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ON DEVELOPMENT OF THE CONCEPT OF PERMANENT ESTABLISHMENT IN THE AGE OF DIGITALIZATION WITHIN THE CONTEXT OF TAXATION OF CROSS-BORDER ACTIVITY

ПРО РОЗВИТОК КОНЦЕПЦІЇ ПОСТІЙНОГО ПРЕДСТАВНИЦТВА В ЕПОХУ ЦИФРОВОЇ ЕКОНОМІКИ

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Introduction. The article considers modern developments of the concept of permanent establishment in the context of taxation of cross-border activities. The concept which was developed in 1920s has remained virtually unchanged since the early 1960s, despite the huge changes in the way that international business is conducted since then. However, as nowadays acknowledged, digitalization of business creates tax challenges, in particular, in a way taxing rights are distributed between the states. These challenges also raise questions regarding the ability of the existing international tax framework to determine where economic activities are carried out and value is created for corporate tax purposes.

The purpose of the paper is to consider the developments around the concept of permanent establishment to address tax challenges of the digital economy, in particular, a new nexus for permanent establishment related to digital activities.

Results. The purpose of the international taxation system's design is to ensure fair allocation of taxing rights between different jurisdictions. While the general consensus is that taxation should take place where the value is created the current tax framework lack mechanisms which would ensure such taxation. This issue has been raised in research papers and addressed by the Organization for Economic Cooperation and Development. Although the BEPS Final Report identified tax challenges created, *inter alia*, by outdated concept of permanent establishment no common consensus was reached regarding measures to be taken to address those challenges. However, as a result of further work the concept of a new nexus was proposed and is being currently discussed.

Conclusion. Introduction of the new nexus on an international level will provide the basis for fair allocation of taxing rights between states and will help to prevent unilateral measures taken by different countries to ensure taxation of digital activities within their jurisdictions that may create further distortions.

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Вступ. Стаття розглядає сучасний розвиток концепції постійного представництва, що з'явилася у 1920-х рр. і фактично залишалася незмінною з 1960-х рр., незважаючи на величезні зміни, яких зазнали способи ведення господарської діяльності, зокрема, та економіка загалом. Проте сучасна діджиталізація бізнесу ставить низку питань у сфері оподаткування, зокрема, стосовно спроможності існуючого міжнародного податкового законодавства визначити, де здійснюється економічна діяльність, де створюється вартість для цілей оподаткування податком на прибуток, і відповідно забезпечувати справедливий розподіл податкових прав між різними юрисдикціями.

Мета. У статті досліджуються напрямки дискусії стосовно необхідності внесення змін до існуючого визначення постійного представництва для вирішення вищевказаних питань, зокрема, пропонування нових критеріїв взаємозв'язку підприємства з певною податковою юрисдикцією для цілей оподаткування податком на прибуток.

Результати. Метою міжнародної системи оподаткування є справедливе розподілення податкових прав між різними юрисдикціями. Хоча загальноприйнятим є погляд, що оподаткування має відбуватися там, де створюється вартість, сучасному податковому регулюванню не вистачає механізмів, які б забезпечували таке оподаткування. Наразі на розгляді цього питання зосереджена увага Організації економічного співробітництва і розвитку. Хоча фінальний звіт ОЕСР з проблем BEPS виявив податкові виклики, пов'язані, зокрема, із застарілою концепцією постійного представництва, однозначної згоди про те, якими засобами можна подолати ці виклики, досягнуто не було. Проте робота ОЕСР у цьому напрямку продовжується, і обговорюються нові пропозиції.

Висновки. Оновлення концепції постійного представництва на міжнародному рівні створить підґрунтя для справедливого розподілу податкових прав між юрисдикціями і допоможе попередити односторонні заходи, що вживаються різними країнами задля забезпечення оподаткування цифрової діяльності в їх юрисдикціях.

Keywords: Permanent establishment, taxation, nexus, digital economy

Ключові слова: постійне представництво, оподаткування, цифрова економіка

INTRODUCTION

Concept of permanent establishment (PE) was introduced in order to give a state the possibility to tax income of non-resident enterprises sourced in that state. However, given the wide-spreading role of e-commerce and opportunities that it offers for cross-border services without actual presence in a country requires that the existing concept of permanent establishment be reviewed.

