Taxable Presence in the Context of Digital Business Models

Inaugural lecture - 2 April 2019

Agenda

1. Setting the scene
2. The PE concept in a nutshell
3. Assessment of digital business models
4. Findings

SETTING THE SCENE

Defining the Digital Economy

From "the digital economy" to the "digitalization of the economy"

Characteristics of digital business models and digital enterprises

- Significant investments and the need for scalability
- Cross-jurisdictional scale-without-mass (heavily involved in economic life without physical presence)
- Reliance on intangibles (software and algorithms)
- Reliance on data, user participation and network effects (i.e. decisions by users may have a direct impact on the benefit received by other users)
- No consensus on the contribution to value creation

Tax Challenges

Overall challenge

- Digitalization impacts all parts of the economy
- The rise of the internet tests many traditional tax principles
- Tax legislation continue to focus primarily on the physical world and have yet to address many of the challenges posed by this new world

Concrete topics to consider

- Data (valuation, nexus, profit allocation and qualification)
- Qualification of income related to digital business models
- Does the digitalization increase the risk of BEPS?
- Impact on automation and AI on the workforce
- Real time tax compliance through big data and analytics
- Impact of online platforms on the changing taxable status of economics actors – standard labor contracts to self employed
- Sufficiency and application of current tax rules with respect to nexus?

Tax Challenges

The OECD, the EU MSs and a number of other countries agree that there is a problem!

- Well, is there? And if so: is there a burning platform......?
- Aim of this lecture:
- Present and analyze the currently applicable notion of a permanent establishment in the context of digital business models.
- To conclude whether there are major shortcommings in the current legislation.
- Contribution to the ongoing debate which in my view jump to conclusions before thorough analysis is carried out.
- No ambition to contribute to the debate on the policy design of a new nexus principle or allocation challenges arising from digital business models.

THE PE CONCEPT IN A NUTSHELL

The PE Concept in a nutshell

- International business income is taxable in the country of residence unless the enterprise has a permanent establishment (PE) in the market state (OECD model article 7 and 5).

- Main rule PE:
  - A fixed place of business through which the business of an enterprise is wholly or partly carried on.

- Exemptions:
  - the use of facilities solely for the purpose of storage, display or delivery of goods;
  - the maintenance of a stock of goods;
  - the overall activity of the fixed place of business, is of a preparatory or auxiliary character.
  - Provided that such activity is of preparatory or auxiliary character.

- Agent PE:
  - Where a person is acting on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification.

The PE Concept in a nutshell

- A PE cannot exist in the absence of some degree of physical presence.

