

G-24 Working Group on tax policy and international tax cooperation¹

Proposal for Addressing Tax Challenges Arising from Digitalisation

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Context, Motivation and Objective

- 1) The Digitalisation of the economy, which is increasingly becoming all pervasive, has rendered the existing international rules that allocate taxing rights among countries largely ineffective, if not completely obsolete. Nowadays, businesses can reach their customers directly from any corner of the world. They can negotiate and conclude contracts with them and deliver goods and services to them without being physically present in the customers' jurisdiction, either through place of business, production facilities, service personnel, a branch office or a sales outlet. In other words, with Digitalisation, business enterprises can be heavily involved in the economic life of a jurisdiction without significant physical presence. Since, as per extant rules, taxing rights are allocated to jurisdictions based primarily on physical presence, the market or source jurisdictions are losing out on their share of taxes.
- 2) Tax challenges posed by Digitalisation were identified as a focused area in the Base Erosion and Profit Shifting (BEPS) Action plan, leading to Action 1 Final report in 2015. As observed in this report, it would be difficult, if not impossible, to ring-fence the digital economy. The Action 1 Report also observed that, beyond BEPS, the Digitalisation of the economy raised a number of broader direct tax challenges primarily relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.
- 3) As has been indicated already, a jurisdiction gets taxing rights over an enterprise if that enterprise has sufficient nexus with the economic life of that jurisdiction. The present concept of nexus is anchored in Article 5 of the tax treaties in which a jurisdiction gets the right to tax a non-resident, if the non-resident has a permanent establishment (PE) in that jurisdiction. Broadly, the tax treaties are based either on UN Model Tax Convention or OECD Model Tax Convention. The two models differ in several aspects, with the UN Model providing a wider scope of a taxable nexus for business profits, which is constituted by PE. If the provisions of both models are taken into account, the definition of PE is primarily based on a fixed place of business, and also includes service or construction activities carried out beyond specific duration, existence of a dependent agent and collection of insurance premiums. The concept of PE creates a sort of legal fiction for

¹ Prepared by the Working Group. Within the G-24 Working Group, India, Colombia and Ghana led the preparation of this Note.

the allocation of taxing rights in the source country, and effectively acts as a threshold which measures the level of economic presence of the non-resident in a jurisdiction.

- 4) However, this concept has been made largely ineffective by the advent of modern means of telecommunication and the spread of Digitalisation. Today, a non-resident can participate in the economic affairs of a jurisdiction without being physically present in the jurisdiction. For example, the ability to conclude contracts remotely through technological means with no involvement of individual employees or dependent agents raises questions about whether the focus of the existing rules on conclusion of contracts by persons other than agents of an independent status remains appropriate in all cases. While some would argue that presence of pervasive modern technology that enables valuable data collection and storage, even without actual physical presence, may create an adequate nexus², even under existing rules, many would contest that claim.
- 5) Thus, such sustained participation of the businesses in the economic life of a country can give rise to profits which are not taxed given the present international tax rules. This creates a mismatch between the source of generation of profits and the jurisdiction where they are taxed. This mismatch is a result of a combination of factors like scale without mass, reliance on intangibles, user data and contribution³ and the fact that digital business models can supply goods and services in a jurisdiction without physical presence. The solution is to rework the international tax framework regarding nexus and profit allocation rules, and take into account value created within the supply chain, representing the contribution of supply side, along with contribution of demand side factors for determining corporate profits attributable in a tax jurisdiction. There is a need to acknowledge the fact that value of goods and services are also contributed by the purchasing power of the markets in which goods and services are consumed. Hence, the country that hosts these markets has a right to tax them.
- 6) It needs to be mentioned here that the spread of Digitalisation has not changed the fundamental nature of the core activities that businesses carry out as part of a business model to generate profits. To generate income, businesses still need to source and acquire inputs, create or add value, and sell to customers. To support sales activities, the businesses are required to carry out

² The US Supreme Court has recently in the case of South Dakota Vs. Wayfair Inc et al (No.17-494, June 21, 2018) held that ...“it is not clear why a single employee or a single warehouse should create a substantial nexus while “physical” aspects of pervasive modern technology should not. For example, a company with a website accessible in South Dakota may be said to have a physical presence in the State via the customers’ computers. A website may leave cookies saved to the customers’ hard-drives, or customers may download the company’s app on to their phones. Or a company may lease data storage that is permanently, or even occasionally, located in South Dakota.”

