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Some Comments on the Attribution of Profits to the Digital Permanent Establishment

Yariv Brauner[*]
and Pasquale Pistone[**]

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In the authors' view, the concept of digital permanent establishment (PE) is the preferable solution to tackle the challenges of the digital economy. In this article, the authors comment on the attribution of profits to digital PEs.

Good tax policy should promptly find solutions to the problems of a community, or even prevent them from arising. Global tax governance, through the projects on global tax transparency and the global reaction to base erosion and profit shifting, has given a global dimension to good tax policy, reaching unprecedented levels of international tax coordination around the world. The political endorsement has facilitated this development in little time and with important repercussions, including in the European Union, where it took less than a year to approve the Anti-Tax Avoidance Directive.

By contrast, the progress of international tax coordination seems much harder in respect of adapting international taxation, its conceptual categories and rules to the new business models of the digitalized economy.

Twenty-seventeen has been a year of intense debate among political institutions, international organizations and technical experts on such issues, marking two important results. First, the so-called digital economy may no longer be secluded from the so-called conventional or physical economy, since new models digitize the cycles of traditional products and services to a minor or major extent. Second, there is an understanding that different business models have different repercussions on value creation and therefore require an urgent intervention with the allocation of taxing powers among states.

However, 2017 has also been a year in which the existence of conflicting positions among the relevant stakeholders and players has become clearer. This situation prevents reaching a global consensus on effective solutions to the problems of international taxation that arise in such context.

In particular, multinational enterprises may create value in countries that currently fail to tax their business in the absence of a physical presence of the enterprise. This situation creates an unintended tax bias in favour of going digital and remotely operating business, thus enjoying in fact more favourable tax conditions than traditional business players operating in a given market. Therefore, any additional year without solving the international tax problems of the digitalized economy represents the source of a powerful boost in the performance of digitalized business, which can legitimately reduce the impact of taxation on global enterprises at a time in which states have otherwise committed to an effective reaction against international tax avoidance and aggressive tax planning.

States, too, have conflicting positions in this respect, since the inadequacy of international tax legal categories, including in particular that of the permanent establishment (PE), deprives some states of the right to exercise their taxing powers on value created within their territory and enriches other states, namely those from which multinational enterprises choose to operate. The current physical boundaries of the PE are in fact acting like a cage, which prevents the state of value creation from exercising its tax sovereignty over business.

This unsatisfactory situation prompts the losing countries to activate unilateral reactions (such as the various unilateral levies that keep blossoming around the world) that are, on the one hand, a necessitated defensive reaction in order to preserve the tax sovereignty and, on the other hand, a very dangerous threat to international tax coordination, which they can seriously undermine. Insofar as such levies do not fall within the scope of existing treaties, they may result in the exposure of digitalized business to forms of over-taxation, resulting from the combination of taxes levied in the country of value creation and in the country of residence without any obligation to give relief. In time, the exposure to this new form of international double taxation may potentially favour domestic over cross-border business.

We believe that quick fixes or tools for facilitating short-term solutions are a dangerous mirage, from which global tax governance should keep its distance, rather than considering them as possible solutions in the short term. They are likely only to distract stakeholders in their efforts to find permanent solutions, to realign interests of states in arbitrary manners and further destabilize the international tax regime, prolonging the process of reform and adjustment to the new economic realities.

* **Hugh Culverhouse Eminent Scholar Professor of Law at the Levin College of Law, the University of Florida. The author can be contacted at brauner@law.ufl.edu.**
** **Academic Chairman of IBFD (the Netherlands); Holder of a Jean Monnet ad personam Chair in European Tax Law and Policy at the WU Vienna University of Economics and Business (Austria) and Professor of Tax Law at the University of Salerno (Italy). The author can be contacted at p.pistone@ibfd.org.**

The only way forward is to adopt inclusive solutions, i.e. solutions that are suitable for applying to any (digitalized and non-digitalized) business models that align international taxation to the needs of the new business models and reflect the way in which the digitalized economy creates value. Yet, the ultimate challenge for global tax governance now is to turn solutions that are preferable from a tax technical perspective, such as the digital PE, into actually operational measures.

