9. Taxing Digitalized Business Models

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Introduction

Under the current Tax Treaty Policy framework[1], business profits are primarily taxable in the State of residence of the enterprise. However, the source (market) jurisdictions can tax the profits if a permanent establishment (PE) is triggered therein. A PE arises when the non-resident operates in the market State through a physical presence such as a fixed place of business or through dependant agents. Thus, when a traditional business operates through a tangible presence in the market State, a PE is constituted unless the activities fall under the list of exceptions.

On the other hand, highly digitalized businesses may operate in the market State through online or digital means and derive substantial revenues from that State. For example, the following digitalized businesses may operate and commercialize in the market State without any physical presence, primarily, due to their heavy reliance on intangibles:

- Businesses that provide an online marketplace for the sale of goods and services;
- Businesses providing online services such as online advertising;
- Businesses selling digitalized products and content through an online platform; and
- Businesses providing online solutions such as cloud computing solutions.

Accordingly, the question arises as to how can market States tax highly digitalized businesses, as the current rules are not equipped to tax such businesses. This fact is also illustrated by the recent Google case in France wherein the Court held that the marketing activities of the local subsidiary did not trigger a PE for the non-resident under the Ireland-France Tax Treaty[2].

The BEPS Action 1 Final Report (October 2015)[3] had left the issue at stake unanswered. Although the OECD put forward certain options to tax such businesses, it did not recommend any option for adoption by States. More recently, the OECD and EU revisited the issue at stake (March 2018). The OECD delivered its Interim Report[4] and laid out its sense of direction for the final report that will be issued in 2020. Likewise, the European Commission put forward two proposals viz., a European Directive on a Digital Services Tax (EU DST)[5] and a European Directive on Significant Digital Presence[6] (EU SDP). Currently, policy makers are discussing two possibilities to solve the issue at stake. The first option, an interim measure, involves the introduction of turnover taxes. The second option, a longer-term measure, involves rethinking nexus and profit allocation rules.

Short Term Measure: Turnover Taxes

In the BEPS Action 1 Final Report, the OECD discusses the possibility that market States could introduce unilateral equalization levies on the turnover derived by non-resident digitalized businesses. Although the option was not endorsed, India (2016) introduced a 6% equalization levy for business-to-business online advertisement and Italy (2017) introduced a 3% web tax on certain digital transactions. In its interim report, the OECD puts forward the position that "there is no consensus on the merits of, or need for" turnover taxes and therefore does not recommend them for adoption by States. Nevertheless, for States that wish to levy such taxes, the OECD discusses the design framework for such taxes. On the other hand, the EU Commission put forward a proposal for a 3% EU DST.

The OECDs design framework and the EU proposal have several similarities. For instance, with respect to the duration, it is stated that such taxes should be temporary until a comprehensive solution is in place. With respect to the scope of the tax, it is stated that the measure should be targeted and be applicable to digitalized businesses which are highly dependant on user participation. For example, the tax would apply to businesses engaged in online advertising and businesses that provide an online marketplace for sale of goods or services. Lastly, in order to ensure that start-ups or small businesses are not subject to such taxes, the OECD and EU have recommended certain thresholds. To illustrate, the tax applies only to businesses that have a global turnover in excess of Euro 750 Million and a local turnover that exceeds a certain monetary threshold. Within the EU, the latter threshold has been set at Euro 50 Million.

Such taxes, in our opinion, if adopted unilaterally, could raise several issues. First, it could be argued that such taxes fall under the scope of Article 2 of tax treaties and hence, tax treaties cover such taxes. If so, the business profit provision of the respective treaty would then prohibit their application. On the contrary, if they fall outside the scope of tax treaties, the taxpayer may not claim a credit for such taxes against its corporate tax liability. At most, the taxpayer can only deduct theses taxes from its taxable basis. Second, such taxes could raise compatibility issues with international trade obligations, in particular, the provisions on national treatment and most favoured nation clauses found under the General Agreement on Trade and Services. Third, such rules could be incompatible with the Constitutional Law provisions of certain States. Lastly, if such taxes are applied only to non-residents within the EU, such rules could conflict with EU primary law, in particular the fundamental freedoms. Also, if they apply to a selected group of taxpayers, potential frictions with EU State Aid rules could arise. This being said, if such taxes are introduced through a EU wide Directive (such as the EU DST proposal) then EU Law issues may be mitigated, especially, when the taxes would apply to residents as well as non-residents

Long Term Measure: Rethinking Nexus and Profit Allocation Rules

Another potential option to solve the issue at stake pertains to rethinking nexus and profit allocation rules. The current debate revolves around whether such new rules should be targeted only for digitalized businesses or for traditional as well as digitalized businesses? As this option requires rethinking the PE definition and profit attribution rules, it is essential that we summarize the impact of BEPS Action 7.

