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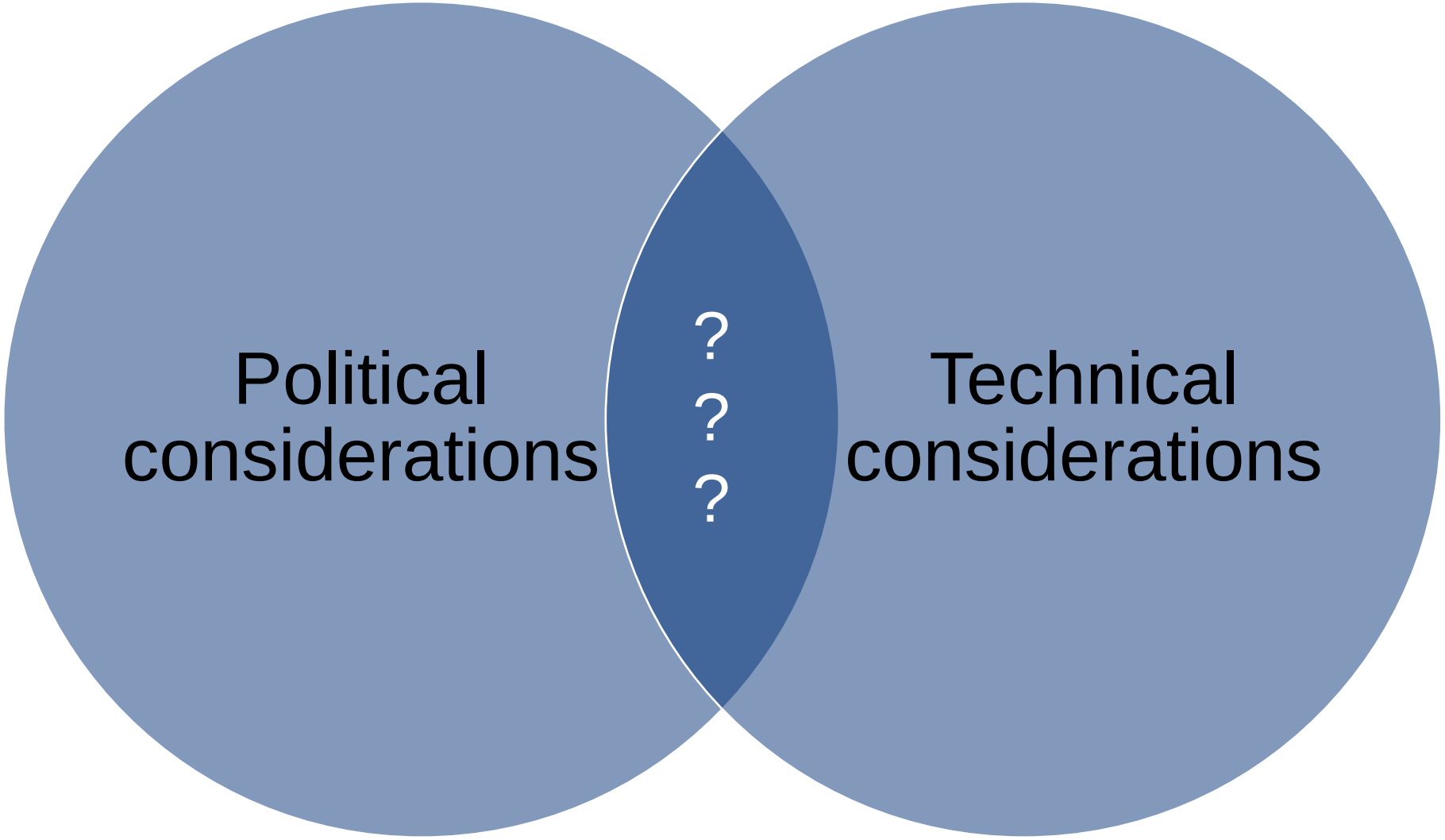
Profit allocation rules in the EU proposal

ACTL-IBFD Conference
Taxing the digital economy: the EU proposals and other insights

28 June 2018 –Jan Bart Schober

DMS number

Profit allocation – Two angles



Political – The right jurisdiction

Allocation of profit taxing rights on the basis of **arm's length principle**:

