Late March 2018 saw the European Commission (EC) issue two new proposals that could potentially change the way digitalized business activity is taxed. Their technical composition aside, the proposals—which could deliver two new EU Directives—immediately raised questions from businesses who wanted to know the likelihood of the proposals passing into law, the timeline on which that may occur and whether or not the technical contours of the proposals are likely to change between now and becoming law.

The legislative processes of the European Union (EU) are unknown to the vast majority of people, and they pose many questions: Does every EU Member State need to agree with the proposals for them to pass into law? Which groups or bodies can influence the final composition of a Directive? Can Member States opt to enact parts but not all of a proposal? In this roundtable discussion, EU tax and law professionals Dr. Klaus von Brocke and Steve Bill walk readers through some of the key steps that these proposals will now be passing through. While not an exhaustive guide to EU governance and processes, it provides a short, effective briefing for tax professionals.
Basis of EU law

Steve Bill: Starting at square one, EU taxation is, and will remain for the foreseeable future, very much a national sovereignty. National and local governments levy all taxes within the EU and retain all receipts. Other than the sole exception of customs duties, the European budget is financed by direct levies on Member States.

Since the EU itself doesn’t levy taxes, why does it get involved in taxation matters at all? The answer to that is quite simple: the EU has an “internal market” that requires some harmonization of Member States’ tax laws to function properly. In particular, and since 1993 when the internal market was set up, there has been a very high level of harmonization of indirect taxes, particularly VAT and excise duties. This is the complete opposite to the US, where indirect local sales taxes are very much non-harmonized.

Harmonization has occurred because the EU constitution (the Treaty) has an article that enables the Commission to make proposals specifically for indirect taxes. The Commission must justify that these proposals improve the functioning of the internal market or help competition within the internal market. This typically falls into two categories. First, there are instruments that are designed to make tax law less onerous for businesses carrying on intracommunity trade. Second, there are instruments for exchanging information and mutual assistance that make it easier for tax administrations to cooperate and to assist each other.

Rob Thomas: Klaus, can you help us understand those articles in the Treaty for the Functioning of the European Union (the EU Treaty) on which the proposals for the taxation of digital activities are based?

Klaus von Brocke: First, Article 113 gives the European Union competence to harmonize indirect taxation. For its part, Article 115 is normally used as the basis for direct tax measures designed to reinforce the functioning of the EU internal market, which is intended to be an area without any barriers to the free flow of goods, capital, services, and persons (for both individuals as well as companies).

From the point of the European Commission, the problem with Article 115 is that it has very strict conditions that must be fulfilled. It is important to note the principle of subsidiarity, which means that the Commission can only make proposals on a specific matter if it can justify that the matter cannot be dealt with in a better and more efficient way at the level of the individual Member States. In other words, the Commission has to demonstrate that a specific problem can only be alleviated if all 28 Member States harmonize their law in a specific area.
The incumbent presidency has the power to set the agenda for the Council’s work and to drive discussion on the specific proposals that it particularly wishes to see adopted. The current President of the Council is Austria, while the last President (from January to July 2018) was Bulgaria, under whose guidance the issue of taxation in the digital economy was made a top priority. Romania will hold the next presidency, beginning 1 December 2018.

Rob Thomas: Let’s move on and talk about the cast of players, if I can call it that, in the EU theater. We have a number of different players that play different roles in the legislative process.

Klaus von Brocke: At the top of the whole institution is the European Council, where all the heads of state and governments meet and deal with pressing current issues. It is a political, rather than a legislative body. More important for day-to-day legislative work are the next three institutions: the Commission, the Council of Ministers, and to a lesser degree, the European Parliament. The European Commission has a hybrid role. On the one hand, it is the “guardian” of the EU Treaty and has responsibility for surveilling the manner in which the Member States implement EU law. On the other hand, it has the sole right to initiate legislative proposals, which it formulates and then presents to the Council of Ministers and the Parliament.

For its part, the Council of Ministers, where all the 28 Member States are represented, has the sole legislative right in taxation matters. So, the Commission proposes, but the Member States in the forum of the Council of Ministers actually decide. Moreover, in the field of taxation, there is a requirement for unanimity — i.e., all 28 Member States have to agree before a proposal can be adopted as law. Lastly, the European Parliament has a purely advisory role in respect of taxation proposals made under Articles 113 and 115. If the Parliament disagrees or proposes amendments, neither the Commission nor the Council is required to take on board its comments.

Finally, there is the EU Presidency. The Treaty lays down a system of rotation whereby each Member State assumes, for a period of six months, the responsibility of chairing and leading the work of the Council of Ministers.

The detailed discussion of proposals put forward by the Commission is carried out in the relevant Council Working Group, in this case, the working party on tax questions (WPTQ), which is comprised of officials from all Member States. When proposals are ripe for conclusion, or when particular issues arise that require political guidance, they are referred to as ECOFIN, which normally meets once a month to discuss an agenda drawn up by the Presidency. COREPER, which is the standing committee of the Permanent Representatives of the Member States, prepares these monthly meetings.