Action 7 of the BEPS plan[7)] recommended changes to the PE definition. In this regard, it should be noted that not all signatories of the Multilateral Convention[8)] adopted the revised definitions, mainly, due to the fact that they were not minimum standards. The changes to the preparatory and auxiliary activities provision will apply only to 277 tax treaties and the changes to the agency PE definition will apply to only 206 tax treaties. Moreover, even for states that adopted the amendments, the issue of profit attribution persists. For example, online advertisers (or any other business) that operate through related sales/marketing intermediaries in the market jurisdiction will trigger a dependant agent PE (DAPE) therein. Even if this is the case, it could be argued that once the related intermediary is compensated on an arm's length basis, there should not be further profit attribution to the DAPE. The analysis rests on the premise that the market jurisdiction follows the authorized OECD approach (AOA)[9)] and considers that the concept of 'significant people functions' relevant to risk assumption for the purposes of Article 7 of the OECD Model[10)] is similar to the concept of 'control over risk' relevant to risk allocation for the purpose of Article 9 of the OECD Model. On the other hand, if the concept of significant people functions includes day-to-day risk mitigation functions, it could be argued that the risks associated with these functions should be allocated to the PE even though they are controlled at the level of the head office, and consequently, the PE would be entitled to additional income. Thus, the tax outcome would depend on how one interprets the concept of significant people functions[11)]. Therefore, tax uncertainty exists for businesses and the main lesson that can be drawn from BEPS Action 7 is that the current allocation of profit framework, i.e. the AOA, is unsettled.

In relation to taxing digitalized businesses, in the BEPS Action 1 Final Report (2015), the OECD also discusses the possibility that States may introduce a significant economic presence (SEP) test. This test proposes to create a new nexus based on either revenue, digital or user related factors, or a combination thereof. Similarly, according to the EU Commissions proposal in the EU SDP, a Digital PE arises in a Member State when the digital services provided through a digital interface exceeds either (i) a revenue threshold of 7 Million Euro or ii) the number of users availing the digital services exceed 100,000 users or; iii) the number of business contracts for digital services concluded by users in a Member State exceeds 3,000 contracts. Both OECD and the EU recognize that the profit allocation rules will need to be modified in order to attribute profits to the digital nexus. The OECD discusses the possibility of modifying the AOA framework; using formulary approaches or deploying deemed profit methods. On the other hand, the EU Commission proposes to modify the current AOA framework. According to the EU Commission: functions, assets and risks that relate to data or users in the market State shall be attributed to the digital PE even if all these activities are performed at the level of the head office. Moreover, the profit attribution principles should take into account the development, enhancement, maintenance, protection and exploitation of intangible assets. Furthermore, it is stated that taxpayers should use the profit split method to allocate profits to such a digital presence unless and until the application of another method is put forward. It is indicated that further guidance on the application of such rules will be developed in the due course of time.

The rules proposed by the EU Commission are based on amending the AOA. However, as discussed in the context of the impact of BEPS Action 7, the AOA is itself unsettled and unclear. Therefore, building new rules on an unstable foundation will surely cause tax uncertainty for businesses and open the doors for tax disputes. Moreover, such rules clearly ring-fence digitalized businesses. Consequently, we are of the opinion that the new nexus and profit attribution rules should apply to 'all enterprises' in a neutral, efficient, simple & certain, fair & equal and flexible manner[12)]. Accordingly, unless and until such new rules are developed for all enterprises, simpler targeted bilateral solutions should be considered to tax highly digitalized businesses.

Conclusion: A Simpler Solution for Taxing Digitalized Businesses

A simpler solution would involve the introduction of a new distributive rule in tax treaties that would deal with fees for specified digital services or activities. The distributive rule could be developed on the basis of the distributive rules currently found in article 10 (dividends) or article 11 (interest) of the OECD Model (2017) or article 12 (royalties) of the UN Model (2011) or the proposed article 12A of the forthcoming updated UN Model. Although this rule could be regarded as ring fencing digital businesses, it is easier to implement in comparison to the digital PE.

1) OECD, Model Tax Convention on Income and on Capital: Condensed Version 2017 (OECD, 2017).
2) See Google Ireland Limited v. Administration générale des finances publiques (Case 1505113/1-1) (12 Jul. 2017).
3) OECD, Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2015).
4) OECD, Tax Challenges Arising from Digitalization – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2018), p. 3.
5) European Commission, Proposal for a Council Directive on the Common System of a Digital Services Tax on revenues resulting from the provision of certain digital services, (21 Mar. 2018).
6) European Commission, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence (21 Mar. 2018).
7) OECD, Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015).
8) OECD, Multilateral Convention to Implement tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (OECD, 2017).
9) OECD, 2010 Report on the Attribution of Profits to Permanent Establishments (OECD 22 July 2010).
10) OECD, Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administrations 2017 (OECD 2017).
11) OECD, BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments (OECD 22 March 2018), Para. 40.
12) OECD, Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions, OECD (2001), p. 11.

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