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Digital Economy Taxation Developments: A marker for the Future of Taxes (Part 2)

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In part 1 of this blog, we focused on the increased involvement of platforms in the levy of direct and indirect taxes. In this blog, we will highlight other digital economy tax trends, such as the shift of taxation rights on digital activities and fixed establishments.

Shift of taxation rights between jurisdictions

More user-and-consumer based levies

Under current international tax rules, multinational enterprises ("**MNEs**") generally pay corporate income tax where they are established rather than where consumers or users are located. On 12 October 2020, the OECD released for public consultation updated reports on its two-pillar proposal to address the tax challenges of the digitalisation of the economy. The Pillar One proposal focuses on new nexus and profit allocation rules, whereas the Pillar Two proposal more broadly pursues a global minimum effective taxation.[1] The submissions received by the OECD as part of this public consultation were publicly discussed on 14 and 15 January 2020. The target deadline for an overall political agreement on Pillar One and Pillar Two is mid-2021.

The Pillar One proposal is designed to re-allocate to market jurisdictions the taxing right on a share of the large MNEs 'residual profit'. Whether an MNE will be in scope of the proposal will be determined based on the global consolidated revenue, where now a threshold of at least €750 million has been mentioned. The intention of the proposal is that a portion of an MNEs residual profit should be taxed in the market jurisdiction where the customer or user is located, independent of whether there is a physical presence of the MNE in such market jurisdiction. This as certain digitalized businesses can now generate significant revenues and profits in jurisdictions in which they have no physical presence with currently no corporate income tax due. This new taxing right for market jurisdictions will be based on a formulaic approach using the consolidated profit and loss statement of the MNE. Only in case of a consolidated profit of the MNE would such a new taxing right result in the levy of corporate income tax, where the proposal also contains a centralized loss carry forward mechanism. The new taxing right will coexist with the current at arm's length principle, where the proposal extensively addresses the elimination of double taxation that will occur due to this coexistence. Under the proposal, the profitable entities of the MNE group that generate the group's residual profits based on the current at arm's length principle (the so-called 'paying entities') will need to provide relief of double taxation to the market jurisdictions to which they are closest connected. As a result, this new taxing right would reallocate part of the current tax base of the entities within the MNE group now earning excess profit under the at arm's length principle to the benefit of the market jurisdictions. Upon implementation of the Pillar One proposal, any unilateral measures that have been implemented by jurisdictions to tax digitalized businesses such as digital services taxes ("**DSTs**"), should be abolished with this global consensus-based solution prevailing.

Highly digitalized businesses providing automated digital services ("**ADS**") are in scope of the proposed new taxing right. The proposal covers all digital services that require minimal human involvement such as online advertising services, social media platforms and online intermediation platforms. The proposal aims to not only cover currently known digital services, but also future automated digital services that will be covered by the ADS definition and subjected to the new taxing right. In addition to ADS, consumer-facing businesses ("**CFB**"), i.e., businesses that sell goods and services primarily targeted at consumers will be in scope of the new taxing right. The concept of 'CFB' covers both the owner of the product or service sold to the consumer as well as the retailer who sells to the consumer. Due to this broad definition of CFB, it covers a significant part of all large MNEs, who will become subject to this new taxing right upon implementation of this proposal.

Further, Pillar One is aimed at simplifying the application of transfer pricing rules to determine the profit attributable to standard marketing and distribution functions and enhancing tax certainty through extensive multilateral tax co-operation. These two measures of the proposal are not exclusively aimed at large MNEs that fall under the scope of ADS or CFB, but rather benefits all MNEs with this simplification and enhanced tax certainty.

Pillar Two effectively seeks to enforce a global (yet to be determined) minimum level of effective taxation on income derived by large **MNEs**. To that end, it combines domestic and treaty-based measures that allow the other jurisdictions where the MNE operates (notably the jurisdiction of the ultimate parent entity) to charge a top-up amount of tax on resident group entities.