³ These three factors have been identified in the OECD Interim Report 2018 on Tax Challenges from Digitalisation.

marketing research, advertisement and customer support. Digital technology has had significant impact on how these activities can be carried out with speed and without having physical presence in the market country, thereby avoiding payment of any tax in that jurisdiction. This leads to the key question as to whether the present definition of PE based on physical presence is appropriate in a modern economy.

Revision of international tax rules on Nexus and Profit Attribution

- 7) As mentioned in the OECD Interim Report 2018 on Tax Challenges from Digitalisation, the member countries of the Inclusive Framework recognise the need to “...undertake a coherent and concurrent review of the two key aspects of the existing tax framework, namely the profit allocation and nexus rules” As also acknowledged in the 2015 Action 1 Report, questions arise with regard to the definition of PE for treaty purposes and the related profit attribution rules in the context of digital economy.
- 8) The G-24 countries are of the view that if a business is able to interact extensively with customers in a market jurisdiction and generate business profits without physical presence, it should give rise to existence of PE, and then, the market jurisdiction should be able to tax such business income on net basis. For this, the modification in PE threshold and associated profit attribution rules would be required.

Revision of Nexus Rules

- 9) The G-24 countries propose that for addressing the limitation in the definition of ‘Permanent Establishment’ in the existing tax treaties, the concept of Significant Economic Presence (SEP) may be brought in Article 5. The option of “significant economic presence” was one of the three options that were discussed in the Chapter VII of the Final Report on Action 1 of BEPS, for addressing the tax challenges of the digital economy. Under this rule, a taxable presence in a country would be created when a non-resident enterprise has a significant economic presence on the basis of factors that are evidence of purposeful and sustained interaction with the economy of that country via technology and other automated rules. For establishing the nexus in terms of significant economic presence, some factors, which have also been referred to in Action 1 Final Report, may be taken into account. These are discussed below in brief.
 - A) Revenue generated on a sustained basis from a jurisdiction: Any digital business model ultimately works for revenue generation, and thus, revenue from sales of goods and services effected through digital means can be considered as one of the clearest indicators of involvement of a non-resident in the jurisdiction. The network effects and the user data add

value to the offering made by the enterprise, which helps it sell more in a jurisdiction or earn a premium on its product / service offerings. In either case, revenue is generated and can be taken as a basic factor to establish nexus along with other factors. While deciding revenue as a factor, consideration has to be given to the types of transactions that are to be covered, the *de minimis* threshold in absolute terms and its administration. These are important considerations for minimising administrative and compliance burdens. In addition to the revenue factor, one or more from the following factors may be considered relevant for constituting the nexus of Significant Economic Presence (SEP).

B) I) The user base and the associated data input- Like in a typical 'brick and mortar' business, the sustained interaction of a digital business is reflected in number of users. The more users an enterprise has, the more significant is its presence in the economy. This user base can itself be divided into active and passive users⁴. The Action 1 Report had suggested using Monthly active users (MAU) and online contract conclusion as possible user-based factors reflecting the level of participation of an enterprise in the economic life of a country.

(II) The volume of digital content collected through a digital platform from users and customers habitually resident in that country in a taxable year can be another indicator. The volume of data collected in the form of user created content, product reviews, search histories etc., reflects the level of participation of an enterprise in the economic life of a country.

(III) Others: There can be other factors like billing and collection in local currency, website in a local language, delivery of goods to customers being the responsibility of the Enterprise or the Enterprise providing other support services, say, after sales service or repairs and maintenance or sustained marketing and sales promotion activities, either online or otherwise, to attract customers to the digital enterprise.

