Redefining the "Permanent Establishment" Concept to Make Its Measurement more Relevant for a Digital Economy

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Abstract: The paper is from the field of the philosophy of measurement and it is based on the assumption that before applying exact and sophisticated methods to measure some phenomena, it is important to define the features of the object to be measured and redefine them if the traditional definition does not correspond to changes in reality. The concept of permanent establishment can be a typical example of the mentioned situation. The term PE basically describes the conditions under which foreign business presence in a country is taxable in that (host) country. That´s why it is intensively discussed in taxation theory and practice. The basic objective of the paper is to show why the traditional definition of the concept becomes irrelevant for the business model of a digital company, to analyze some alternative solutions and, in the conclusion, to show that an international consensus in defining the concept (although difficult to achieve) is badly needed.

Keywords: digital economy and taxation; permanent establishment concept; significant economic presence; knowledge workers in a digital economy; relevance of the PE concept for Slovakia

1 Introduction

The recent years have been a period of intensive debates among political institutions, international organizations and theorists (especially in economics and law|) about the principles of international taxation under conditions of a digitalized economy. Although very differing views have been presented, the consensus has been achieved in two important results: 1) The so called digital economy can't be separated (ring-fenced) from the traditional "physical" economy because new models digitize also the cycles of traditional products and services; 2) The different business models have different repercussions on value creation in different countries and changes in the taxing power of individual states are needed. Of special importance is the fact that multinational enterprises may create value (and taxable income) in countries where they are not physically present. The traditional definition of PE concept deprives host countries of a (sometimes significant) part of their taxing power in the value created within their territory but without physical presence of foreign companies.

The structure of the paper is as follows: The first part briefly summarizes the traditional philosophy of the PE concept and its basic features. The traditional definition has been codified in legal documents and is still a basis for international tax treaties. However, some measurement problems appeared also under the old philosophy. The second – the most important part – of the paper describes why the traditional definition of PE is not appropriate under conditions of a digital economy. The third part analyses the main alternatives to the PE concept suggested so far – especially the concept of "significant economic presence" designed by OECD. In this part, some practical policy measures to apply the alternative concepts will be mentioned.

In conclusion, it will be shown that any generally accepted modification (or reconstruction) of the PE concept requires international consensus. However, even before achieving such a consensus (which will be very difficult), the theoretical contribution of the discussions on the

PE concept is valuable. It can contribute to creating new knowledge (about the recent strategy of global business players) and to better understanding of some topics connected with the knowledge management (the role of knowledge workers in the digital economy, their extreme mobility and flexibility, the importance of intangible assets and intellectual capital, etc.).

2 Traditional philosophy of the PE concept

Although it is difficult to find some stabile (relatively long-term valid) norms in international taxation, certain basic, generally accepted features can be found. (OECD Convention 2014)

Primarily, a PE requires a fixed place of business within the geographical boundaries of the country of sales. The fixed place may include administrative offices, a factory, or a workshop, but not necessarily sales offices or storage facilities. Under most double taxation treaties, the income of a firm is taxed in the country where it has permanent establishment only if it carries out a business of a continuing and lasting kind there. It is usually assumed that a foreign organization operates from a fixed place, an employee's job title or description indicates that he or she performs activities related to revenue generation or sales of the organization, an employee operates in the host country for a prolonged period, sales are made to customers based in the host county and local contracts are negotiated by a locally-based employee or dependent agent.

On the other hand, a permanent establishment does not include (OECD Convention, 2014):

- the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise

Another problem is how to interpret time of "permanency" or how long the organization should perform business activities in the country and when (in the case of building a new enterprise) the taxing right of the host country authority can be applied. There are different views regarding this issue. Many treaties provide specific rules with respect to construction sites. Under those treaties, a building site or a construction or installation project constitutes a PE only if it lasts more than a specified length of time (e.g. 2 years).

If the basic PE criteria are not satisfied, the enterprise will be taxed only in the state of its residency (home country). The traditional definition of the PE is of qualitative nature. It measures the qualities of economic presence against the agreed upon standards.

According to the traditional definition, a PE need not be a legal entity, but it is treated as an functionally separate and independent entity, an object important for the fiscal policy.

3 Why the traditional PE definition is not appropriate for a digitalized economy

As already mentioned, companies going digital may operate their business remotely and create value in foreign countries without physical presence in the country. From the "common sense" point of view, it seems that the most visible impact of globalization is the rapidly growing share of e-commerce (to final consumers, to other businesses), which distorts traditional working of the market mechanism. Cross-jurisdictional local sales without local physical presence of the supplier company existed even before; however, the scale of these transactions and their involvement in the economic life of the country leads to serious problems.

