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New nexus for digital economy: an analysis of digital, revenue-based and user-based factors

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Introduction

- points of departure:
  - OECD's work on BEPS Action 1
    - „Tax Challenges Arising from Digitalisation" Interim Report (April 2018)
  - EC package on taxation of digital economy (March 2018)
    - proposal for a new nexus based on „significant digital presence" (SDP)
  - unilateral legislative measures
    - e.g. usage of „significant economic presence" (SEP) nexus in India, Israel

- question:
  - which criteria should be used in developing a new nexus for taxation of „digital companies"?

Introduction (2)

- OECD (2015 Report): „*The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business, combined with the increasing role of network effects generated by customer interactions, can raise questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate.*"
  - Interim Report (2018) – problem of „**scale without mass**"

- EC (March 2018): „*(...) such rules fail to capture the global reach of digital activities where physical presence is not a requirement anymore in order to be able to supply digital services.* ***New indicators for significant economic presence*** *are therefore required in order to establish taxing rights in relation to the new digitalised business models*."

Introduction (3)

- The idea of „significant economic presence" (SEP) – outlined in BEPS Action 1 Final Report (2015):
  - „*purposeful and sustained interaction with the economy of that country via technology and other automated tools.*"
  - Criteria signaling SEP:
    - Total **revenue** generated within a country – "*one of the clearest potential indicators of the existence of a SEP*"
    - **Digital factors** (e.g. local domain name, local digital platform, local payment options)
    - **User-based factors** (e.g. number of active users, number of contracts, etc.)

Comparative overview of new nexus norms

	European Commission – SDP	India - SEP	Israel - SEP
Revenue-based threshold	YES (7.000.000 EUR threshold)	YES (amount to be prescribed)	NO
Digital factors	NO	NO	YES (website localised for the Israeli market)
User-based factors	number of users exceeding 100.000	YES (minimum number of users to be prescribed)	YES (number of contracts concluded with Israeli customers)
	Number of B2B contracts exceeding 3.000		

Policy perspective

- Why are many countries frustrated by the operation of “traditional” nexus norms, particularly Art. 5 OECD MC?
  - Policy behind the usage of the PE nexus: PE as a signal of economic allegiance a taxpayer has with the state other than the state of residence
  - Also: PE threshold beneficial for international trade/investment and exhibits many administrative advantages

- But: in the “new economy” it is possible to achieve same or similar level of market penetration, irrespective of the physical factors embedded in the PE norm
  - “*The circumstance that short-term business operations may accumulate substantial profits from domestic sources indicates on the contrary that the taxpayer benefits substantially from the infrastructure of the host country, even though no PE exists. It seems that an enterprise which does not need to invest in immovable facilities, or other fixed places of business, may still derive considerable advantages from the community in which its income sources are located*” (Skaar)

Policy perspective (2)

I. PRECEPT OF TAX EQUITY

- with regard to the nexus issue: question of “justification to tax”
  - “*the forgotten question*” (Klaus Vogel)

- At what point may a country legitimately ask to participate in the sharing of profits derived by non-residents?
  - link with the benefit principle
  - the “membership principle” (Dietsch) – taxpayer should be liable to tax in a country of which he is a member
  - Economic allegiance / value creation / source of income

Policy perspective (3)

- PE rule particularly problematic from the perspective of tax equity
  - factors relating to taxpayer's physical presence in a country are not *per se* decisive for production of cross-border business income
  - non-PE market state provides significant benefits to non-resident business operators, particularly in the digital economy
  - Demand/destination has an important role for value creation

- Reform proposals: "market states" have a legitimate taxing claim over cross-border income
  - Location of customers as a proxy for source of income / value creation

Policy perspective (4)

II. ECONOMIC EFFICIENCY/NEUTRALITY

- Important to avoid frictions, or “quantum leaps”, in recognizing taxing claim of a country over non-resident’s business income; a threshold of taxable presence in a country should be commensurate with the potential extent of non-resident’s economic activities therein
- Thus minimizing distortions of taxpayers’ behaviour

II. ADMINISTRATIVE ISSUES

- problems associated with the enforcement of new nexus rules
- legal certainty

Assessment of SEP/SDP

- new PE-deeming rules (e.g. SEP, SDP) – justified extensions of market states' taxing rights
- key role should be played by the revenue-based threshold
  - parallels with the developments regarding taxation of services (e.g. new Art. 12A UN MC)
  - attention should be paid to compliance costs, especially for start-ups
- Digital-based factors – not neccesary as additional criteria for a new nexus, but may be useful for the purpose of risk management
- User-based factors - legitimate evidence of non-residents' economic allegiance, especially when the revenue threshold has not been reached
  - Useful for profit attribution?

Instead of conclusion

- Broader concerns:
  - Is the physical presence nexus really moribund?
    - See: decision of the US Supreme Court in *South Dakota v. Wayfair, Inc.*
  - Is SEP/SDP better than the alternatives?
    - Particularly withholding tax on income from (not only) digital services
  - Perception of the “international tax regime” as a product of international powerplay
    - Is this the reason for “ring-fencing” of digital economy, instead of a more comprehensive realignment of the rights to tax on a global level?

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