After the launch of the idea of a new nexus based on the concept of the digital PE, the international tax community has thoroughly discussed the merits and shortcomings of this solution. Among others, the main criticism of the digital PE does not concern the establishment of the nexus, but rather the attribution of profits.

In general, insofar as the attribution of profits for taxing purposes was developed in line with the typical dynamics of the traditional economy, it is no surprise that it may be hard to reconcile with different business models, such as those of the digitalized economy. However, this should not imply that we ought to ignore the different ways of creating value in the digitalized economy, but rather that we should make efforts for adapting the criteria for the attribution of profits. Any different approach to this problem would, in our view, clash with the object and purpose of the BEPS Project, which has made significant efforts for aligning transfer pricing outcome with value creation.

Petruzzi and Buriak[1] put forward ways for using the existing transfer pricing rules to cope with the tax challenges of the digitalization of the economy, stressing the role of value creation analysis in such context, which sees data as a very valuable asset especially for the highly digitalized business. In such context, they argue that the functional analysis should take into account various activities, including the transfer of data, their purchasing and selling, further processing or transformation, all of which have a significant value for highly digitalized businesses. However, it is noteworthy that empirical evidence shows an increase in the number of companies willing to build up a customer-centric business model in which the product offered is customized following the information acquired from big data. For instance, one of the major airlines in Europe decided to exploit the potential of massive information to make profiles of the passengers to know in advance how to render the flight as enjoyable as possible and to predict the needs to satisfy during or after the flight. This exacerbates the issue of developing an appropriate approach to deal with digitalized activities and value creation. Indeed, no one questions that enterprises currently trade data.

Insofar as most digitalized business customers become unconscious providers of digitalized business, they contribute to enhance the value of such business rather than merely consuming its products. The involvement of customers as users and the automatic recording and processing of their preferences by algorithms significantly enhances the performance of business as compared to the various steps of complex marketing studies that constituted an indispensable feature of the conventional business. In particular, the combination of the direct involvement of the customer and new technologies able to receive and process a limitless amount of data has completely changed the way of conducting marketing analysis. In the past, only sectorial analyses based on a predetermined number of people surveyed were feasible; nowadays it is possible to have access to unstructured data describing all the aspects of people's lives, which enables the analyst to get to know even those needs that people are not aware of. Returning to the example of airlines, knowing in advance that a passenger is flying for leisure and likes to see paintings of particular artists allows the company to advise the sale of tickets for the museums in which some of those paintings are exhibited. If successful, the company will at least make an additional profit and secure the loyalty of that customer. This clearly shows that, also in the context of attribution of profits, due consideration should be paid to the circumstance that the mere interaction of users and algorithms allows value creation for the digitalized business and should therefore also be taken into account for taxing purposes.

Therefore, users' data and algorithms, when bundled together, become a powerful element for value creation analysis. Yet, Petruzzi and Buriak indicate that the role of data for the digitalized business should be kept within the proper boundaries for transfer pricing purposes, since only data generating high value for the company should be relevant in such a context.

The main merits of the work done by Petruzzi and Buriak, therefore, are to prove that it is possible to attribute profits to the digital PE in line with the existing transfer pricing analysis and to demonstrate possible ways for doing this. They ask what country should capture the value of data, considering that data may be generated in one jurisdiction and processed (or even used) elsewhere. In our view, this situation raises similar problems to the ones that concern call centres of airlines specialized in a market of a targeted group of users (and usually fluent in a given language) but established in a different country.

The solution to such problems is not easy and requires a thorough consideration of the role of risk, functions and people. Insofar as the role of users becomes that of active customers of a digitalized business, attracting at least a portion of such income to the country of the users[2] is, in our view, reasonable. Furthermore, it would also establish a reasonable degree of neutrality with the situation in which conventional business creates value on the territory of the country of such users and, hence, should necessarily promote efficiency.