This issue has been discussed in research papers,

including by Peter Hongler, Pasquale Pistone and Arthur Cockfield. It was also outlined in Action 1 of BEPS Final Report prepared by the OECD to tackle tax-avoidance strategies that exploit gaps and mismatches in tax rules. Even though digital activities do not constitute harmful tax practices within the meaning of BEPS the current international taxation rules, in fact, contribute to stripping off the tax base of source countries. Although Action 1 does not offer any specific solution to the issue the

subsequent work of the OECD in this area focuses on introducing new nexus for PE to ensure fair allocation of taxing rights.

The **PURPOSE** of the paper is to consider the modern developments around the concept of permanent establishment within the context of international direct taxation.

RESULTS

International taxation is essentially based on two principles which are commonly used to determine the extent of a country's tax jurisdiction: residence and source. The PE concept evolved in 1920s as a compromise that strikes a balance between the taxing rights of the state of residence of the enterprise and the right of the source country to have a fair share of taxes in respect of business activities that are located on its territory. According to that concept a foreign enterprise should reach certain level of presence in the other state for taxing rights of that state to be triggered. As soon as it is identified that a permanent establishment exists in that other state a PE will be deemed as a separate legal entity for tax purposes and such state may tax part of the profit of a foreign enterprise attributable to that permanent establishment. This is sometimes referred to as 'nexus' rule which implies sufficient economic ties of an enterprise with a certain jurisdiction for that jurisdiction to be able to tax this particular enterprise.

According to international practice laid down in the model tax conventions there are several types of PE which are based on different thresholds, namely: (1) actual PE when a foreign enterprise is deemed to have a fixed place of business in another state through which the business of an enterprise is wholly or partly carried on; (2) agency PE when a dependent agent of a foreign enterprise carries business in another state in behalf of that enterprise; and (3) service PE when a foreign enterprise provides services to customers in another state for a certain period via personnel employed for this purposes. The last type of PE is only provided by UN model tax convention between developed and developing countries [1] which is designed to impart more taxing rights to developing states as opposed to the OECD model tax convention [2] which does not have this provision.

In all of the above cases of PE the taxable presence is dependent on physical presence in either form in a source jurisdiction: through a fixed place of business, or dependent agents, or employees.

In relation to e-commerce activities in its commentary to the Model Tax Convention OECD stated that the level of presence for a foreign enterprise to constitute actual PE may be reached when the server is located on the territory of another country [2, commentary on Article 5, paragraph 123]. Such rule is, in particular, found in the Ukrainian tax law [3, article 14.1.193]. Even though many countries have decided not to track down servers owned by foreign firms that are located in their territories to establish their taxable presence, in particular, in view of the problem of discovery [4, p. 245], there still a requirement for an actual piece of machinery to constitute a PE.

It has become evident though that in the era of digital economy emerging as a result of wide-spreading of information and communication technology a lot of operations do not create a fixed place of business and therefore do

not constitute a PE or, in other words, as it was said, "the notion of a fixed place of business hardly ever applies in the digital economy" [5, P. 12].

Outlining tax challenges raised by changing environment the OECD notes in 2015 BEPS Final Report on Action 1 'Addressing the Tax Challenges of the Digital Economy' that the evolution of business models in general and the growth of the digital economy, in particular, have resulted in non-resident companies operating in a market jurisdiction in a fundamentally different manner today that at the time international tax rules were designed [6, para. 246]. Thus, many functions that previously required local presence can be managed centrally. Besides, customer and market data has become a valuable asset that can be used to generate profits.

Thus, the degree of physical presence in the customer country is no longer a good proxy for the extent business being done in that country [4, P. 290]. Furthermore, growing reliance in certain business models on data raises questions regarding whether collection of data from users located in a jurisdiction should give raise to taxable presence in that jurisdiction and whether the income generated from the use of these data should be attributed to such nexus.

The reliance on server location within the existing definition of PE to establish taxable presence does not provide adequate tool for such business models. Cockfield asserts that this rule is even misguided because it focuses on the software function within the servers (which can be easily shifted across a border) instead of emphasizing the physical world factors that lead to the generation of the cross-border profits [7, P. 938].

The 2015 BEPS Final Report on Action 1 concludes that the traditional concept of the PE may no longer be a good basis for dividing taxing rights between states over the business profit of an enterprise. As Miller and Oats put it, it fails to award a 'reasonable share of the taxing rights' over business profits of non-residents, even where there is no overt tax avoidance [4, P. 289].