- E-commerce in the OECD Model commentary:
  - A website (data and software) does not in itself constitute tangible property - not a "place of business".
  - The server = a piece of equipment having a physical location which may constitute a "place of business".
  - Case-by-case assessment should be made to determine whether business of an enterprise is at the disposal and wholly or partly carried on though the equipment.
  - Many functions are auxiliary and preparatory (ensure communication lines, advertising, collection of data).
  - Hosting of a website by an Internet Service Provider (ISP) does not result in the server and its location being at the disposal of the enterprise doing business through the website.
  - An ISP is generally not an agent of the enterprise carrying on business through the web sites that are being hosted by the ISP.
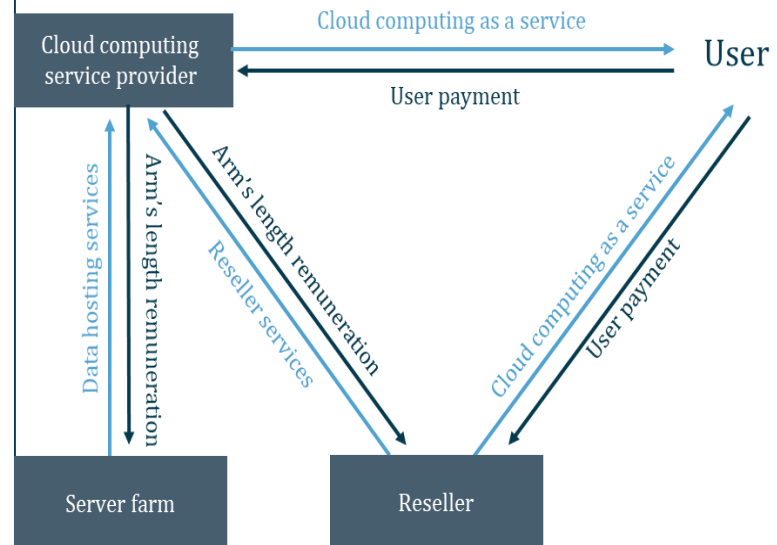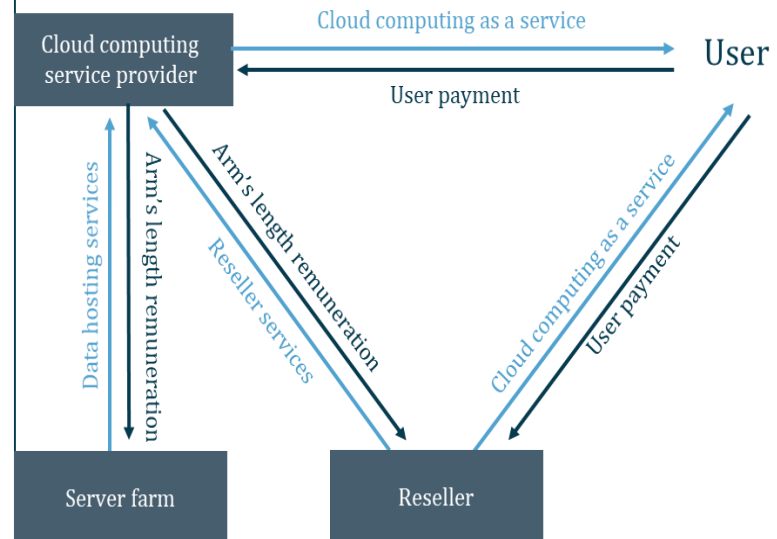
ASSESSMENT OF DIGITAL BUSINESS MODELS

Cloud computing

- A cloud computing business provides a broad set of on-demand standardized and highly automated computing services to customers (IaaS, PaaS, SaaS).

- Customers can access the most recent technology as cloud devices are updated remotely.

- B2C market: cloud services are typically provided on a subscription basis or as a freemium model, generating revenue through advertising, sale of user data or sale of expanded services requiring payment.

- B2B market: cloud services are typically sold by subscription or pay-as-you-go.

Cloud computing service provider — Cloud computing as a service → User

User payment ←

Data hosting services / Arm's length remuneration — Server farm

Arm's length remuneration / Reseller services — Reseller

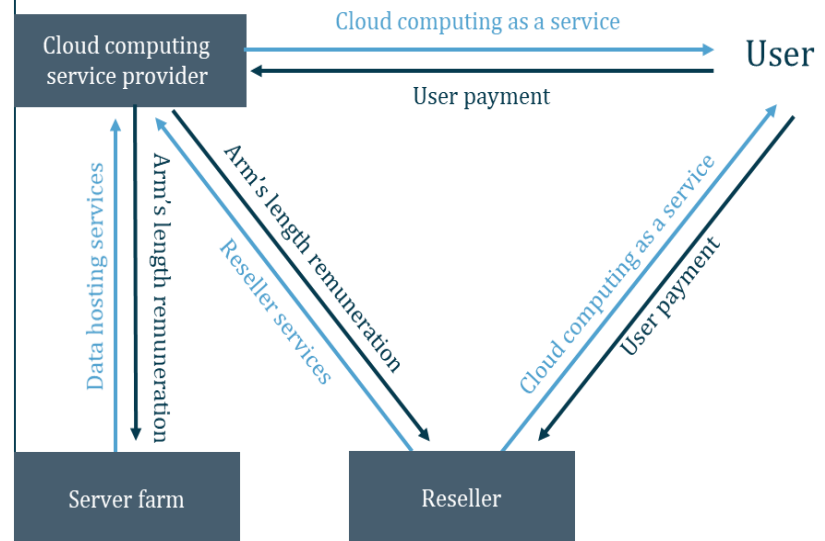Cloud computing as a service / User payment — Reseller → User

