of the digital sector, NSD underlines the need to take into account the changes in the tax code going forward due to the ongoing implementation of BEPS rules, and, in particular the substantially increased level of taxation of US digital firms operating in the EU, due to changes in the US Tax Code.<sup>2</sup> Admittedly, these taxes are not paid in Europe but will nevertheless impact the willingness of companies to invest in Sweden and in Europe.

The Commission reports that under current tax rules companies with digital business models pay on average half the effective tax rate of companies with traditional business models.<sup>3</sup> However, the Commission also acknowledges that there are valid reasons why the former do not have the same effective tax rate. The reason why digital companies, to a certain extent, have a lower tax level simply reflects that modern tax policy recognizes the importance of R&D and digitalization for future growth and prosperity.<sup>4</sup> The Commission lists three factors explaining the difference in effective average tax rates.<sup>5</sup>

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<sup>1</sup> In the EU, corporate profit shifting and base erosion by companies have by the Commission been reported to amount to 50-70 bn euro, equivalent to 4 pro mille of GDP. SWD(2018) 81 final. Impact assessment, p 19.

<sup>2</sup> Tax Cuts and Jobs Act, Dec. 22, 2017.

<sup>3</sup> European Commission - Fact Sheet - Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market. Brussels, 21 March 2018. p 1.

<sup>4</sup> SWD(2018) 81 final. Impact assessment, p 18.

<sup>5</sup> SWD(2018) 81 final. Impact assessment, p 18, footnote 26.

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Firstly, expenses for the creation of software and other intangible goods, which play a much bigger role for digital businesses, are often deductible whereas physical assets used in traditional business models are depreciated over time. Secondly, business active in digital activities typically spend relatively more on research and development activities, for which many countries apply tax incentives. Finally, an important number of countries offer lower tax rates for earnings derived from intellectual property. All in all, one can therefore not conclude that a business sector is undertaxed even if the effective tax rate is below the average.

### *Fair Distribution of Taxes*

NSD underlines that any solution, short-term or long-term, to taxation of digital business models must not unduly undermine the possibility of smaller economies to meet their social objectives. These economies must also receive a fair share of the total tax revenues from businesses.

Extracted from the impact assessment,<sup>6</sup> below is a comparison of the geographical allocation of web visits (left-hand side) and profits (right-hand side) for five large web companies. The right-hand picture shows that a large part of the companies' profits currently is reported in Sweden and Ireland. However, and as shown in the left picture, Sweden and Ireland have relatively few users. If the taxing rights would shift from profits to user location, Sweden would lose a major part of this tax base. Instead, countries with larger markets, such as France and the UK, would benefit from the proposed shift in tax base.



<sup>6</sup> SWD(2018) 81 final. Impact assessment, p 41.

### *Shift of Taxation Rights to Larger Economies*

The consequence of the proposals would be that jurisdictions claiming the right to tax under current principles (based on function, assets and risks) will have to give up all or part of that right. These jurisdictions are likely to be small economies like the Nordic with substantial exports and small markets of their own. Should those countries choose not to give up the right to tax, double taxation would inevitably be the result. The negative revenue implications for a large number of countries, and for a country like Sweden in particular, could be substantial. In fact, many countries with small domestic markets could experience a considerable erosion of their national tax base as a consequence of actions taken by the larger economies such as the French, German and Italian.

If companies must pay taxes where sales are made, they are likely to also bring costs to that country. This process entails moving innovation, research, production and functions abroad. Such a process results in the loss of jobs with potentially severe tax revenue loss for a small country like Sweden.

### *EU Competitiveness*

In order to create a competitive internal market in the EU it is of utmost importance to reduce double taxation and to ensure that tax systems are also efficient, so that they can support a stronger and more competitive economy. The EU Commission has previously stated that this should be done by creating a more favorable tax environment for businesses that reduces compliance costs and administrative burdens, and ensure tax certainty. In particular, the importance of tax certainty in promoting investment and stimulating growth has also been recognized by G20 leaders and has become the new global focus in the taxation area.

The lack of cross-border profit and loss relief and the large number of transfer pricing and PE related disputes within the EU frequently result in international double taxation, thus constituting significant barriers to the Single Market. Introducing a non-creditable turnover tax on digital services further increases double taxation thus adding yet another barrier to the internal market.

It would be preferable if the deliberations in Council resulted in an outcome that does not risk hampering digitalization but instead enhanced the functioning of the Single Market.

