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Tax challenges arising from the digital economy

BY NEDELINA GORTER AND PATRICK SCHRIEVERS

The first and most important principle in the international tax system is said to be the physical presence rule. Technically, physical presence can be made possible through a subsidiary or a permanent establishment. The second fundamental principle is the arm's length principle. In short, the arm's length principle means that corporate profits of an internationally operating group are allocated to the country in which the company carries out activities, uses assets and assumes risks. For this, each entity or permanent establishment of the international group is considered independent. Transfer prices which are to be applied between the various parts of the company for goods sold and services provided are then determined on the basis of margins that independent third parties would agree with each other in comparable circumstances. In today's business world, these two fundamental principles of international taxation seem to have lost their value. Today's new 'digital' business models have a number of features that often make it possible for consumers to be offered goods and services across borders and through digital networks. While the same goods and services provided in a more traditional way would normally be subject to taxes, these 'digital' activities often remain untaxed in the country where the service is provided.

An abnormal tax burden in the digital economy

The characteristics of these new digital business models are difficult to reconcile with the principles of the current international tax system. For internationally operating companies that offer goods and services digitally, a physical presence in a country is no longer necessary in order to be able to acquire a significant market position in that country. The success of such companies depends on, for example, data or user participation. Value is often created by intangible assets that are allocated at a centralised location. Under the current legislation of most countries, if a company is not physically present in a certain country through a subsidiary or a permanent establishment, the corporate profits gained in that country cannot be taxed. On the contrary, the underlying idea of the digital economy is that value creation does not take place only where companies are physically present. In the digital economy, value creation also takes place where companies collect data from customers and users. Hence, the aim of addressing the tax challenges of the digitalisation of the economy is, among others, to shift taxation rights of profits from countries where companies develop their

products and services, to countries where they sell them.

The three OECD proposals

On 13 February 2019, the Organisation for Economic Co-operation and Development (OECD) launched an extensive online consultation document – 'Addressing the tax challenges of the digitalisation of the economy' – in which the OECD presents some suggestions to the public for possible solutions for taxation in the digitalised economy. According to the OECD, new profit allocation rules should be introduced with regard to the distribution of taxing rights between jurisdictions that take into account the characteristics of the quickly digitalising economy. The OECD suggests three proposals that can be applied to various digital business models. These are proposals to take into account user participation, marketing intangibles and significant economic presence (SEP).

The user participation proposal is aimed at new digital business models, in particular social media, search engines and online marketplaces. The proposal recognises that user activities on these platforms create value for the enterprise in the users' country of residence. The essence of the user participation proposal is to grant taxing rights to the users' country of residence, regardless of whether the company is physically present there.

The second OECD proposal is based on the concept of marketing intangibles. Like the user participation proposal, this proposal also aims to change profit allocation rules, but it is not exclusively focused on digital business models. It has a wider reach and offers a solution for companies that have limited to no physical presence in a certain jurisdiction but still develop marketing intangibles there. One can think of online retailers and companies that have strong brand rights.

With regard to SEP, corporate profits are assumed to be earned in a certain jurisdiction if a non-resident company has a significant economic presence in the jurisdiction concerned. A significant economic presence requirement demands a deliberate and sustainable interaction in the jurisdiction through digital technology and other automated means. In this regard, one or more of the following factors may be considered relevant: (i) the existence of a user file and the associated data entry; (ii) the amount of digital content derived from the jurisdiction; (iii) payments in local currency; (iv) maintaining a website in a local language; (v) responsibility for the eventual delivery of goods to customers or the provision of other supporting services, such as customer service and maintenance; or (vi) the presence of marketing and sales promotion activities, online or otherwise, to attract customers. These are very similar to the criteria set out by the European Commission (EC) in its proposal for a directive on a significant digital presence, published on 21 March 2018.

The significant digital presence proposal of the EC

In this proposal, the EC extends the currently applicable concept of 'permanent establishment' to situations where there is a significant digital presence, and thus introduces new principles for profit allocation. With this proposal, just like the OECD, the EC is pursuing the same objectives of the principles of legitimacy and justice, and the main idea behind the base erosion and profit shifting (BEPS) project that taxes should be levied where the economic activity takes place and value is created. The new element in the proposal put forward by the EC recommends the extension of the category of activities that are considered to be economically significant activities resulting from a digital presence in the relevant jurisdiction. Activities to be considered in each case, according to the EC, are: the collection, storage, processing, analysis, deployment and sale of data at user level; the collection, storage, processing and display of user-generated content; the sale of online advertising space; and making third-party content available on a digital marketplace.

Final remarks

The main objective of the possible solutions that the OECD and EC have proposed for taxation in the digitalised economy is to eliminate the differences in tax systems that potentially lead to abnormal tax burdens and tax avoidance, and to better align taxable profits with underlying economic activities and value creation. Despite the fact that the OECD and the EC are committed to continuing to work toward a solution with the goal of producing a final report in 2020, so far they have not succeeded in moving the international community into a consensus. The result is that countries take unilateral measures with regard to the profit allocation rules in order to create an even playing field between the taxation in the digitalised sectors of the economy and other not-yet-digitalised economic sectors. In recent years, legislative changes have already been introduced in Israel and India that deal with the concept of a digital presence. One of the most recent developments on the subject is the US Supreme Court ruling in *South Dakota v. Wayfair.* In this ruling the Supreme Court seems to adopt the proposal set forth by the EC regarding significant digital presence. This is an important decision which will affect US, as well as non-US, businesses. ■

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