Cloud computing

- Do datacenters create a PE for CSP?
  - Servers may constitute a PE if fixed for a certain time.
  - Even if servers can function without any employees involved if the servers and computer equipment carry out essential business functions.
- What if owned by a subsidiary?
  - Local subsidiary of a digital MNE sets up a datacenter and allows the foreign parent company to use the datacenter for storage against arm's length remuneration.
  - The servers and the equipment will be used by the local subsidiary for the purpose of hosting web pages for the foreign parent entity.
- Case law
  - Denmark: SKM 2016.188 SR: No PE in Denmark
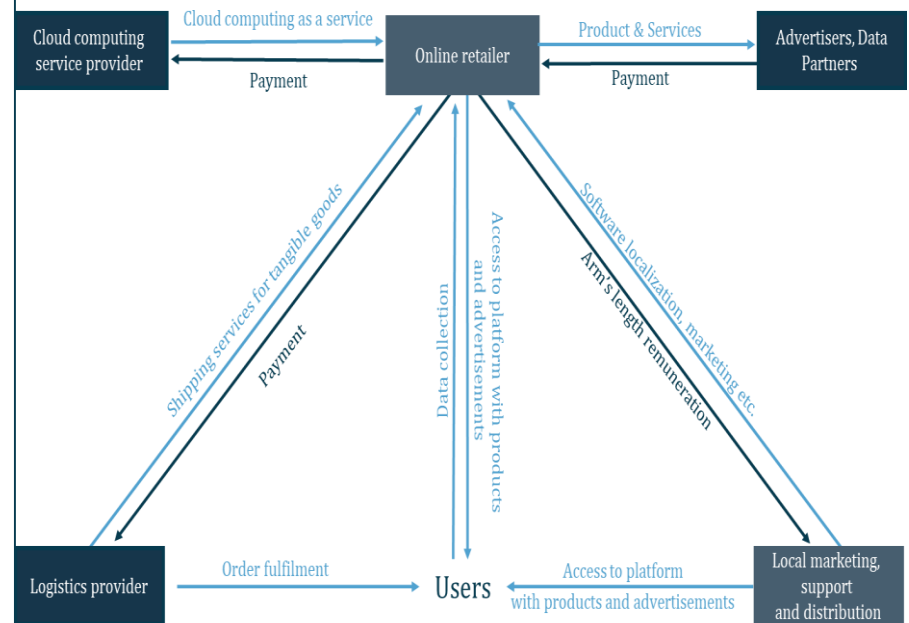 - Canada: CRA 2012-0432141R3 E: No PE in Canada