DST

In advance of any international consensus at OECD level on the taxation of the digital economy, around half of all European Union ("**EU**") Member States have already adopted unilateral DSTs on marketplace services, digital marketing and advertising and/or sales of user data.[2]

In general, we believe that the Pillar One proposal is a preferred solution over unilateral initiatives such as DSTs. Moreover, a unilateral DST levies a tax on the revenue of the company, instead of on its profits. This may impose a disproportionate tax burden on companies that are hardly profitable or even loss-making such as start-ups. Such companies would still be liable to the DST, regardless of whether they make a profit or not, whereas the Pillar One proposal is based on the profits of the company combined with the proposal only applying to large MNEs above a certain revenue threshold. Also, one of the aims of the Pillar One proposal is to ensure no double taxation and to provide global certainty for taxpayers, whereas such local DSTs would have the opposite effect. Further, local DSTs do entail a burden of doing cross-border business within the internal market, not quite different from the wide range of local indirect taxes in the early days of the EU. In our view, either all of these DSTs should be eliminated upon the implementation of the Pillar One proposal or, when Pillar One is not (yet) implemented, such DSTs should be harmonized on an EU level.

On 14 January 2021, the European Commission also launched an "Inception Impact Assessment" (roadmap) on a legislative proposal introducing an EU-harmonized digital levy.[3] The following alternatives are mentioned in the Impact Assessment: a corporate income tax top-up to be applied to all companies conducting certain digital activities in the EU, a tax on revenues created by certain digital activities conducted in the EU and a tax on digital transactions conducted business-to-business in the EU. The Impact Assessment mentions that any EU initiative should be compatible with the agreement that may be reached within the OECD on the two-pillar proposal. A legislative proposal is expected in the second quarter of 2021.

Fixed establishments

The traditional concept of permanent establishments to tax profits generated by digital activities is under intense scrutiny. The permanent establishment is also highly debated from a VAT perspective, where we notice that more countries are actively 'defending' taxation rights and trying to extract more revenues from value created within their borders by trying to expand the permanent establishment concept.

For instance, Poland tries to enforce a broad concept of permanent establishment. In the ECJ case *Dong Yang Electronics**[4]***, the Polish tax authority took the position that a subsidiary company qualified as a permanent establishment of its parent company. The ECJ did not rule out the possibility that a subsidiary could constitute a permanent establishment. In order for a permanent establishment to be recognized, the subsidiary company should be characterised by a sufficient degree of permanence and a suitable structure in terms of human and technical resources to enable the parent company to receive and use the services supplied to it for its own needs. A permanent establishment may not be inferred from the mere fact that a company has a subsidiary in an EU Member State.

The Polish tax authorities also applied a broad concept of permanent establishment in the *Welmory*[5] case, where it considered that a Cypriot auction that used a Polish domain name and purchased advertising, information and data processing services from a Polish company also resulted in a permanent establishment. In this case, the ECJ ruled that Welmory should at the very least have a structure characterised by a sufficient degree of permanence, suitable in terms of human and technical resources to enable it to receive in Poland the services supplied to it by the Polish company and to use them for its business, namely running the electronic auction system. The fact that Welmory could carry on its business without requiring an effective human and material structure in Poland is not determinative. Such a business requires at least a structure that is appropriate in terms of human and technical resources, such as appropriate computer equipment, servers and software. Therefore it has been argued that this judgement seems to leave open the option that a server could also be regarded as a permanent establishment for VAT purposes.

The discussion on the permanent establishment concept is also nicely illustrated by the recent landmark judgement from the French High Administrative Court, which revised the traditional approach to the characterization of a permanent establishment for both corporate income tax and VAT purposes.[6]

Valueclick is a U.S. group carrying out marketing affiliation and media services. In Europe, this activity was carried out by Valueclick International, an Irish company, that owned the non-exclusive right to use intellectual property rights for the European market. For the French market, Valueclick International made use of the services from Valueclick France. It was agreed that

Valueclick France would receive a cost plus 8% fee for being in charge of the administrative, financial and HR support and for acting as “marketing representative” in the business development and the management of the commercial relations with the clients of Valueclick International.

Given the role Valueclick France had in preparing, negotiating and implementing client transactions for Valueclick International, and based on the fact that these transactions were automatically accepted by Valueclick International (i.e. Valueclick France was able to legally bind Valueclick International into commercial relationships), the High Court ruled that Valueclick France qualified as a dependent agent constituting a permanent establishment of Valueclick International. The circumstance that Valueclick France did not formally sign contracts with clients in the name of Valueclick International did not make any difference.