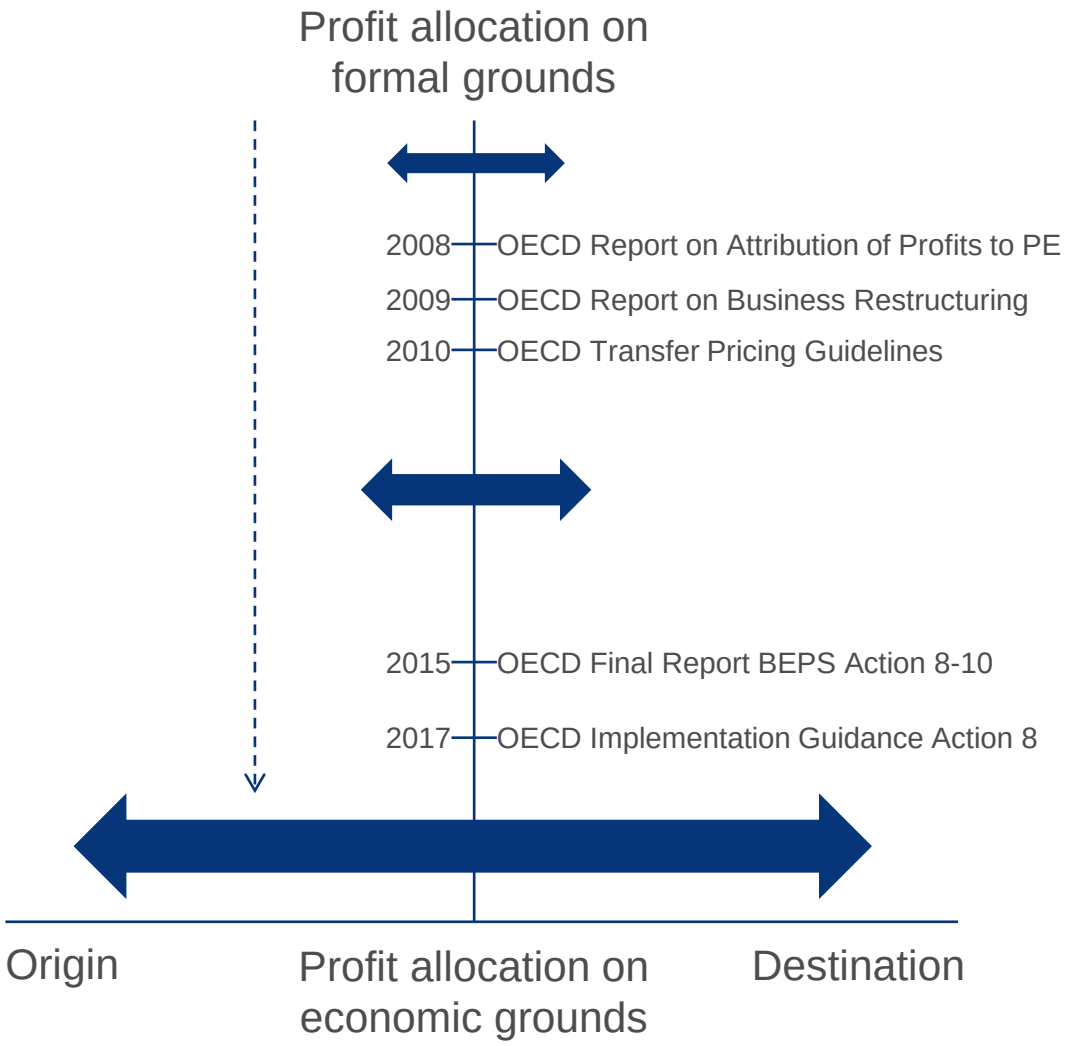
- Place where the significant people functions, the assets and the risks are located
- BEPS Action 8-10: increasing relevance of people functions
- No relevance of 'destination' as consumers are considered 'passive'

Policy makers / market sentiment

"…profits should be taxable in **the right jurisdiction**…"

What is the **right jurisdiction**?