Cloud computing

- Does reseller create an agent PE for CSP?
  - PE requires: acting on behalf or playing a principal role leading to the conclusion of contracts. Will typically not include low risk distributors.
- Do users create a PE for the CSP?
- PE for User?
  - Website hosting facilities will not create a PE for the entity carrying on business through the website.
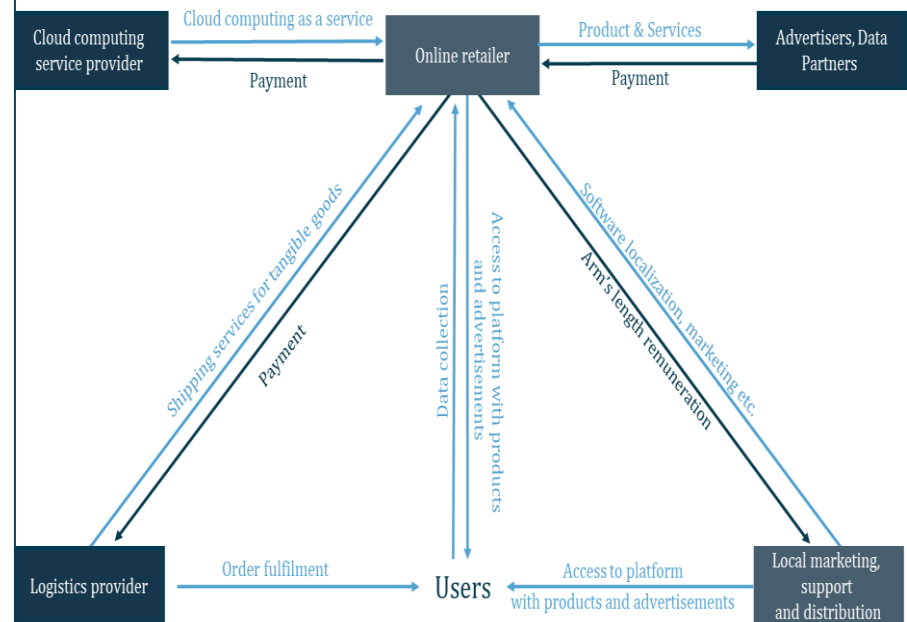
Online retailer

- Online retailer sells goods to final customers through an online store.

- The goods sold may be tangible (e.g., books) or intangible (e.g., digital downloads of music or software).

- Source of profit => mark-up on the sale of tangible and intangible goods to customers and sale of customer data.

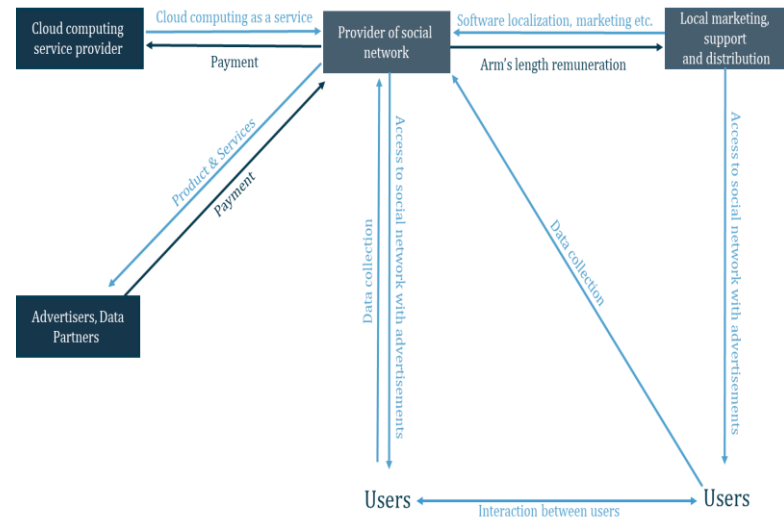- Examples of companies using this model are Amazon, Zalando and Ebay.