### *Impact Assessment*

NSD would like to underline the need for a proper impact assessment. NSD finds the impact assessment too patchy and not comprehensive enough. The Commission has for instance not analyzed whether the interim measure is urgent or its impact on investments, start-ups, jobs and growth. Nor has the revenue impact for smaller and larger economies been analyzed or the effect stemming from the measures operating alongside with BEPS implementations in various countries and the US tax reform. The costs of introducing a unilateral definition of a digital PE, different from the OECD definition, is not analyzed either.

### *Impact on International Cooperation*

It is important that new principles of how to attribute and tax corporate profits to an EU-country, are developed in dialogue with trading partners, in order to avoid any escalation of trade and tax tensions between major economic players in the world. Consequently, NSD underlines the need for fair and consensus-based solutions.

## **The Digital Services Tax**

### *The Proposal in Short*

The proposal sets out a digital service tax levied on businesses at a rate of 3 % on gross revenues from certain digital services. The tax would apply to businesses that meet the threshold criteria of global revenues exceeding €750 million and taxable revenue according to the directive of over €50 million in the EU. The following services by an entity would qualify as taxable revenues:

- a) The placing on a digital interface of advertising targeted at users of that interface;
- b) The making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which

may also facilitate the provision of underlying supplies of goods or services directly between users

- c) The transmission of data collected about users and generated from users' activities on digital interfaces.

### *Departure from International Taxation Principles*

The step towards a taxation on turnover is in its essence a new element in taxation, which will have a direct negative effect on exporting countries. NSD is concerned that companies will face taxes which are not based on profit or value creation. The transition to base corporate taxation on the market where products and services are sold rather than where production are located also increases the risk of conflicting taxation claims.

In addition, this departure from accepted principles in international taxation sets a dangerous precedence. If the proposal “turns out well” for some (big) countries, similar initiatives will no doubt follow. Sweden, together with other small economies, should therefore work to stop this proposal from becoming reality.

### *Disadvantage of Small, Innovative Export Markets*

Sweden has so far been successful in producing start-ups. NSD is concerned that by taxing turnover, with the cascading effects explicitly recognized by the Commission, the development of digital services and in particular start-ups, would be harmed and the productivity enhancing effect from digitalization would be hampered. It may also lead to a shift in taxation rights to larger economies where sales and data gathering takes place.

In the impact assessment<sup>7</sup> the Commission highlights that younger companies often are loss making, and could be particularly hit by a tax on gross revenue. Several companies that will be taxable have become world leaders before they can show profit. This is not only an issue for small countries like Sweden, but for the whole development of the digital economy in Europe. A level playing field is required to ensure European competitiveness. NSD believes that the DST proposal constitutes a major obstacle to achieve this.

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<sup>7</sup> SWD(2018) 81 final. Impact assessment, p 66

### *Alleviation of International Double Taxation*

The proposal does not contain a provision to alleviate the double taxation that will follow from the introduction of the DST. The Commission communicates that “it is expected” that Member States will permit businesses to deduct the DST as a cost, in their own territory, regardless if taxes are paid in the same Member State or in different ones. Whether or not the DST will be deducted from the corporate income tax is consequently to be decided by each Member State. It should further be noted that a deduction would not eliminate double taxation. It would only mitigate it.

### *Consequences of an Interim Solution*

The digital services tax is supposed to be an interim solution, which is explained as a stop-gap solution until the more comprehensive proposal is in place.

Considering the lack of international consensus on how to tax the digital economy and given the fact that there is no mechanism to ensure the termination of the temporary measure once an internationally accepted solution is in place, there is a real risk that the DST instead becomes a permanent solution. In contrast to domestic legislation, a Directive is extremely difficult to change since it requires unanimity. After having enjoyed increased tax revenues due to the DST, large countries may not be so keen to abolish the Directive.

NSD would also like to question the logic in having both the interim solution and the comprehensive solution implemented on the same date. This clearly raises questions about the intentions of the DST proposal.

### *Additional Comments*

As far as NSD sees it, the Commission fails to achieve at least the following two general objectives of the proposal;

1. *To make sure that the public finances within the European Union are sustainable and that the national tax base are not eroded.*

The expected outcome of the proposal is in direct contradiction to the mentioned aim since many national tax bases will be eroded to benefit countries with big markets.

*2. To ensure the social fairness is preserved and that there is a level playing field for all businesses operating in the union.* Yet again only the big countries will benefit from the proposal. The level playing field that is mentioned in the aim, will not be achieved for all businesses operating in the EU. Small countries with a trade surplus will not be able to compete with countries having large markets.

