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"INTERNATIONAL TAXATION ASPECTS THAT AFFECT MANAGEMENT OF THE TAX ADMINISTRATIONS"

Topic 1

"DOUBLE TAXATION, INTERNATIONAL TAX EVASION AND TREATIES FOR THE AVOIDANCE OF DOUBLE TAXATION"

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Double taxation, international tax evasion and Double Taxation Conventions (DTCs)

The evolution of the economy, particularly marked by the increasing internationalization of business and the strengthening of the strategic importance of intangible assets (patents, trademarks, etc.), has increased opportunities for tax planning for businesses.

For tax administrations the issue is to fight against this tax evasion, paying attention not to create double taxation, which is unfavourable to the development of international trade, but also with the aim of eradicating cases of double non-taxation.

In response, during the summit held on 18 and 19 June 2012 in Los Cabos, the Heads of States and Governments of the G20 countries, at the initiative of France and the United States, requested the Organization for Economic Cooperation and Development (OECD) to propose an action plan against the erosion of bases in terms of corporate tax and transfer of profits (Base Erosion and Profit Shifting - BEPS). OECD presented a document about this issue to the Finance Ministers in Moscow on 14 and 15 February. It will present in June 2013 a roadmap on possible options.

These works, organized by the OECD, are made in three groups.

The first group examines more particularly the topics relating to anti-abuse measures, the packages based on differences of qualification between states (hybrid), the abuse of conventions, the deductibility of payments and the preferential regimes. The second group carries out reflections on the rules of territoriality and more precisely on the notion of permanent establishment, withholding, the concept of residence, the tax regimes of the controlled foreign corporations. Finally, the third group focuses its work on transfer pricing.

I. Areas of work for the Focus Group # 1 on anti-abuse measures

In order to limit the erosion of the bases, the first working group focuses on the strengthening of the measures that, in tax treaties and national laws, help to fight against abusive schemes and to prevent the tax-free transfer of the profits towards States where they will be submitted to little or no tax.

It also deals with the regimes designed and implemented for aggressive tax competition.

France is involved on this issue within the OECD through its chairmanship of the Forum on harmful tax practices.

In the frame of the BEPS project, France wants to promote the strengthening of the actions undertaken, in particular by extending this approach to third countries, which seems to be winning a consensus within the working group.

The first consideration concerns the harmful tax. The challenge is to move beyond a purely legal analysis of preferential arrangements, to take an interest in their

economic effects and their use, especially by proposing broader criteria (vehicles for tax minimization, regimes that foster transactions for tax purposes).

France stands up for an approach that better takes into account the real economic effects of the tax measures to assess their own damaging features, by overcoming their legal characteristics.

The second axis of work focuses on the analysis and the search for joint solutions against strategies based on asymmetries of qualifications between different national laws and treaty provisions.

These asymmetries render possible the formation of hybrid structures (equity loans, transparent companies, permanent establishments, etc.). designed to lead to situations of either double non-taxation or double deduction.

The third issue is to review the national legislations on abuse, in order to recommend their strengthening. On this point, the solutions seem to lie in a commitment of the States to improve their systems. In addition, the Member States of the European Union will increasingly fall within the limits of the jurisprudence of the Court of Justice of the European Union.

Finally, the BEPS approach can and must be accompanied by action at EU level.

Indeed, the current functioning of the European internal market amplifies, by promoting the elimination of double taxation and economic freedoms, the optimization strategies identified in the BEPS diagnostic, while depriving the Member States of the margins to counter this phenomenon individually.

This has enabled in particular the emergence within the EU of "tunnel States" used to enable the tax free output of profits to tax havens by taking advantage of the European law, the various laws and the provisions of some particularly favourable tax treaties (phenomenon known as treaty shopping, including in the Netherlands).