Online retailer

- Does the server/website constitute a PE for the provider of online retailer store?
  - Case-by-case analysis
  - Server at the disposal of the enterprise?
- Delivery through logistics centres (warehouses).
  - Pre-BEPS:"the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise".
  - BEPS 7 – MLI art. 13: not exempt if warehousing and logistics is core activity.
  - Still no PE if not even a warehouse in the market/user state.
- Do users create a PE for the online retailer?
- Does Local marketing and support create an agent PE for retailer?
  - PE requires: acting on behalf or playing a leading role leading to the conclusion of contracts.
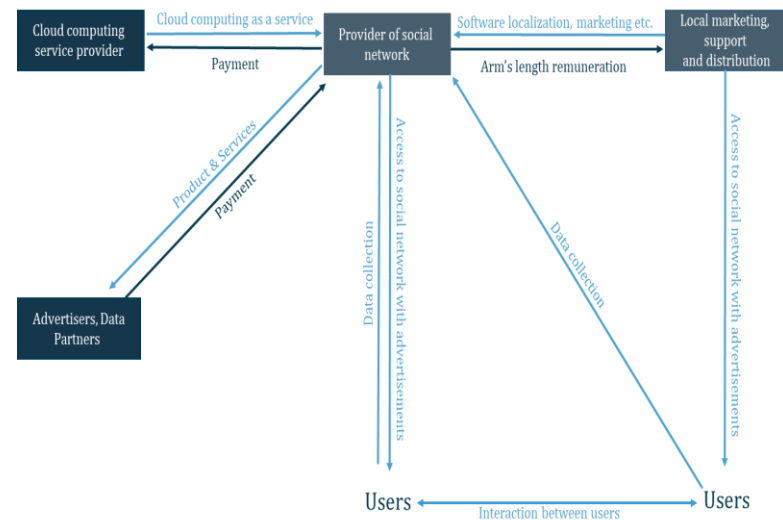- PE for advertisers?

Social network

- Multi-sided platforms offering a free network for users and collect user data and provide advertising services.

- Examples of such business models are Facebook, LinkedIn, Snapchat, Nice, Kuaishou, Sina Weibo, Tencent Weibo, Twitter, and Qzone.
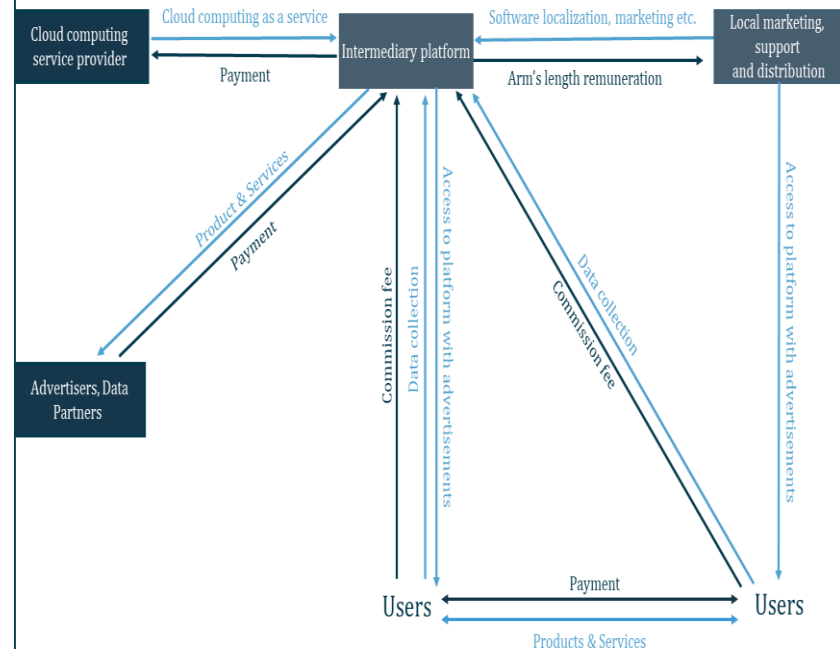
Social network

