

ADAPTATION OF TAX PRINCIPLES TO NEW ECONOMIC MODELS

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In March, the OECD published a document of more than two hundred pages in which it set out the tax challenges generated by the digital economy. In addition, and practically simultaneously, the European Commission announced two legislative proposals to “reform” the taxation of digital businesses in the EU.

The actions of the OECD and the EU are linked and share the same aim: to develop the principles underlying the taxation of international businesses to allow the profits earned from the digital economy to be taxed where they arise. Existing principles, starting from the notion that profits are earned in the country in which a business is physically present, are out of step with the new business structures and business models of the digital economy.

One of the pillars of the international tax framework, which gives a country the power to tax the profits arising from an economic activity, is the concept of the permanent establishment as profit-generating entity

Up to now, a permanent establishment has been defined in double taxation treaties which follow the OECD model treaty on the basis of various criteria linked to a physical presence in a country, such as a place of management, offices, a factory or a place of extraction of natural resources.

A definition of a centre of profit generation from an economic activity based on physical location does not seem to fit well enough with the business models of the “new” digital economy, characterised as they are by the remote provision of services, the exploitation of intangible assets, data transfer, downloads of music or books and the use of digital platforms allowing direct interaction between individuals who want to exchange goods or services, because all these activities can be carried out in a country in a physically delocalised fashion.

On the other hand, as the OECD's report reminds us, digital economic activity also has its own unique characteristics, such as high fixed costs linked to investment in IT infrastructure, low variable costs and even marginal costs which are sometimes virtually nil - all of which encourages and requires the global search for new customer-users for a business to be viable and which can be carried out without the need for a physical presence in a particular place. It is also characteristic of the digital economy that different goods and services are highly complementary, leading the consumer to acquire two or more goods or services at the same time, which in turn makes it difficult to attribute to those goods and services their true individual value.

The value chain is also different in the digital economy, and often the main driver of value in the value chain is in something intangible, whether it be a brand, an application or even user-generated data, which is definitely not a good or produced by the transformation of a good.

The “virtual presence” of the main driver of value, which is something intangible, makes it mobile and allows it to be located in one jurisdiction as much as another, so that it does not have to be physically linked to the place in which the profits that it generates truly arise.

All this leads to the need either to widen the existing definitions or to make new ones in order to be able to tax the profits of these digital companies in the places in which those profits actually arise.

To that end, the European Union is the first to have made two specific legislative proposals to tax the profits of the digital economy where they actually arise: one interim, but to be implemented immediately, which consists in the imposition of a new tax of 3% on the gross revenue created from certain digital services provided by businesses with an annual turnover of more than €750 million; and the other, root-and-branch reform proposal, which would see the reform of the rules for the taxation of corporate profits, based on the redefinition of the notion of permanent establishment and the reform of the rules for the attribution of

profits.

The new basis for tax connection to a country would be a “significant digital presence”, which does not use criteria of physical presence to tax profits but rather would be defined according to the income obtained through the provision of digital services (more than €7 million), number of on-line users (more than 100,000) or number of commercial digital services contracts (more than 3,000) in a given Member State of the EU. Once it has reached those thresholds, a digital business would be considered to be located in that Member State, which would then be entitled to tax the profits obtained within its borders, as determined by the attribution principles.

It is, therefore, a first step towards the payment by digital businesses of fair levels of taxation in the countries in which their profits truly arise, also taking into account their specific value creation models.

Of course, as the Commission itself has recognised, given the practical difficulties in its implementation, the proposal cannot be seen as a short-term solution - hence the proposal for the new interim indirect tax of 3% on revenue from certain digital services.