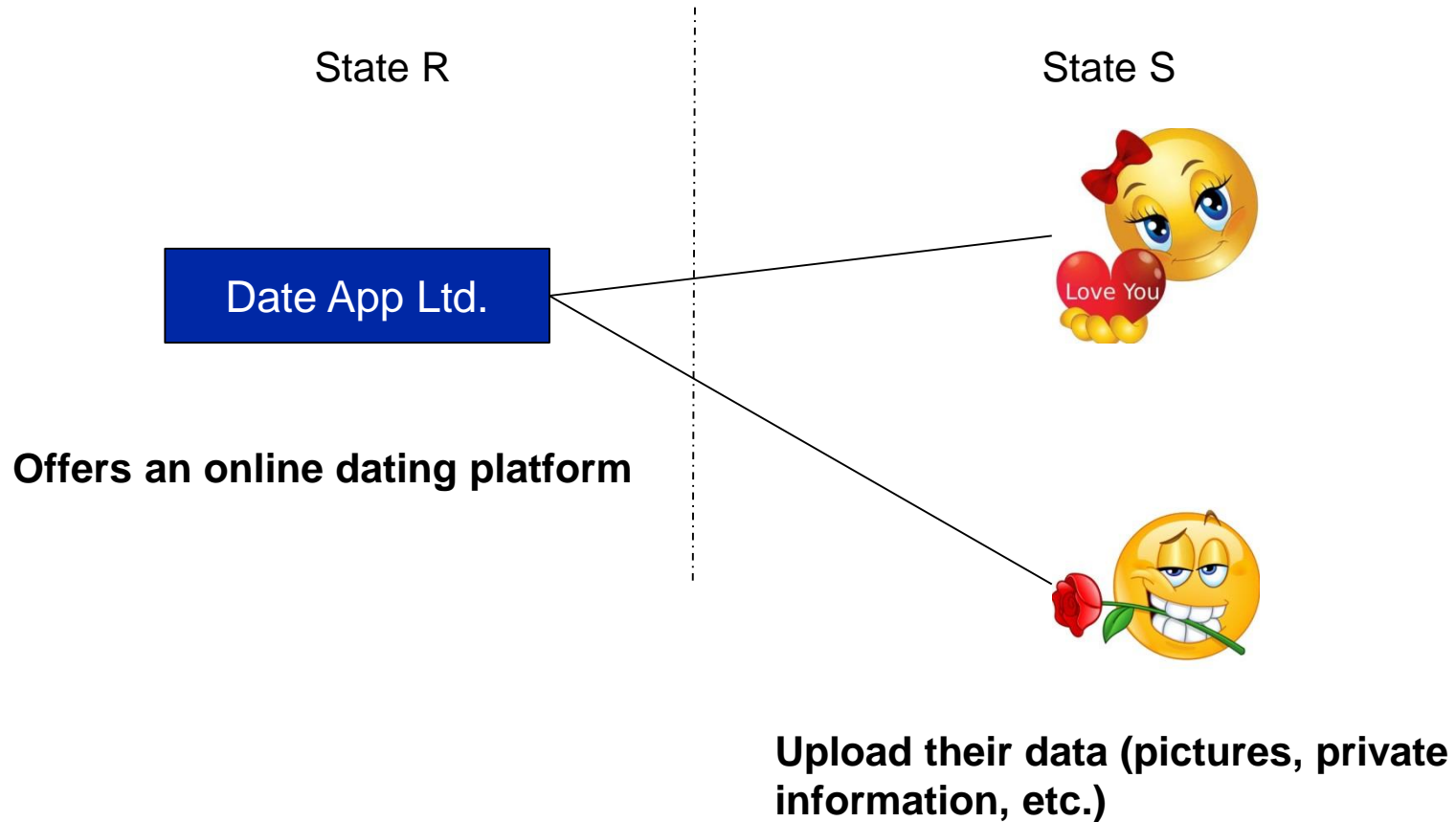




DIGITAL PERMANENT ESTABLISHMENT

DR. PETER HONGLER
LECTURER UNIVERSITY OF ZURICH
COUNSEL WALDER WYSS LTD.

An introductory example





Digital PE - Overview

- Some conceptual remarks
- Current legislative proposals
- Digital PE threshold
- Attribution of income
- Issues to be solved



SOME CONCEPTUAL REMARKS



Digital PE – Hypothesis

- The physical presence threshold stems from a brick and mortar era
- **If we were to negotiate the OECD-MC from scratch, states would agree on a different PE threshold**



Digital PE - Justifications

- Two traditional theories (sourcing and benefit theories) can be framed in the context of the new business models in order to keep taxing rights in line with value creation
- The sourcing theory allows countries to exercise their taxing jurisdiction on business income produced on their own territory.
- Its new dimension within the digital economy makes value creation not being depending only on the supply side, but also on the demand side. Accordingly, the market itself can enhance the value of the enterprise and can establish a nexus with the market country, removing the need for a PE concept based on physical presence



Digital PE – Justifications

- The benefit theory obliges all recipients of services to bear the cost of the community
- Its new dimension within the digital economy gives the market country taxing rights in connection with the benefits and services (e.g. legal system, protection of IP, energy supply, infrastructure...) that it provides to all enterprises that create value on its territory, even in the absence of physical presence



Why are these theories/principles so persuasive?

- Why should we have taxation where the value is created?
- Why should a state have taxing right if an enterprise obtains public benefits?

- → it is all about sovereignty!

- First conclusion: a global minimum tax as suggested by Olaf Scholz (finance minister Germany) does not solve the issue
- Second conclusion: If we want to allow the market states to tax part of the profit, we need to change the rules



CURRENT LEGISLATIVE PROPOSAL



Why are these theories/principles so persuasive?