Political – Pandora's box of international taxation



- OECD promotes profit allocation rules based on significant people functions, referring to **'value creation'**
- This development exposes the difference in (political) views of countries on whether the *origin* or the *destination* is **'the true source of income'**
- These deviating opinions put pressure on finding a global consensus

Will this only lead to
geopolitical conflicts
or is there any hope that it will lead to a
fair and robust consensus-based outcome?

Political – In or out of the box

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Considerations

- Can the digital economy be ring-fenced?
- Does data add value to digital business models?
- Are consumers still ‘passive’ and do users play an active role in digital business models?

How does this help to find a solution ‘within the box’?

- Who actually creates the value, the digital business or the user?
- Is the user an employee or agent for the digital business?
- Is the user – perhaps unknowingly – ‘selling’ his data for a consideration (in kind)?

Technical – Significant digital presence

Article 4, paragraph 3

A 'significant digital presence' shall be considered to exist (...) if the business carried on through it consists (...) of the **supply of digital services** through a **digital interface** and (...):

a) the (...) **revenues** (...) exceeds EUR 7 000 000;

b) the number of **users** (...) exceeds 100 000;

c) the number of **business contracts** (...) exceeds 3 000.

Observation: definition contains **qualitative and quantitative** criteria

Technical – Profit allocation rules

Article 5, paragraph 2-4

2. The profits attributable to (…) the significant digital presence shall be those that the digital presence would have earned if it had been a **separate and independent enterprise** performing the same or similar activities under the same or similar conditions, (…), **taking into account the functions performed, assets used and risks assumed, through a digital interface**
3. (…) the determination of profits attributable to (…) the significant digital presence shall be based on a **functional analysis**. In order to determine the functions (…), the **economically significant activities performed by such presence** (…) shall be taken into account. For this purpose, activities (…) related to **data or users** shall be considered economically significant activities (…) which **attribute risks and the economic ownership of assets** to such presence
4. In determining the attributable profits under paragraph 2, due account shall be taken of the economically significant activities **performed by the significant digital presence** which are relevant to the “DEMPE” of the enterprise’s intangible assets

Technical – Explanatory notes EC

Framework as presented by EC

- Proposed profit allocation rules built on current framework applicable to PEs
- Authorised OECD Approach (AOA) remains the underlying principle for attributing profits to a significant digital presence
- However, framework needs to be adapted to reflect the way value is created in digital activities: criterion of significant people functions is not sufficient (in absence of physical presence)

Observations

- Value creation is not necessarily the same as the arm's length principle
- Profit allocation based on significant people functions does not match with digital business activities, as digital business are 'scalable without mass'

Technical – Explanatory notes EC

The proposed EC solution

- Activities undertaken through digital interface related to data and users should be considered economically significant functions
- Profit allocation should take into account DEMPE functions in the performance of the economically significant activities by the digital presence, even if not linked to people functions in Member State
- Profit split method would therefore often be considered most appropriate
- Possible splitting factors: expenses incurred for R&D and marketing, number of users, data collected.

Observations

- Deemed allocation of DEMPE functions to country of user
- Allocation based on factors that are potentially subject to debate

The long term agenda – Significant economic presence?

Article 4, paragraph 3

A 'significant ~~digital~~ **economic** presence' shall be considered to exist (...) if the business carried on through it consists (...) of the **supply of** ~~digital~~ **goods or services** ~~through a digital interface~~ and (...):

a) the (...) **revenues** (...) exceeds [EUR 7 000 000];

~~b) the number of **users** (...) exceeds 100 000;~~

~~c) the number of **business contracts** (...) exceeds 3 000.~~

The long term agenda – Profit allocation?

Article 5, paragraph 2-4

~~2. The profits attributable to (…) the significant digital presence shall be those that the digital presence would have earned if it had been a **separate and independent enterprise** performing the same or similar activities under the same or similar conditions, (…), **taking into account the functions performed, assets used and risks assumed, through a digital interface**~~

3. (…) the determination of profits attributable to (…) the significant ~~digital~~ economic presence shall be based on [(a) sales, (b) labor, (c) assets, and (d) R&D expenses] ~~a functional analysis. In order to determine the functions (…), the economically significant activities performed by such presence (…) shall be taken into account. For this purpose, activities (…) related to data or users shall be considered economically significant activities (…) which attribute risks and the economic ownership of assets to such presence~~

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Profit allocation – Two angles meet

