Taxation of entities with a significant digital presence in the EU

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OECD permanent establishment model

The proposed Directive affects a solution via the use of the permanent establishment rules in the OECD model DTA (double taxation agreement - which Australia tends to follow).

Article 7 of the [OECD model DTA] in regard to business profits provides:

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
3. ...
4. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
5. …
6. …

Article 5 defines "Permanent Establishment" to mean a fixed place of business through which the business or enterprise is arranged wholly or partly carried on. The examples in Article 5.2 include physical presence and places of management, branches or offices. There is no permanent establishment merely because the enterprise carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

The EU proposal

The European Commission notes that:

- The input obtained by business from users could be located in a tax jurisdiction where the company is not physically established (and therefore not established for tax purposes according to the OECD).
- Even where a company has a permanent establishment in the jurisdiction, the value created is not taken into account when deciding how much tax should be paid in each country.
- As a matter of internationally agreed principle, the profits should be taxed where value is created.
- "Bricks and mortar" businesses are the base of the current model which was not designed to cope with business models driven primarily by intangible assets, data and knowledge.
- Through aggressive tax planning, the tax burden can create an imbalanced system which disadvantages traditional companies with bricks and mortar/physical presence in particular jurisdictions.

The draft directive proposes a theoretically simple solution to this problem by:

- extending the concept of a permanent establishment to include a "significant digital presence through which a business is wholly or partly carried on"
- defining a significant digital presence to exist in a Member State in the relevant period if the business carried through it consists wholly or partly of the supply of digital services through a digital interface and one or more of the following conditions are met:
  - (i) The proportion of total revenues obtained in that tax period are resulting from the supply of those digital services to users located in that Member State in the period exceeds €7 million.
  - (ii) The number of users of one or more of those digital services who are located in that Member State in that tax period exceeds 100,000, and/or
  - (iii) The number of business contracts for the supply of any such digital services are concluded in that tax period by users located in that Member State exceeds 3,000.

The profits that are attributable to or in respect of a significant digital presence in a Member State would be taxable within the corporate tax framework of that Member State only (ie, it is not an EU tax but a national tax).

The profits attributable are those that the digital presence would have earned if the permanent establishment had been a separate and independent enterprise performing the same or similar activities under the same or similar conditions, in particular in its dealings with other parts of the enterprise, taking into account the functions performed, assets used and risks assumed, through a digital interface.

The determination profits shall be based on a functional analysis and it is assumed that the OECD's recent Implementation Guidance on Hard-to-Value Intangibles will be applied (these guidelines permit taxation authorities to use *ex post facto* data to test and verify transfer pricing).

The solution fits relatively neatly within the framework of the OECD model DTAs (although there will no doubt be much negotiation in view of the current structuring of digital businesses), and it is possible that it will attract some significant attention due to the economic weight of the EU within the OECD.

However, it will require modification of the various DTAs to be fully functional.

The recent US Supreme Court decision in *Wayfair*

In late June 2018, the US Supreme Court ruled on the constitutionality of a state tax (ie, not a Federal one) that required remote sellers to collect and remit tax to a state (*South Dakota v Wayfair, Inc*).

Generally, subsidiary national entities have a somewhat restricted power to legislate tax than a national state, both in the US and in Australia.

In Australia, a state's power to tax is restricted by the requirement that the exercise of a state's powers must relate to the "peace, order and good governance" of the state, and section 92 of the Australian Constitution (the freedom of interstate trade and commerce clause).

Although the cases on section 92 are complex, broadly, a state in Australia has the power to tax interstate trade and commerce, so long as the tax is not protectionist. If the tax is discriminatory, it may survive if there is reasonable necessity and it is proportional.

Since the prior taxing cases in Australia, Australian states as a political matter do not tend to levy many taxes other than local taxes (such as land tax, stamp duty and payroll tax) but they would be entitled to do so. At the moment they instead obtain funding via the GST sharing mechanism.

The US position is relatively similar, in that a state may tax so long as the tax is:

- applied to an activity with a substantial nexus with the taxing state
- fairly apportioned
- does not discriminate against interstate commerce, and
- is fairly related to the services the state provides

In *South Dakota v Wayfair, Inc*, the US Supreme Court needed to consider whether a law, similar in structure to the new Australian legislation on GST on low-value imports, was within the power of the state.

Prior cases had determined that a supplying entity must have a physical presence in the state before the state could have the power to tax it. As this law had been in place since before internet trading commerce, this had led to a distorted scenario where out-of-state suppliers could export into a state without charging sales tax.

This meant that consumers within a state had an incentive to purchase from out of state and avoid paying the sales tax they would be paying to an entity located within the state.

The practical effect of the $1,000 minimum threshold in Australia for GST imports was similar and many retailers, both in the US and Australia, have complained about the distortionary effect of the practical exemption from consumption tax (although the Productivity Commission has questioned this, which you can read about in its Inquiry report *Collection Models for GST on Low Value Imported Goods*, October 2017).

The US Supreme Court observed that the old-fashioned ideas of physical presence in a state, developed in times of pre-internet commerce, had little applicability in the current economy. In any event, the Court noted arguments that making a website available within a state, or downloading cookies onto a consumer's computer, could constitute a physical presence.

It held that the old physical presence rule was distortionary and allowed customers of out-of-state enterprises to escape payment of sales taxes.

The Court noted that the physical presence rule had permitted start-ups of small businesses to use the internet without exposing them to the "daunting complexity and business development obstacles" of national tax collection (which are extreme in the US given the number of states and districts that levy sales taxes, but could also be of some difficulty in Australia at a state level, where there are at least six sub-national entities that could levy a tax).

The Court observed that the state afforded small merchants a reasonable degree of protection because the merchant was required to collect the tax only if it did a considerable amount of business in the state (similar to the Australian $75,000 threshold rule for the liability to collect GST).

Impact on Australian suppliers

Just as the Australian government has sought to exercise GST jurisdiction over foreign importers of low-value goods into Australia, it is clear that other countries will seek to tax "value" (however that is defined) that is "created" in their jurisdictions.

A simple way is via a consumption tax (eg, the US issue), but there are other ways, such as the EU proposal which would attribute income to permanent establishments that would then be taxed in the normal way, via withholding tax or similar.

In light of this, Australian exporters should review their supply chains and importantly their transfer pricing arrangements, given that many DTAs have a "co-operation" clause between taxing authorities and exporters may find themselves at the end of action taken by the ATO to "preserve" a foreign state's tax.