Traditionally, special taxes such as excise duties, have been used and considered to prevent unwanted or harmful behavior. The structure of the DST is in a way an excise duty on digital services. The Commission has a digital agenda and has declared that the digital Single Market is one of the main political priorities.<sup>8</sup> Against this background it is difficult to understand why then the Commission penalize digital companies by proposing a tax on the productivity increasing factor in digitalization.

The short-term impact of the interim tax amounting to 5 billion euro is probably limited. It represents 0.03 per cent of EU GDP and it is around 1 per cent of corporate tax revenues. It therefore has limited impact on fiscal sustainability in the couple of years it is expected to be in place. However, the principal change by taxing turnover and not profit, and by levying the tax in the country where the market is (i.e. large economies) is of paramount importance as a principle. It represents a shift in taxation from smaller economies in general, and exporting economies in particular, to the benefit of larger economies with many consumers. The long term negative impact of such a shift is far more harmful than the short-term revenue.

## **Significant Digital Presence (Digital PE)**

### *The Proposal in Short*

In essence, the proposal lays down rules extending the concept of a permanent establishment, so as to include a significant digital presence through which a business is wholly or partly carried on. The proposal suggests that a permanent establishment shall be deemed to exist if a

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<sup>8</sup> COM(2015) 192 final.

business in a tax period supplies digital services and the business fulfils any one of the following three criteria:

- a) the revenues obtained from the supply of those digital services to users located in a Member State exceeds €7 million;
- b) the number of users of one or more of those digital services who are located in that Member State exceeds 100 000; or
- c) the number of business contracts for the supply of any such digital service by users located in that Member State exceeds 3 000.

The profits attributable to or in respect of the significant digital presence are those that the digital presence would have earned if it had been a separate and independent enterprise performing the same or similar activities under the same or similar conditions. In order to determine the attributable profits, the profit split method shall be used unless the taxpayer proves that an alternative method based on international accepted principles is more appropriate.

#### *EU Lacks OECD's Field of Expertise*

The OECD is continuously updating its Model Tax Convention (MTC). Over the years, Article 5 and its Commentary on PE:s has been revised on numerous occasions.

The OECD method of developing the PE definition is a dynamic procedure where the changes in principle have found global acceptance. By deviating from this procedure, the complexity of the system would multiply. Firstly, considering the lack of consensus on how to tax the digital economy it seems highly unlikely that the OECD would accept the definition as proposed by the Commission. The result would be two different PE definitions existing in parallel, one in the EU and one in the rest of the world. Such a system would be almost impossible to apply for the taxpayers and the potential problems leading to increased uncertainty are obvious. Furthermore, even in the unlikely event that the OECD would adopt the same definition in its expected final report on the digital economy in 2020, it would not be long before the two systems would part ways and result in two different definitions. The reason for this is that the PE definition enacted by the EU through a Directive would develop through judgements from the ECJ. The definition applied in the rest of the world, laid down by the OECD, would instead develop through international consensus expressed by the OECD through its dynamic working procedure.

The tax challenges stemming from the digitalization of the economy is a global issue that requires an internationally accepted solution. Consequently, any discussion on the introduction of digital PE should be handled by the OECD. A rushed unilateral regional solution for the EU is clearly not the right way forward. NSD urges the Swedish government to oppose and reject this proposal and to work closely with the OECD to find a solution based on international consensus.

### *International Double Taxation*

Questions concerning transfer pricing and PE related issues constitute a large number of double taxation cases every year. As a consequence of the BEPS project, the OECD PE definition has been widened. The lower PE threshold that now is being implemented in tax treaties around the world are expected to result in a flood of new PE:s and an increasing number of double taxation cases.

Should the Commission's proposal of an EU definition become reality another layer of complexity would be added and the number of double taxation cases relating to PE:s increase exponentially.

### *Consequences of a Permanent Establishment*

Needless to say, being deemed to have a permanent establishment in a foreign country results in several obligations for the company. Therefore, such an expansion is normally foregone by careful analysis in the company of various factors affecting the preferred way of conducting the business, e.g. the consumer base and local regulations. It is a fundamental principle that companies must be able to control in which jurisdiction they are active or deemed to be active. The proposal however does not give the company control over in which jurisdiction it is deemed to be operating. It is sufficient that the number of users of one or more of those digital services exceeds 100 000. The company can't control the number of clicks or users. Considering the fact that geo-blocking is being prohibited in the EU, this may actually result in a PE being established without the companies' participation, since it will be outside the companies' control where their services are available. It can also be questioned whether all security aspects have been sufficiently analyzed. Considering the number of reports on hacker attacks it

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cannot be ruled out that someone, in order to sabotage for a company, by a DDoS attack (or similar) can create a permanent establishment for the company.