For VAT purposes, the High Court also ruled that Valueclick International had a permanent establishment in France characterized by a sufficient degree of permanence and a suitable structure in terms of human and technical resources to enable it to provide the services. Valueclick France employed the personnel that was able to decide to autonomously conclude Valueclick International’s contracts with clients and had access to the technological tools that were required to manage the implementation of these contracts and assist the clients.

Where are we headed?

The introduction of DSTs in various countries combined with the developments of the Pillar One and Two proposals of the OECD will determine the tax position of the digitalized businesses in the coming years. If Pillar One is implemented, this would change not only the tax position of digitalized businesses, but the whole global tax system as we currently know would evolve towards a more market orientated taxation system to better suit the digital business models that have developed. Further, we also expect that more and more EU countries will actively try to defend taxation rights and try to extract more revenues from value created within their borders.

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[1] OECD, tax challenges arising from digitalization – report on pillar one blueprint, Inclusive framework on BEPS & OECD, tax challenges arising from digitalization – report on pillar two blueprint, Inclusive framework on BEPS.

[2] Elke Asen, What European OECD Countries Are Doing about Digital Services Taxes, Digital Tax Update: Digital Services Taxes in Europe (taxfoundation.org).

[3] Inception Impact Assessment, Digital levy, Ref. Ares(2021)312667 – 14/01/2021.

[4] European Court of Justice, nr. C-547/18 (*Dong Yang Electronics Sp. z o.o*), ECLI:EU:C:2020:350.

[5] European Court of Justice, nr. C-605/12 (*Welmory sp. z o.o.*), ECLI:EU:C:2014:2298.

[6] Victor Camatta & Pierre-Marie Roch, Valueclick Case: French Administrative Supreme court rules in favor of a broad interpretation of “dependent agent”, Victor Camatta, Pierre-Marie Roch (europeantax.blog).

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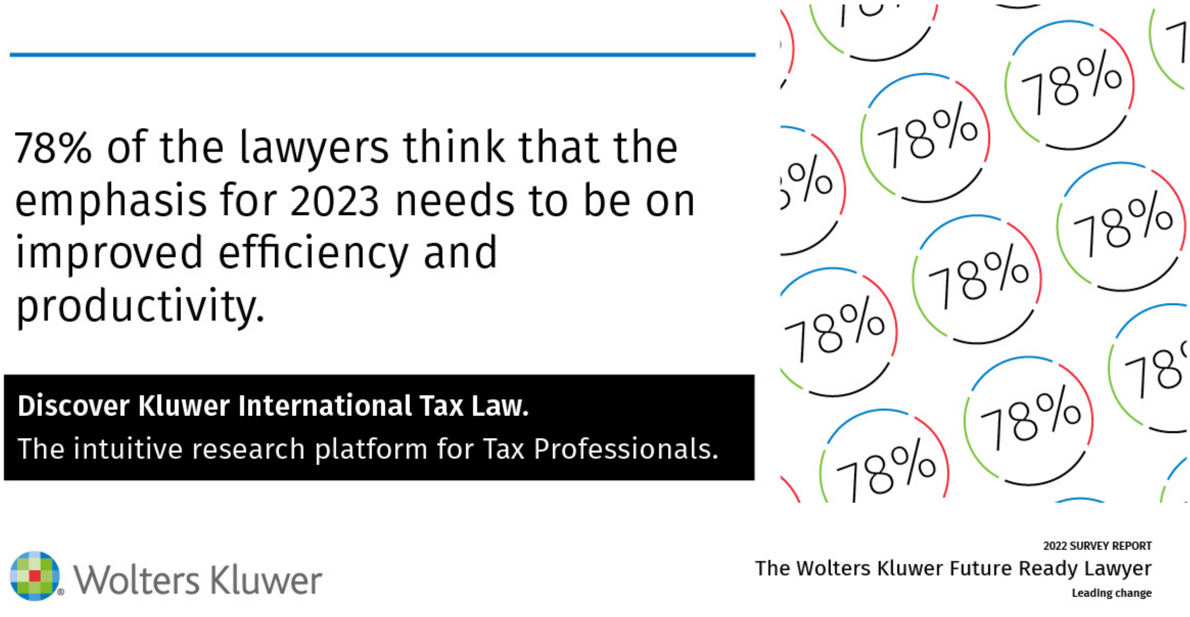

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