Nonetheless, the dichotomy between data generation and data processing can be solved starting from the point that, for the implementation of a given business strategy, the processing activity per se does not generate much value, because it only gathers and reclassifies data using apposite servers and statistical software, the final output being information that was already present, although not clearly identifiable, in the data forwarded. Moreover, the real value driver resides not in each single datum, but in the massive amount of combined data that renders the reclassification much more reliable even in the absence of human intervention and intuition. Starting from this hypothesis, the value generated can be split, attributing to the processing activities carried out via the use of hardware and software

1. *See* R. Petruzzi & S. Buriak, *Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules?* 72 Bull. Intl. Taxn. 4a (2018), Journals IBFD.
2. *See* P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, Working Paper, pp. 34-35 (20 Jan. 2015), which suggest attributing a percentage of one-third of the income that will be split between all the market jurisdictions.

a cost-plus markup derived from the margin applied on the market by independent companies rendering similar services and to the data provided by the users the residual value. Even considering risk, functions and people, the data are accumulated thanks to the interactions (functions) between people and the Internet, significantly reducing the risks of implementing whatever business strategy.

The point is that the nexus approach recognizes the significant presence of digital players in an economy, significant presence that should be accompanied with significant taxing rights. Only an allocation methodology that both ensures such rights and visibly demonstrates the adaptation of the international tax rules to the new economic reality and the need for just division of tax bases, acknowledging, inter alia, the value of market country data, will enjoy the legitimacy required of such reform. Adopting such an allocation methodology would be the “moving in an orderly fashion” indicated on 20 February 2018 as desirable by Commissioner Moscovici.[3]

Petruzzi and Buriak support the use of the current allocation (transfer pricing) rules in the same manner that the OECD promotes them in the context of the new article 7 of the OECD Model and the so-called authorized OECD approach. However, as is well known, this methodology does not enjoy a global consensus and is very much the subject of discussion and disagreement about its precise application. Coupling it with the similarly developing value creation concept increases the risk of introducing further uncertainty exactly where more certainty is in order. We believe that the methodologies we previously proposed[4] are both generally in line with the spirit of the normal profit allocation rules and, at the same time, improve legal certainty and the visibility of justice in the proposed reform.

This is perhaps one of the most delicate technical confrontations in the history of international taxation, which goes well beyond tax technicalities deep into political issues, and beyond the eagerness of most stakeholders to preserve and enhance their tax competitiveness and that of their multinational enterprises.

Since the very essence of international tax coordination and global tax governance is at stake, academics should remind the various stakeholders about the need to reach consensus soon on globally agreed solutions.[5]

However, such solutions must achieve legal certainty, while securing a fair and balanced allocation of taxing rights in line with value creation. After all, this development is consistent with the commitment of many countries to counter base erosion and profit shifting in order to preserve the exercise of taxing powers in the country of value creation.[6]

Therefore, we should all make our best efforts to overcome any difficulties on nexus and attribution of profits, including for the digital PE, which, in our view, remains the qualitatively preferable solution to meet the needs of new business models of the digitalized economy.[7]

And indeed, while in Rome they discuss, Saguntum is taken (*dum Romae consulitur, Saguntum expugnatur*):[8] time for talks is up; it is now time for the digital PE before the blossoming of unilateral levies on the digital economy around the world takes over the delicate balance of international tax coordination.

3. *See* http://europa.eu/rapid/press-release_SPEECH-18-981_en.htm?locale=en.
4. Id.
5. This should not prevent areas with strong integration of business across borders, such as the European Union, to reach technical solutions that preserve the consistency with the goals of supranational rules, or establish forms of closer international tax coordination.
6. In the same sense, *see* R.J.S. Tavares & J. Owens, *Human Capital in Value Creation and Post-BEPS Tax Policy: An Outlook*, 69 Bull. Intl. Taxn. 10, p. 600 (2015), Journals IBFD. The authors indicate that the most effective way to tackle BEPS is to strengthen transfer pricing guidelines so as to include rules that attribute value to knowledge-based capital, which in the digitalized era becomes one of the main value drivers.
7. *See also*, alternatively, A. Baez & Y. Brauner, *Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy* (2 Feb. 2015), White Papers IBFD.
8. T. Livius, *Historiae*, XXI, 7, 1.