- Does the server/website constitute a PE for the provider the social network?
  - Case-by-case analysis
  - Server at the disposal of the enterprise?
- Do users create a PE for the social network provider?
- Does local marketing entity create an agent PE for CSP?
  - PE requires: acting on behalf or playing a leading role leading to the conclusion of contracts.
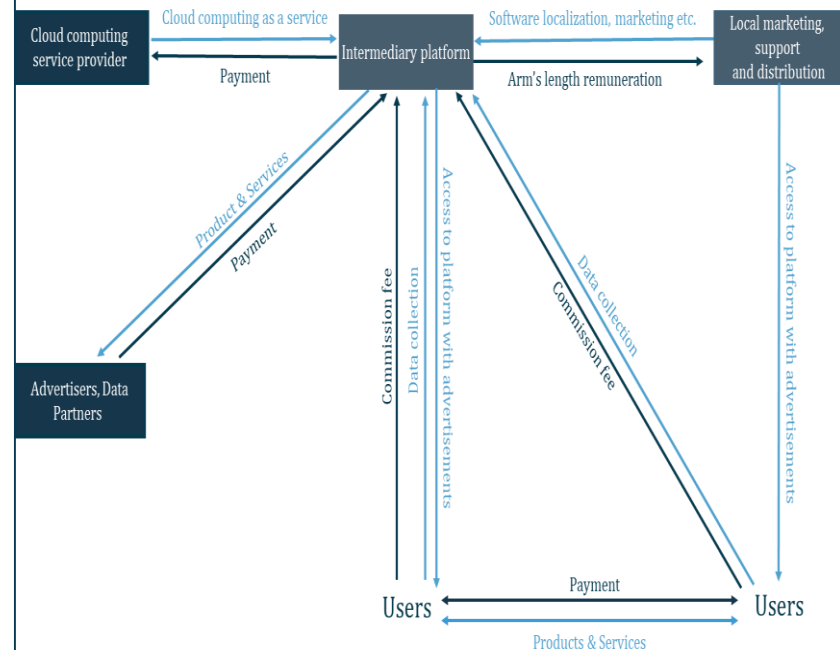- PE for advertisers?

Intermediary platforms

- Business model: relies on a three-party relationship between the platform, the providing users and the buying users.
- Matching end-users using mediation technology by linking users of the network, as well as organize and facilitate the exchange between users, and ensure transaction quality using a review system.
- Primary source of revenue:
  - Commissions earned on transactions between the users
  - Sale of collected user data
  - Online advertising.
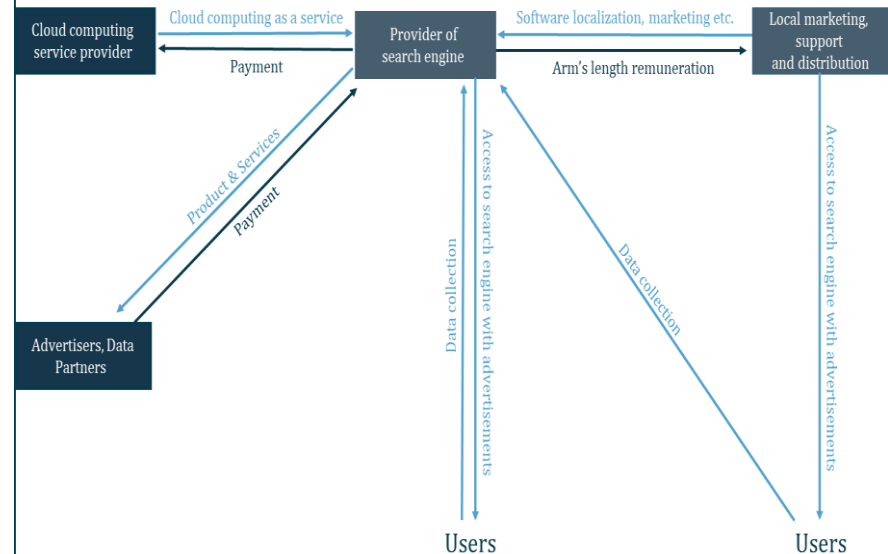- Examples of such models are Airbnb and Uber.

