Outline of a “Significant Digital Presence” Nexus

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Outline

1. The PE nexus and the new business models
2. Presence, value creation and tax nexus
3. The role of algorithms and users in the new business models
4. Significant digital presence and allocation of taxing powers
5. The digital/virtual PE: our proposal

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1. The PE nexus and the new business models

- The PE nexus: a fair compromise between source and residence-based taxation for the allocation of taxing powers on cross-border business income
- Non-occasional presence of an enterprise on the territory of a country suffices for triggering the objective nexus, allowing the source state for exercising its taxing powers
- The PE concept was created at a time in which non-occasional physical presence was required in order to derive business profits from the territory of a country
- New business models have now made it possible to derive business profits without physical presence in a country
- Consequently, the PE nexus as it currently stands has now turned into a cage for the exercise of taxing powers by the source State

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2. Presence, value creation and tax nexus

- The objective nexus presupposes a link with the territory of the country in order to justify the exercise of taxing jurisdiction
- For some categories of income, physical presence of the recipient is unnecessary for the exercise of taxing jurisdiction, e.g. dividends, interest, royalties, (some) capital gains, directors' fees
- Nowadays exercise of business in a country produces income of an enterprise even when there is no physical presence in a country
- The actual meaning of value creation and its relation with the source of income is the real dilemma for adjusting the exercise of taxing powers to the new business models
- Global value creation chains impose a multilateral approach to tax nexus, in order to achieve achieve a balanced exercise of taxing powers between/among all countries involved

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3. The role of algorithms and users in the new business models

- Algorithms can create value without the involvement of staff
- The enterprise staff elaborates them, but they learn from the experience and process information supplied by the users
- New business models of digitalized economy internalise users in business cycles, thus becoming an asset of the enterprise
- Algorithms process all data, regardless of whether a sale occurs
- Users may, but need not necessarily be consumers
- Users may, but need not necessarily be in the same country of the consumers
  - However, different markets often lead enterprises to behave differently in each country in order to maximise return on profits

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4. Significant digital presence and allocation of taxing powers

- When a sale occurs, consumption is taxed in the hands of the consumer, but the value created for business also ought to be taxed in the hands of the enterprise
  - Symmetry with taxation of value creation in the physical economy
- Significant digital presence as indicator of non-occasional exercise of business activity in country ≠ that of residence of the enterprise
- Three basic options
  1. Adapting the PE concept to the new business models
  2. Overcoming the PE concept and taxing business income without any threshold
  3. Creating new forms of taxation for the digitalized economy
- Option 1 is inclusive, 2 is more radical and 3 is divisive

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5. The digital/virtual PE: our proposal

- **To be added to Article 5 OECD MC:**

  "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 the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum"

Hongler P., Pistone P., "*Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*", IBFD White Papers, 20 January 2015

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5. The digital/virtual PE

- Triple threshold limits nexus marks a significant digital presence of the enterprise, singling out from cases of occasional presence
- Attribution of profits
  - Currently hard to reconcile with transfer pricing guidelines, which were designed to apply to physical economy
  - Correct weight to be given to involvement of users, difference in assets and value creation
- Compliance is apparently a problem, but digitalization of transactions and CbCR make solutions possible
- Treaty amendment solution is preferable: possible via MLI?
- EU vs worldwide scenarios may have different implications on global competition
- This solution fits within a framework of international tax coordination and avoids disruptive effects of unilateral action

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Thank you for your attention!

- **Work in progress….**

Your comments and suggestion are welcome

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