The G-24 countries acknowledge that all of the above factors, including possible new factors or touch points that are evidence of sustained and purposeful participation of a digitalised enterprise in the economic life of a country need to be discussed and deliberated in detail so as to develop a concrete design of the new rule based on Significant Economic Presence.

⁴ Passive user participation does not necessarily require the user to enter any information, but data is collected by the company, for example, through cookies even after the user is no longer on the specific platform of the business but using other websites. Active user participation involves an explicit action. Examples of active engagement range from bookmarking a page to creating and uploading a video or post.

Principles for Profit Attribution

- 10) Attribution of profits is a key consideration in developing a nexus based on significant economic presence. In the context of income/corporation tax, the taxable base is equivalent to the total 'business profits', which can arise only when an economic good is sold to the customer. Since no profits can arise to an enterprise merely by producing goods, the primary location where the value contributing to the business profits is created is the market where the customers are located. This is the basic underlying principle that has been recognized very clearly right from the inception of the international taxation regime in the early 20th Century, as evident from the California oranges example⁵ in the report of four economists⁶ to the League of Nations, which is considered as the conceptual basis for international taxation regime. This example only elaborates a basic principle that is always recognized by all businessmen, that it is the market and the demand for consumption that dictates production and not vice versa. Besides, production is also an essential element to business. Thus, both production and sales are essential for generation of profits, and neither can be ignored for the purpose of determining the profits that would be taxable in a jurisdiction. The jurisdiction that contributes towards demand by facilitating the economy, or by maintenance of markets, and the ability of its residents to pay that enable sales, as well as the jurisdiction that contributes to the production or supply of goods, contribute towards the business profits of an enterprise. In some cases, the market jurisdiction also contributes infrastructure networks that are used by the enterprise to perform its services or to deliver its products. This gives rise to a valid justification of taxation by them of the profits to which their economies have contributed.
- 11) Value and profits for the enterprise can be generated by a new category of third parties ("users"), whose activities create value and profits for the enterprises without being directly remunerated financially, may not be very different from the other individuals like employees, contractual workers or vendors and accordingly, the activities carried out by 'users' need to be treated at par with the activities carried out by such other individuals. The "users' contribute in the form of generation of content, network effects, creation of content and depth of engagement. As the attribution of profits must be aligned with value creation, the activities and

⁵*"The oranges upon the trees in California are not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, up to the point where wealth reaches fruition, may be shared in by different territorial authorities"*

⁶League of Nations Document E.F.S.73.F.19 Economic and Fiscal Commission, 'Report on Double Taxation'(1923).

existence of users in a particular jurisdiction should be taken into account as a factor for profit attribution to a permanent establishment with a significant economic presence in said jurisdiction.

- 12) The 2018 OECD Interim Report on Tax Challenges Arising from Digitalisation also highlights the importance of varying degree of user participation. For characterising the user participation, the Report gives three broad categories where the participation of the user can be low, medium or high depending on the value of the user action.
- 13) The value of user action may be taxed by means of establishing a clear proxy such as revenue generated from transactions undertaken with those users. In the case of developing countries, using this proxy may simplify the determination and collection of attributable profits, as countries may levy their income tax by means of withholding on transactions undertaken with users located therein. Permissible withholding rates and base for withholding are two issues that the G-24 acknowledges should be further discussed at a technical level. Market jurisdictions under this proposal should provide for a credit for withholding paid during loss periods to be carried forward indefinitely.