Therefore, the challenge is to go beyond the simple coordination to achieve a legislative package:

- a draft directive specific to the digital sector, separate from the debate on the Directive on the common consolidated corporate tax base, and proposing the creation of a virtual European permanent establishment, in order to spread the benefits of this sector between the Member States in which these firms operate, will they be physically present or not;
- the strengthening of the existing Directive 2003/43 EC, relating to payments of interest and royalties in order to condition the exemption from withholding tax at a minimum effective taxation in the Member State of the recipient;
- the definition by the legislator of a European anti-abuse clause that goes beyond what the ECJ currently allows the Member States to do in their national laws;
- a legislative initiative to solve the problems of hybridisation when they can not be solved through coordination;

- the definition of a rule ensuring effective taxation of profits going out of the EU and allowing the source States to regain their right to taxation when a profit, thanks to the derived and conventional laws, circulates free of tax within the EU internal market and exits without actually being taxed;
- the adoption of a safeguard clause to limit the effects of the free movement of capital, currently granted to third States without compensation.

II. The work of the Focus Group # 2 on territoriality

Work on the rules of territoriality of corporate income tax includes a reflection on the concept of permanent establishment, which allows taxing the activity of a company in a state where it does not have its headquarters.

Currently, the characterisation of the existence of a permanent establishment relies on the presence of material, technical and human means and resources and the ability of these means and resources to commit an enterprise from a State towards its customers on the territory of another State. However, activities are now developing, particularly lucrative, which can be performed through modern means of communication without having human and material resources on a specific territory.

The evolution of the rules only proves necessary in the case of volatile activities, hardly attributable to a territory.

This is the case with digital companies' activities. Thinking on the rules provided by tax treaties to allocate the right to tax some of these non-physical operations, and the separation of these from traditional notions of residence and permanent establishment, now appears necessary.
However, companies like some states do not want to face flat rate approaches, disconnected from well established tax concepts.

As regards withholding taxes, the OECD model recommends an exemption to limit cases of double taxation. Thus, the vast majority of tax treaties concluded by France provides either an exemption or a limitation in the rate of applicable withholding tax to 5% or more rarely 10%.

France supports a case-by-case approach of the level of withholding taxation with respect to non-EU States depending on the local taxation level and strives to change the rules designed to fight against double exemption situations in the EU.

Finally, France can not but endorse proposals of reflections on the evolution of some concepts (such as residence) to restrict in some instances access to benefits provided by the treaties, including treaty based reductions or exemptions on withholding tax (front companies without economic substance, symbolic flat rate taxation ...). They fully meet our concerns already included in many of our tax treaties.

III. Issues of transfer pricing under the Focus Group 3

The growing internationalisation of business and groups restructuring, as well as the rise of the strategic significance of intangible assets (patents, trademarks, etc.) have multiplied the opportunities for corporate tax optimisation.

Transfer pricing is a stake and an allocation tool for the tax base between states. In order to ensure avoidance of double taxation for companies, domestic laws adopted by states are now governed by the OECD standard based on arm's length principle.

The first discussion addresses the relevance of the arm's length principle itself.

The alternative options to this principle consist in establishing a flat rate method for profit allocation between states. This method either depends on a unilateral determination by each State of the level of profits it considers should be attributed to it or on the application of an allocation key based upon objective criteria (assets localised in each state, domestic turnover, amount of wages therein paid ...) to a group worldwide profits.

However, the first alternative would likely result in double taxations, going backwards from development of international trade targets.

For its part, setting allocation keys would result in a project of an unprecedented magnitude, both materially and technically. In addition, objective criteria may, more than the arm's length principle, be likely not to match the reality of the profit made on a territory: a group can operate in an area while locating most of its payroll and intangible assets in low tax burden states. The criterion of turnover can also promote certain markets.

However, it is clear that in some situations the implementation of arm's length principle based on the sales comparison approach comprises such practical obstacles that it hinders the control and the fight against tax evasion. It should then be looked for specific solutions to address these special difficulties.

The second discussion relates to intangible assets. As a matter of principle, France is committed to the completion of work on the intangible assets, but in compliance with the arm's length principle.

OECD’s Secretariat, in the preparatory documents, suggests a broadening of the definition and an evolution of the treatment of income derived from intangible assets under transfer pricing (sharing of economic ownership within the group).