Also of importance in the tax area is the Code of Conduct on Business Taxation group. This is a standing committee of Member State officials that has been set up by the Council outside the normal legislative framework. It appoints its own chairman and thus does not have the rotating Presidency of normal Council groups. It was initially established as a peer review group designed to eliminate “harmful” tax practices.

Rob Thomas: Klaus, regarding the Code of Conduct group, we almost see that as working in parallel with the OECD’s group that looks at harmful tax practices under BEPS Action 5. Is that EU Code of Conduct group also looking at some of the US tax reform proposals that some Member States do not necessarily like?
Klaus von Brocke: The agenda for the Code of Conduct group, until 2020, is focused on three areas. The first is a further round of examination of peer reviews of potentially harmful tax practices. The second issue is the role of monitoring the EU’s “black” and “grey” lists of non-cooperative jurisdictions. The third issue involves monitoring the newly-enacted mechanism to avoid double taxation.

Rob Thomas: Steve, what does the actual legislative process tend to look like—and I use the word tend, because it does not always play out as expected? Who are the really important players in terms of taking an idea through to actual national implementation in the EU?

There is no time limit to the discussions and the Council is not obliged to adopt a Commission proposal. Given that there has to be unanimity in tax matters, it is not unusual therefore for discussions to carry on inconclusively for several months or years and for the Council to finally stop its discussions. At that point, the Commission may withdraw its proposal and go back to the drawing board.

There are basically two types of proposals; one type is designed to harmonize the tax rules in the EU Member States, (in order to make trading easier within the EU), and the other is designed to improve cooperation between Member States. The first proposals are the difficult ones, because Member States may not be very keen to agree to something that means that they have to change their tax laws. On the other hand, when the Commission comes forward with proposals to improve cooperation between Member States, not unsurprisingly, the Member States perk up their ears and seem to be much more keen and ready to agree.

Where does the Parliament fit into all of this? The Parliament merely gives an opinion. The Council cannot adopt a proposal if it does not have an opinion from the Parliament, but it does not have to take any account of that opinion—and often does not.

There is an escape clause from unanimity, but it is very rarely used, and has only been tried once in the tax area and in fact, has only been used a couple of times in all. This is the so-called “enhanced cooperation” mechanism. This is a procedure that can be enacted if the Council fails to secure the necessary level of agreement but a group of nine or more Member States indicate that they still want to do something in the relevant area. The Commission may withdraw its initial proposal and come forward with a new proposal that would only be applicable within those Member States who want to be bound by the new rules. It will only really be used when the discussions have halted, but there has been significant agreement between a significant number of Member States on the type of rules that they would like to see introduced.

Steve Bill: The process normally starts within the Commission’s Directorate General for Taxation and the Customs Union (known as “DG Taxud”). The Commission identifies areas where it considers that legislation is necessary in order to improve the functioning of the internal market and/or to reduce the distortion on competition.

In order to establish the necessity for a proposal, the Commission normally carries out an impact assessment, which includes a public consultation. If there is justification, the Commission comes forward with a proposal which is then sent to the Council of Ministers and the Parliament.

At this stage, the Member States’ ministers make an initial review of the proposal at one of their monthly ECOFIN meetings, then send it down to the WPTQ, which is where the real work gets done. Here the representatives meet regularly and discuss the details of the proposal. In those discussions, guided by the Presidency, the Council is free to make whatever amendments it wants to what the Commission has proposed. The Commission participates in the discussion, but cannot prevent the Council from amending its proposal. The only sanction that the Commission has, and this very rarely happens, is to withdraw its proposal.

Rob Thomas: Let’s talk about all this in relation to the digital proposals. We have two proposals, one short term and one long term. The first is a 3% gross revenues tax and the second is a significant digital presence – or in other words, a change to both nexus and profit attribution rules.
Rob Thomas: Klaus, do you have a picture of who is for and against at this point in time and what impact might that actually have as the Council meetings move forward?

Klaus von Brocke: You have, of course, the obvious ones, mainly the smaller countries who are strongly against this kind of proposal, such as Ireland, Netherlands, Luxembourg, but you also have a very prominent Nordic country, Finland, which hosts quite a lot of multinationals, that is also fiercely against this proposal.

On the other side, you have five big Member States, in France, Germany, Italy, Spain and the UK, who, alongside Estonia, originally initiated this action. We understand that Germany in particular was initially strongly in favor of the digital services tax and not just as an interim solution. But politics changes rapidly, and we’ve seen Germany in particular soften its stance quite considerably lately.

Rob Thomas: Steve, the existing VAT Directive that says Member States may not move forward independently with other turnover taxes. On this basis, are Member States precluded from moving forward with a gross revenues tax independently if they feel that the timeline of the Commission, because of all this internal debate, is too long?

Steve Bill: Member States were looking at what was going on in the OECD and they weren’t happy that the OECD was saying, in effect, that special digital rules are not necessary since the current general rules are sufficient. What these Member States fear is that they are not getting their fair slice of the tax cake and therefore want some form of indirect tax, at least in the short term. So, at the end of 2017, they asked the Commission to come forward with an appropriate proposal. But the Commission already had its own ideas on what was necessary, which is set out in the second proposal, and which could easily be embodied in the already-proposed Common Consolidated Corporate Tax Base.
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