- 14) Another possible way of attributing profits based on the user factor is the fractional apportionment. Article 7 of the UN Model and pre-2010 OECD Model Tax Convention both provide for attribution of profit to a permanent establishment based either on the direct accounting method or on the apportionment method, where books of account are not maintained for the PE. The provision of attribution of profits to PE was first time dealt with by OECD Draft Convention 1963. The OECD commentary was updated in 1977 with regard to paragraph 4 of Article 7 and it underwent a few changes till 2010 but the sum and substance of it remained the same. In this commentary it was acknowledged that apportionment of profits based on the criteria i.e., receipts (sales revenue), expenses and working capital, was a reasonable way of apportioning profits to the PE. It is important to note that no country had documented any reservation, observation or position in respect of this paragraph in the OECD Model Tax Convention, 2008 (before it was omitted), indicating the existence of a very broad international consensus prior to 2010 about the principles laid down in this paragraph regarding the appropriateness of apportionment based on sales, expenses or working capital for attributing profits. Thus, the pre-revised version of Article 7 in the OECD model tax convention as well as the Article 7 in the UN model tax convention clearly recognized the right of a contracting state to determine taxable profits attributable to a permanent establishment by way of apportionment.

- 15) Keeping the broad tax policy considerations that have been guiding the development of taxation systems (which include neutrality, efficiency, certainty and simplicity, effectiveness and fairness), a simple method for apportionment of business profit is proposed in a case where an enterprise has a significant economic presence in a Contracting State whose tax treaty contains Article 7 based on UN Model or pre 2010 OECD Model Tax Convention. This rule will apply when the enterprise does not maintain books of account with respect to the PE existing in a jurisdiction. In such cases, the profit attribution may be based on fractional apportionment. For this purpose, (a) the definition of the tax base to be divided; (b) the determination of the factors based on which that tax base is to be divided; and (c) the weight of these factors, need to be determined. The tax base can be determined by applying the global profit rate to the revenues (sales) generated in a particular jurisdiction. For apportionment of business profits of an enterprise which has a physical presence PE, the three factors, that is, sales (demand side factor), asset and employees (supply side factors) are taken into account. This is also the methodology when the books of account are maintained and the profit is computed on the basis of direct accounting method. In the context of the digital economy, users play a significant role in generation of business profits. Therefore, the factors based on which the tax base is to be divided should also include users. As users can be substitute to assets or employees and supplement their role in contributing to the profits of the enterprise, a portion of profit needs to be attributed taking into account user contribution as a factor in addition to the other three factors ie., sales (demand side factor), manpower and assets (supply side factors). For apportionment of business profits, where users have no role to play, sales, manpower and assets are generally given equal weightage. The users generally substitute assets and employees of the enterprise, therefore, while giving weightage to the user being the fourth factor, consideration must be given to the intensity of their participation.
- 16) In any case, where demand and supply are spread across two different jurisdictions for a cross-border enterprise, this virtuous cycle can be maintained only by a just and fair allocation of taxing rights to both states in a manner that does not lead to double tax burden. Tax paid in the jurisdiction where supply chain is located facilitates the reduction of costs and makes supplying more efficient, whereas tax paid in the jurisdiction which contributes the demand would facilitate in promoting economic development there and consequential rise in demand, thereby leading to a virtuous cycle wherein all stakeholders continue to gain.

Conclusion

- 17) To sum up, the concept of significant economic presence is required to be incorporated in the existing nexus rule contained in Article 5 to address the challenges posed by digital economy. Along with this, the rules for attribution of business profits to the PE created in the form of significant economic presence are also necessary taking into account the variations in Article 7 existing in various treaties.

- 18) Given the differences in tax laws in different tax jurisdictions and the preferences of countries regarding their tax treaties, as evident from their preference for different Model Tax Conventions, any recommended approach must be flexible to accommodate these differences. In particular, the recommendations must take into account the fact that several countries have already opted for unilateral measures that should be replaced by coordinated global action. Countries may also opt for approaches in the UN Model Tax Convention that are significantly at variance from those recommended by the OECD Model Tax Convention and cannot be expected to adapt solutions that are designed primarily for the challenges that arise from the limitations of the provisions in the OECD Model Tax Convention. In view of this need for flexibility, it is also suggested that in addition to the option of “significant economic presence”, the “withholding tax on digital transactions” as proposed in Chapter VII of the Final Report on Action 1 or a provision on the lines Article 12A of the UN Model Tax Convention also needs to be taken into consideration.