France supports a limited evolution of standard which should be technically robust, so as to avoid any unilateral arbitrary statist approach. Recognition of the existence of an intangible asset may be based on a legal analysis of the concept of assets likely to benefit from some form of legal protection (intellectual property law, commercial or competition law). The income derived from them should be taxed in the state of legal ownership, unless abusive situation.

Issues related to the taxation of the digital economy

France is currently thinking about the taxation of digital economy. In this purpose the Minister of Economy and Finance, Pierre Moscovici, commissioned a report in July 2012 to Pierre Collin, State Councillor, and Nicolas Colin, Inspector of Finance. This report provides a detailed picture of the rise of the digital economy and calls for new tax regulations, in particular for budgetary reasons.

The digital revolution calls entirely into question our understanding of value creation. The digital economy is indeed based on traditional production of goods and services activities. But increasingly, seeding start-up companies or global firms dealing with hundreds of millions of users overturn the rules of the game and radically alter every sector of the economy.

Even though the digital economy now affects billions of people its added value slips out of our hands. How it is organized, its powerful network effects and the extent of externalities caused by its business models circumvent the rules of added value. The number of terminals and connected objects increases exponentially, the time spent using them is experiencing sustained growth, entertainment, purchasing and production, are now held in a digital economy that penetrates everyone's daily routine.

Yet a significant part of the created value is collected by companies benefiting from preferential tax regimes. Large firms in the digital economy pay almost no taxes anymore.

1 - The digital economy presents characteristics and obeys logic radically different from mature activities

Firstly the digital economy is accelerating the pace of innovation and dissemination of new goods and services. Thus, such an application as Facebook has gained 1 billion users in less than eight years.

The digital economy channels massive investments financed by venture capital firms which select businesses that successfully generate returns offsetting the failures of others.

The digital economy often leads to the acquisition of a dominant position covering various related markets.

The digital economy is built on a model of reinvestment of most profits, rather than distributing dividends, shareholders are obtaining their remuneration by potential capital gains.

The digital economy is perpetually evolving so that it is difficult to identify areas of stability to establish a tax.

The digital economy constantly disconnects the place of establishment from the place of consumption. It is increasingly difficult to spot the created value and to apply to it the rules of tax law henceforth inadequate.

2 - Large firms in the digital economy make profits by exploiting data from regular and systematic monitoring of user activity

Data, including personal data, are the key resource of the digital economy. They allow companies that collect them to measure and improve the performance of an

application, to customize the service, to recommend purchases to customers, to support innovative efforts giving rise to other applications, to make strategic decisions. They can also be valued by licensing them to third parties.
In short, it is the lever that enables large digital companies to achieve greater scales and a high degree of profitability.

Yet data collection is based on the free labor provided by users. Through regular and systematic monitoring of their online activity, applications' user data can be collected without any compensation. This lack of compensation partly explains the striking productivity gains in this economy. Is it normal that companies established in a territory do not contribute to the tax revenue of the state where their customers live and contributed to generate profits?

Attracted by the quality of the interfaces and the network effects, users become, through this data, output auxiliaries and create value generating profits on the different sides of the digital economy's business models. Yet the activity of applications' users is enabled and tenfold by public expenditures especially in education, social protection and deployment of networks throughout the territory of a State.

3 - Digital technology gradually devours every sector of the economy

The intermediation model that predominates the digital economy guts the tax base. Thus, online advertising allows redirecting the consumer to a provider established in another State. Transactions between individuals get growing.

In addition, digital sector companies exert downward pressure on prices. The margin of companies established in a territory declines as the position of the digital intermediate is becoming inevitable and it is essential for a supplier to be indexed.

In tourism, banking, telecommunications, automotive, health, digital economy's companies are currently inserting themselves into the value chains. They focus their efforts on a strategic link, make their users work and capture a growing share of the margin of local enterprises.

As the digital technology spreads throughout the economy, the margins of the various sectors will relocate abroad and disappear from the GDP of some countries depriving public authorities of the tax revenue needed, particularly in times of crisis or to contribute in funding development.

4 - A common feature of global firms of the digital economy is the low level of taxation of their profits

Even if they are not alone in practicing tax optimisation, firms in the digital economy have more opportunities to benefit from the competition states are engaged in.