Although the existing concept of PE has become obsolete, as argued by Hongler and Pistone, the theoretical framework behind this concept allows for an exercise of taxing powers on business income that achieves a fair balance between taxing rights and the services and/or infrastructure provided by each state, including the one whose market is being exploited. The introduction of a new PE nexus is still in line with the general principles of international taxation [5, P. 23].

Accordingly, the question was raised in the BEPS Final Report whether in the circumstances of evolving ways of doing business and increasing role of e-commerce the current nexus rules that rely on physical presence, are still appropriate and whether allocation of taxing powers between states on income generated from cross-border activities is fair [6, para. 378].

Even though at that stage no specific solution was recommended the OECD underpinned that the location of taxable profits should be aligned with the location where economic activities and value creation take place.

At that time the OECD more specifically addressed and subsequent international measures, in particular, within the EU, were focused on the collection of VAT on sales of electronic goods and services by non-residents.

However, such approach shifts the burden of taxation directly and completely on to customers, i.e. residents of the customer state (as opposed to indirectly and incompletely which is likely to be the case with income tax on the profits of non-resident). This leaves the customer state without any share of tax on the business profits of the non-resident.

Therefore, in practical terms, the development of a new PE nexus is required not dependent on physical presence in a country, but related to digital presence which gives rise to value creation.

On 31 May 2019, the OECD/G20 Inclusive Framework on BEPS published update on its further work in the direction of addressing tax challenges related to digitalization explaining that it would explore the development of a concept of remote taxable presence along with a new concept of taxable income derived from a jurisdiction. It was also noted that new rules may either lead to amendments of the PE definition in Article 5 of the Model Convention (and potentially Article 7), or to development of a standalone rule establishing a new and separate nexus either through a new taxable presence or a concept of source [8, paras. 39, 40].

Addressing the above issues (so-called Pillar One) on 9 October 2019 the OECD released for public a consultation document which outlines a “Unified Approach” for nexus and profit allocation rules. Admitting that certain aspects require further work the OECD proposes a new nexus based on sales whereby a company is taxable in a jurisdiction where its sales exceed a certain threshold even if it is not physically present in that market. At this, only ‘highly digital business models as well as consumer-facing businesses’ are suggested to be covered by this threshold. It is suggested that revenue threshold would also take into account certain activities such as online advertising services, that it would also apply to groups that sell in a market through a distributor, and that this new nexus would be introduced as a standalone rule, on top of the PE rule [9, paras 22, 23]. This concept has already been named as ‘Quantitative Economic Presence Permanent Establishment’ by some researchers [10].

Despite the OECD sought to establish “the simplest way of operating the new rule” it still may be difficult for many authorities to enforce, especially in case of business-to-customer transactions. Number of public comments that have been provided as a response to the “Unified Approach” raise concerns as to cost of implementation as well as administrability of this model [11].

On the other hand, it should be noted that cross-border business-to-customer transactions involving international e-commerce activities have already been subject to international direct taxation, and similar approach, including one-stop-shop, seems to be a reasonable approach. Necessary reporting can also be integrated with the tax disclosures required under BEPS Action 13 regarding country-by-country reporting within transfer pricing rules.

Although the consensus on the above matters as well as other matters in connection with the development of the new concept is yet to be reached, it should be remembered that the issues related to tax challenges of digitalization and, in particular, nexus issue, are addressed by individual countries which aim at protecting or expanding

source taxation of online business activities. This results in measures which were named by the OECD as ‘uncoordinated and unilateral’ including introducing withholding and turnover taxes as well as specific regimes targeting large MNEs [12, para. 342]. As such measures can potentially create further distortions in international tax system development of new international rules is of top priority and in case such rules are introduced, cancellation of those measures is to be considered.

CONCLUSION

The new concept is gradually formed to allow taxation of cross-border profits in the digital economy. Its details as well as implementation mechanism is yet to be developed and international consensus is yet to be reached. Still, in the world divided by state frontiers unification in the area of taxation should be welcome because it will prevent unilateral measures which have already been taken by some states to protect their taxing rights, that could potentially create distortions and allow for new ways of tax avoidance. At the same time, unified measures in a long run will contribute to neutral tax environment and as a result to fairer distribution of taxing rights between the states.

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