NSD does not share the Commission's view that the proposed levels of the digital activity thresholds effectively would exclude small enterprises from the scope. On the contrary, many small companies (e.g. in the gaming industry) usually exceed 100 000 users even though the profits are very small. For Sweden, which has a prominent position in this market and similar sectors, the proposal could hamper the development of small and medium sized business.

If the threshold is increased, it may on the other hand make it even harder for a small country to be considered to have a PE within its territory and therefore to collect taxes. The criterion should therefore never be considered as an appropriate indication of presence.

### *Additional Comments*

The proposal raises several questions regarding its details. Taking the huge impact of the proposed legislation into consideration, it is evident that such ambiguities are troublesome. For example, in article 4.5 b) how will the situation where the user is resident for corporate tax purposes in a third country but has a permanent establishment in more than one Member State be handled? Questions can also be raised whether there are any differences between the services in 4.3 since the phrasing differs.

Furthermore, NSD anticipate problems regarding the calculation of each Member State's share of the revenues. Apart from the question whether it really is more suitable to base the proportion on the number of time the device has been used rather than time or attributable income, it is plausible that disputes will arise on the interpretation of Article 4.3 a) in conjunction with Article 4.7.

### **Concluding Remarks**

Taxes must not be used as barriers to trade and investment to the detriment of the welfare of citizens. The digital economy is an area where a thorough in-depth policy debate on the merits of direct/indirect tax solutions is needed.

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Making market size the basis for income taxation would have significant revenue implications for a large number of countries, in particular for small countries with a limited domestic market

Market jurisdictions argument for sales as a basis of taxation seems to be that the value attributable to a digital transaction is based solely on a large market, i.e. a large number of consumers. Consequently, the tax base should be considered as derived from that market jurisdiction and taxed therein. The argument that taxation can be based on the location of sales and irrespective of any substance (presence of assets, functions and employees) is in sharp contrast to the BEPS approach, requiring and calling for more substance in order for companies to allocate income to low tax jurisdictions. Although markets are essential to businesses, they provide by themselves nothing more than a business opportunity to be explored. They do not constitute a basis for taxation. However, sales and consumption are justifiably important sources of revenue for countries relying on consumption taxes like the VAT, GST or other consumption based taxes.

For smaller open economies like Sweden and the other Nordic countries, attributing sales an increased importance when assessing where taxation should be exercised, would result in substantial revenue losses from the corporate income tax. It would deprive governments in such jurisdictions with tools, within the framework of the corporate tax system, to keep parent companies and central functions within the country. In the long run it could result in the reallocation of production and activity which would further diminish tax revenues for small open economies.

NSD finds it highly questionable that the Commission jeopardizes the work of the OECD through the introduction of a unilateral regional solution. In addition, temporary measures such as the DST run the risk of becoming permanent, especially without a “sunset clause” ensuring its termination. Terminating the DST Directive will require a unanimous decision by the Council, something which of course cannot be guaranteed. Furthermore, a digital PE definition in an EU Directive will, as opposed to a definition in the OECD Model Treaty, be interpreted and defined by court decisions by the ECJ. In time this will lead to divergent digital PE definitions between the EU and the rest of the world.

The Commission’s proposals open the door to a completely new system for allocating international taxation rights across countries. In addition, it does not only favor countries with big markets at the expense of smaller countries

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like the Nordic, it also increases the risk of conflicting taxation claims and double taxation.

The tax challenges stemming from the digitalization of the economy is a global issue requiring global solutions. Considering the complexity of the topic, such work cannot be rushed. Any proposal in this area must also take into consideration the interests of small open economies like the Nordic. This work should be left to the OECD to handle and the EU must naturally await the outcome of the OECD 2020 final report.

The Commission has not shown that urgent measures are needed or that digital service companies do not pay taxes according to its location and value creation. The effect of ongoing BEPS implementation or the new US tax rules, with considerably more efficient US CFC legislation, are not analyzed at all. The impact on trade and development is not analyzed. The consequences for smaller economies are more or less ignored. This is not acceptable.

Consequently, NSD urges the Swedish government to protect Swedish national interest and oppose and reject the proposals by the Commission.

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Johan Fall



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