Intermediary platforms

- Does the server constitute a PE for the provider of intermediary platform?
  - Case-by-case analysis
  - Server at the disposal of the enterprise?
- Do users create a PE for the provider of intermediary platform?
- Does Local marketing and support create an agent PE for the intermediary platform?
  - PE requires: acting on behalf or playing a principal role leading to the conclusion of contracts.
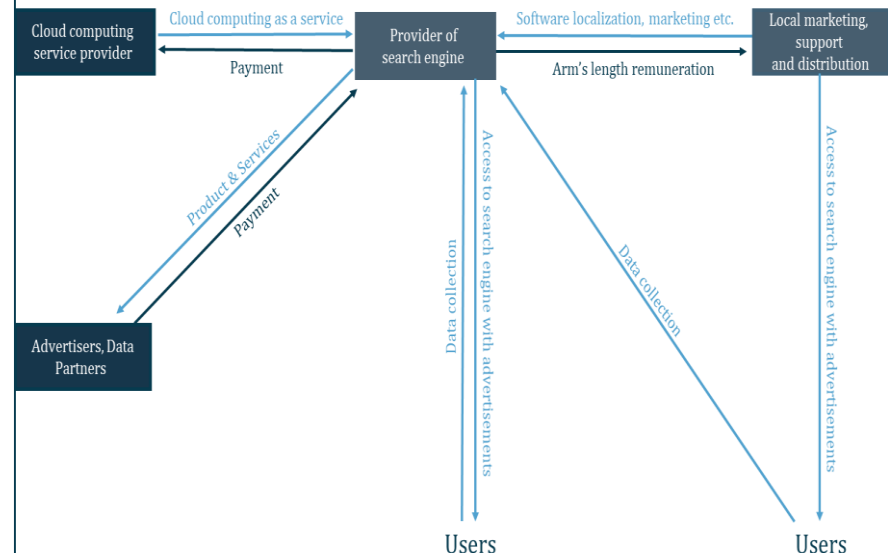- PE for advertisers?

Search engine

- Search engines are internet-enabled value networks that provide web-based services typically for free.

- Generating revenues from targeted advertising and other monetization of user data.

- Examples of such business models are Google, Bing, Yahoo, Baidu and NetEase.

Search engine

- Does the server constitute a PE for the provider of the search engine?
  - Case-by-case analysis
  - Server at the disposal of the enterprise?
- Do users create a PE for the provider of the search engine?
- Does Local marketing and support create an agent PE for the provider of the search engine?
  - PE requires: acting on behalf or playing a leading role leading to the conclusion of contracts.
  - GOOGLE: support services to the local market: admin, promotion, marketing etc.
  - Costumers engage with GOOGLE Ireland (subsidiary of US)
  - No local agent PE through local subsidiaries:
    - Challenged unsuccessfully in several countries, including France (Paris Administrative Tribunal 12. July 2017).
  - BEPS 7 – MLI art. 12: expansion of agent PE definition:
    - Doubtful whether actual impact on the GOOGLE business model.
    - Who plays the principal role leading to the conclusion of contracts and why?
    - A mere introducer?
- PE for advertisers?

FINDINGS

Findings

- Basis: Absence of physical presence generally lead to no taxable presence.
- The review has demonstrated that the PE analysis is more complex than seemingly assumed in the debate and at least requires concrete analysis of digital business models.
- PE's may occur within the digital space across business models:
  – Server of ISP - although can be avoided though subsidiary ownership
  – Server at the disposal
  – Warehouses constituting core business
  – Resellers, marketing, support functions may constitute an agent PE if playing a principal role leading to the conclusion of contracts
- PE is currently escaped:
  – Server not at the disposal (hosting – webpage, software, data storage etc.)
  – Users
  – Resellers, marketing and support if not constituting an agent
  – Advertisors
- Whether taxable nexus should occur or not depends on political views.
- On meaningfull discussion if the issue of allocation of profits is handled simultaneously – opens the discussion of value creation which is highly sensitive and widely debated.
- EU proposal: Significant Digital Presence PE:
  – A PE shall be taken to exist if a significant digital presence exists through which a business is wholly or partly carried on.
  – Definition of "significant digital presence".
    - If the business carried on through it consists wholly of partly of the supply of digital services through a digital interface.

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