COM(2018) 147

- Art. 1 Subject matter
- Art. 2 Scope
- **Art. 3 Definitions**
- **Art. 4 Significant digital presence (SDP)**
- **Art. 5 Profits attributable**
- Art. 6 Review
- Art. 7 Committee on the taxation of the digital economy
- Art. 8 Limitation of data collected from users
- Art. 9 Transposition
- Art. 10 Entry into force
- Art. 11 Addressees



PE THRESHOLD SIGNIFICANT DIGITAL PRESENCE



Digital PE – Elements of a threshold

- What kind of digital services are covered?
- How to define the threshold - quantitative and qualitative elements
- Reference to value creation or to the benefit principle?
- What kind of business models should be covered?



Digital PE – Option 1 – «Hongler/Pistone Proposal» 2015

- Elements of new PE concept for exercising taxing jurisdiction on business income:
- Digital presence - e-commerce enterprises (understood in a narrow sense) will not be affected by the new nexus. Amendments to PE definition (BEPS Action Item 7) already achieve reallocation of income.
- Triple-threshold
 - User threshold (1,000 per month) – key factor, more users being indicators of higher value creation (*)
 - Time threshold (12 months after user criterion is met) – stability
 - De minimis threshold – avoid excessive fragmentation and burden for SMEs
- (*) this threshold can be replaced by data or similar threshold related to benefits and value created in market jurisdiction



Digital PE – Option 1 – «Hongler/Pistone Proposal» 2015

- “If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum”.



Digital PE – Option 2 – «COM(2018) 147 final»

- Art. 3 (5) COM(2018) 147: Digital services means (simplified):
 - supply of digitised products
 - services providing or supporting a business or personal presence on an electronic network such as a website or a webpage
 - services automatically generated from a computer via the internet or an electronic network, in response to specific data input by the recipient
 - the transfer for consideration of the right to put goods or services up for sale on an internet site operating as an online market on which potential buyers make their bids by an automated procedure
 - Internet Service Packages (ISP) of information in which the telecommunications component forms an ancillary and subordinate part, in other words packages going beyond mere internet access and including other elements such as content pages giving access to news, weather or travel reports, playgrounds, website hosting, access to online debates or any other similar elements
- :



Digital PE – Option 2 – «COM(2018) 147 final»

- Art. 4 (3) COM(2018) 147 (simplified)
- A 'significant digital presence' shall be considered to exist in a Member State in a tax period if the business carried on through it consists wholly or partly of the supply of digital services and one of the following conditions is met
 - a. the proportion of **total revenues** obtained in that tax period and resulting from the supply of those digital services to users located in that Member State in that tax period **exceeds EUR 7 000 000**;
 - b. the **number of users** of one or more of those digital services who are located in that Member State in that tax period **exceeds 100'000**;
 - c. the number of **business contracts** for the supply of any such digital service that are **concluded** in that tax period by users located in that Member State **exceeds 3'000**.



Digital PE

Will there be an option 3?



ATTRIBUTION OF INCOME



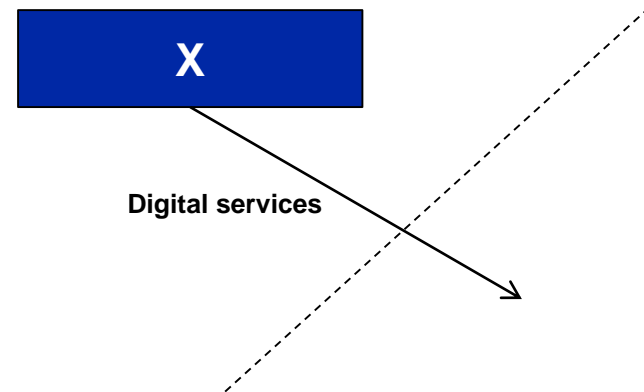
Digital PE – Attribution of Income

- Options:
 - Use existing transfer pricing regime
 - Apply lump-sum allocations without detailed functional analysis
 - Formulary apportionment or partial formulary apportionment



Digital PE – Attribution of income

- Art. 5 (2) COM(2018), 417
- The digital PE should be calculated as it were a separate and independent enterprise





Digital PE – Attribution of income

- Art. 5 (3) COM(2018), 417
- Functional analysis
- *“[t]he economically significant activities performed by such presence through a digital interface shall be taken into account”*
- *“For this purpose, activities undertaken by the enterprise through a digital interface related to data or users shall be considered economically significant activities of the significant digital presence which attribute risks and the economic ownership of assets to such presence.”*



Digital PE – Attribution of income

- Art. 5 (4) COM(2018), 417
- *“due account shall be taken of the economically significant activities performed by the significant digital presence which are relevant to the **development, enhancement, maintenance, protection and exploitation** of the enterprise’s intangible assets”*
- Is it appropriate to refer to DEMPE?



Digital PE – Attribution of income

- Art. 5 (5) COM(2018), 417

“5. The economically significant activities performed by the significant digital presence through a digital interface include, inter alia, the following activities:

- a. the collection, storage, processing, analysis, deployment and sale of user-level data;*
- b. the collection, storage, processing and display of user-generated content;*
- c. the sale of online advertising space;*
- d. the making available of third-party created content on a digital marketplace;*
- e. the supply of any digital service not listed in points (a) to (d).”*



Digital PE – Issues still to be solved

- Offset of losses?
- Technical implementation?
- How to consider the interests of small and very small countries/markets?
- Collection of taxes?
- Distortive impact?
- Multiple PEs?
- Separation of digital and non-digital services/goods?
- Careful review of existing business models?

A closing example