Instruments which the multinationals rely on to reduce their effective tax rate are well known.

- The reclassification of certain activities in the value chain to reduce profit and to ensure the absence of permanent establishment: the transformation of a distribution subsidiary into a mere commission agent reduces its turnover to its sole margin and minimizes the business risk associated with its activity.

- The strategic location in some states in order to enjoy tax benefits from legislations or conventions. National schemes may allow a more favourable taxation for holding companies, intellectual property rights or research and development activities. Legal asymmetries in terms of deductibility of loan interest make it possible to reach situations of double non-taxation of some profits. Finally, some states called "tunnel states" do not practice withholding tax on profits transferred to tax havens.
- Centralisation of intangible assets in the country where the income tax is the most advantageous. In the functional analysis of a multinational group, ownership of intangible assets is the main characteristic of entrepreneurial functions. So-called routine functions are compensated by a steady and minimal profit while entrepreneurial functions capture the residual profit, albeit volatile but potentially higher.
- Optimisation of transfer pricing practiced among the different entities of a group is all the easier that practicing some small variations on a multitude of transactions groups can significantly reduce their overall tax rate.

So it is easy for digital companies to transfer their profits in tax havens by paying intangible assets the value of which is tenfold by the returns to scale.

Since these profits do not result in a dividend payment, they can be retained and reinvested without being subject to tax.

These companies focus the activity from which they earn their income on territories where it is easier to transfer profits to tax havens. The "double Irish arrangement" and the "Dutch Sandwich" and its variants are apparently implemented by most of these companies.

The increasing dominance of intermediaries business models allows companies described as prime contractors to capture a growing share of the margin at the expense of other actors in the chain of value creation.

Newly established, digital companies immediately were organized to get the most of differences between States tax systems, including choosing the one where they set their headquarters, localize their assets or their employees.

5 - The national and international tax law is struggling to adapt to the effects of the digital revolution

In principle, the bilateral model tax treaty established by the OECD to prevent double taxation situations, assigns the authority to impose the profits to the State in which the company has its headquarters.

There is an exception to this rule in the presence of a permanent establishment on the territory of another State. However, the concept of permanent establishment refers to that of fixed place of business or dependent agent which involve both the tangible presence of buildings or people. It is proving inadequate to the digital economy.

Although since 2003, it is recognized that a server, where a software application is hosted and through which it is available, may constitute a fixed place of business. But the OECD considers the data and computer code do not constitute a permanent establishment due to their intangible nature.

In Europe, the debate on a Common Consolidated Corporate Tax to eliminate tax competition does not advance and does not take into account the specificities of the digital economy. Within the OECD, thinking has just begun.

At the national level, the first attempts to create a specific tax for the digital economy have missed their target.

6 - States should be able to tax the profits that are made on their territory by digital economy companies.

The need to find the power to tax corporate profits of the digital sector companies must be satisfied with strategies that operate on several grounds.

In the short term, tax audits can enable to:

- highlight permanent establishments thanks to the analysis of the reality of the activity in a localised area, either by demonstrating that the subsidiary is a fixed place of business from which the operations of the foreign company are made, or by demonstrating that it is actually a dependent agent with authority to engage the liability of the foreign company to carry out its operations.

In this regard, the comments on section 5-5 of OECD model convention indicate that the agent has actual authority to conclude contracts when soliciting and receiving orders without formally finalizing them and when the foreign company does nothing but approve foreign transactions routinely.

- In case of treaty shopping, it is possible to apply a withholding tax if the beneficial owner of the royalties is located in a State to which it is applicable.

In the longer term the conventional way can be used, either bilaterally or through a multilateral convention whose provisions would replace the bilateral agreements.

The income tax seems the most appropriate tool to search for a contribution in proportion to the value creation in a localized area.

This requires a concept of territoriality adapted to the digital economy.

But a reflection on the rules of territoriality is probably not sufficient, it is also important to think about the determination of transfer prices based on various factors of production that contribute to the value creation in the digital economy.

In conclusion, the digital economy is far from being the most difficult to control by tax authorities, it is abundantly commented and digital workflows are measurable. What remains to be done is to bring out valuation rules accepted by all.