European Parliament - FISC Subcommittee
Public Hearing on

« Potential Distortions of the Single Market due to Personal Income Tax: challenges for SMEs and risks of harmful tax competition »

MONDAY, 9 JANUARY 2023

Cross-Border Teleworkers and Single Market Potential Distortions

1. Introduction

The technological revolution - especially the digitalization - has made remote working much easier. The pandemic crisis has accelerated the process of transforming the labour market. Such changes have important economic and social implications: for example, those with a strong impact on the real estate market and even on interpersonal relationships.

The taxation - especially cross-border taxation - has to deal with this transformed labour market and the new challenges connected to it. First of all, it should be noted that the rules of international taxation which nowadays govern cross-border economic relations - including those within the borders of the European Union - were drawn up in the 1920s by the League of Nations. These rules build the legal nexus (from which the tax obligation derives) on concepts such as "physical presence", "registered residence" and "territorial sovereignty" which match very well to the *analogical world* of the last century, but encounter great difficulty in adapting to *digital world*. A new world where remote working has become the norm, algorithms determine business choices, blockchain technology makes our online transactions sure and social relationships take place in the metaverse.

2. Initiatives adopted individually by Member States and risks of fragmentation for the internal market

As mentioned, transformed labour market has not yet been followed by a corresponding adjustment of the rules of international taxation. A long physical stay of an individual in the Member State is normally the main connecting factor of his tax jurisdiction. A nexus that allows the State to exercise on the individual its full fiscal sovereignty, taxing him (often progressively) on his total worldwide income.

Many countries - including some Member States ([1]) – have been inspired by the success of these tax measures in attracting high-net worth individuals into their tax jurisdiction, therefore many have substantially relaunched the same model to entice the so-called “digital nomads” to move their domicile into a territory, adding interesting tax incentives - including multi-year exemptions from income taxes - to usual forces of attraction, such as the mild climate or high standard of living.

Ideally, a joint action is needed to avoid the harmful effects of a fragmented internal market. Since this transformed labour market does not only affect the European Union, but the entire world, a global response would be even more desirable. At the moment, the implementation of this kind of joint response is meeting enormous difficulties to be implemented, due to the presence of opposing economic interests and the inadequacy of the legal instruments at the disposal of the main players on the international scene (United Nations, OECD, G-20, EU, ...).

At European level, if the tax system of the Member States of the European Union were fully harmonized (or, at least, could count on a strong coordination between the tax systems of its Member States), the movements of workers within the internal market would not create excessive tax problems. Any cross-border situations would be resolved through fair formulary apportionment or distribution of income. However, the process of European integration is a solid reality in many legal and economic areas (it has even created a broad monetary union) but, for many reasons, fiscal harmonisation, in particular that of individuals’ taxation, still remains a substantially unexplored area.

3. Potential solutions

The process of adopting common legislative measures on tax matters at the European level often fences insurmountable obstacles from both a political and legal point of view in obtaining the indispensable unanimous agreement of the Member States. A legislative proposal, in addition to respecting the principles of subsidiarity and proportionality proper to the EU unitary intervention, must adequately take into consideration the economic consequences it entails for the citizens of the Union and for the Treasury of the Member States if there is any hope it will be successful. Therefore, it would be more appropriate to work on the existing legal framework and formulate proposals which ensure a proper functioning of the Internal Market, whilst respecting the fiscal sovereignty of the Member States.

[1] Special tax measures have been adopted, for example, in Greece and Croatia.

Furthermore, the chosen solution must be easy to apply and it should take account, for example, the fact that, within the European Union, the free movement of citizens and of workers - one of the fundamental freedoms of the internal market - has been removed of physical borders within the European Union, making it difficult to trace the movements of cross-border workers.

Therefore, among the various operational proposals formulated by the doctrine and by various supranational institutions, two were taken into consideration, both based essentially on double tax conventions.

Option 1.

Amendments to the notion of "tax residence" in domestic legislation and of "tax treaty residence" in bilateral conventions

In practice, the European Commission, proposing a directive, should require the Member States (or at least those that do not already provide for it) to adapt their tax legislation by including the "centre of main economic activity" among the list of connecting factors (nexus) which allow Member States to tax an individual on his total worldwide income. It should also be specified that the abovementioned expression - in the case of work carried out remotely by electronic means - indicates the place where the economic source of the telework is located and not the (totally volatile) place from which this work can be carried out.

After that, the Member States should change ([2]) the order of priorities in the article of their bilateral conventions aimed at eliminating cases of dual residence (generally it is the article 4 of the tax conventions - the so-called "tie-breaker rules"), giving precedence to the State in which the main economic source of the worker is located, rather than to the State in which the individual resides (which, for a remote worker is often of a temporary nature). In this way, the taxation of teleworkers and other *digital nomads* would be identical to that of ordinary workers.

Option 2.

The inclusion in the bilateral conventions of a new provision that takes into account the specificity of cross-border teleworking.

In this option, it would be appropriate for the Member States to introduce - through a directive - a uniform definition of the concept of "remote work" into their respective tax systems. Alternatively, this definition could be included in the

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[2] Perhaps through a multilateral agreement, which could be a binding instrument of international law, open to the interested Member States of the Union (such as the so-called "arbitration agreement" on transfer pricing - 90/436/EEC).

article (generally, the article 3) on common definitions of bilateral conventions between Member States.

The category of remote workers could be added in the already existing one of seafarers (OECD Model, art.15, para. 3), taxed in the place of their permanent residence, regardless of where they exercise their activity. Furthermore, thresholds could be set for the presence of the worker in the country of the economic source of income (generally, the Member State in which the employer is located), which would allow a shared taxation with that State. Obviously, this would lead to greater complexity of the system due to the difficulties in verifying the physical presence and keeping track of the mobility of workers within the Union.

The two proposals described briefly above favor, respectively, the taxation of income only by the source State (option 1) or by the residence State (option 2). The choice between the two solutions is, eminently, a political decision.

Both proposals present some critical points ([3]), in particular as regards a balanced apportionment of tax sovereignty. However, if we want to ensure a simple and, at the same time, effective application of the proposals for employees and employers, the choice of the taxation by only one contracting State seems preferable. If these proposals should cause a significant shift in tax revenue among Member States, a solution can be found through budgetary compensations between States, which, in some cases, has been already applied on a bilateral level ([4]).

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[3] For example option 1 could be circumvented by changing the nature of the employment relationship (from subordinate work to self-employed); and in the option 2, in certain cases, the employer could be considered having a permanent establishment in the State from which his employee is teleworking.

[4] For example, this is what currently occurs regulating cross-border work between Switzerland and Italy (a new agreement on frontier workers - with different rules - is expected to entry into force this year).