New rules regarding the destination principle for determining the place of taxation of cross-border supplies and effective collection mechanisms are to be found. This is basically the problem of indirect taxes, mainly VAT, which is not analyzed in our paper. A short-term solution for VAT will probably be easier to find than in the case of direct taxes. However, digitalization also makes the distinction between direct and indirect taxes less clear – as both types of tax optimization are involved in the new business model.

The core of our paper and the principal connection with the PE concept is in the field of corporate income taxes (CIT). How does the new business model of digitalized companies influence the value creation process in different countries? How to define criteria authorizing the local administration to tax profit achieved (or a part of profit)? A fixed place as the basic criterion of the PE concept can´t be used in many cases. The basic value creating factor in digital companies is *intangible assets (intellectual capital),* which are not clearly defined in accounting theory and practice and it is difficult to measure them. Even if measured in some way, it is difficult to connect their effect with a specific place. Digital business models enjoy high flexibility of business functions, assets, consumers and operations. The place that was actual for a specific function at the beginning of the fiscal year may be different at the end of the year. Rights to software and other intangibles can be easily transported to an associated enterprise in another jurisdiction. Which country has the right to tax the profit achieved?

Another factor often mentioned in connection with the digital business model is *reliance on data and user participation* (UiO, 2017, p. 8). Digital companies rely heavily on collection of data. The data are collected from users, suppliers and customers around the world. Some of the data are paid for; some are free. Data are used to improve products and services and to customize marketing. However, data are also sold to other organizations that combine and process them and use them for their profitability improvement. Is this process "value creation"? Has the local tax authority (in the country where the providers of data live) got a right to tax a profit derived from using these data?

OECD (2015) defines a positive externality, where two user groups meet and allow third parties to develop content for devices produced by themselves as the *multi-sided business* model (an example can be Facebook). At the beginning, a project requires a little or no capital. With acquiring new customers, the revenues grow. Who and where is creating value in such projects? These approaches can bring countless benefits to consumers and enterprises in many countries. However, some expenditures are not paid for (not covered in the monetary form). These platforms are often connected with monopoly power and some citizens or organizations are discriminated. These practices are more an issue of anti-monopoly policies. Ethical issues are also involved in multi-sided business platforms.

Multinational companies that are perfectly informed about the PE requirements try to avoid the PE status artificially. The areas discussed in this context include mainly conditions of commissionaire agreements (role of agents), including auxiliary activities into the value creation chain and fragmentation of business activities.

Even if there is "no fixed place of business", the PE will exist – according to OECD, MTC 2014, Article 5 – if the agent "habitually exercises" a right to conclude contracts on behalf of the foreign company. It means that the foreign producer (supplier) can sell products and services in another country using intermediaries to solicit sales and persuade customers to enter into contractual relations with the foreign company. This is a step forward (in the sense of widening the scope of PE) but the discussion goes on how to define the term "habitually".

Another widely discussed problem is the role of *preparatory and auxiliary activities* exempted from the traditional PE definition. It is well known that nowadays these activities play a very important role in the value creating process and can significantly contribute to profitability. According to some suggestions, it would be fair to include all these activities into the costs of the product or service and then to define a formula how to divide the resulting proceeds between the involved countries. However, achieving of consensus in this area will be extremely difficult.

Moreover, preparatory and auxiliary activities controlled by the same company can be located in different places within the same country and between countries. This fragmentation is a further problem for tax authorities. A multinational company can split the functions of cohesive business operations between different legal entities with physical presence in different states, and the tax liability is not clear.

Attempts on altering the original PE concept by different partial modifications are very frequent and contribute to making the concept more suitable for the modern economic era. However, usually they are dealing with separate, partial issues and do not provide a coherent alternative.

4 Some alternatives to the PE concept

Important modifications of the PE concept were suggested after publishing the OECD BEPS (base erosion and profit shifting) Action Plan of 2015. Let us mention mainly the suggestion that no activities of the preparatory or auxiliary character should be automatically exempted from the definition of the PE status. In the digital business model, such activities may, in fact, present a core business function. For an online retailer, for example, local storage activities should be regarded as core activities. The same can be said about gathering of information, which is an important value-driver for digital enterprises.

Probably the most discussed (especially in Europe) alternative to the PE concept is the concept of **significant economic presence** (sometimes called significant digital presence) or a **virtual permanent establishment**. This option was set out by the European Commission in a communication published in September 2017. In defining the significant economic presence three groups of factors are to be considered: digital factors, revenue-based factors and user-based factors. (EU, 2017)

Regarding digital factors, the proposed concept describes the virtual permanent establishment as the situation "when a non-resident taxpayer provides access to or offers a *digital platform,* such as an electronic application, database, online market place, storage room, or offers search engine or advertising services on a website or in an electronic application". Other potential digital factors are a local domain name or local payment options.

While the first type of criteria - types of digital transactions to be included in the definition - can be of qualitative character, user-based and revenue-based criteria require a quantitatively defined threshold from which the activity becomes "significant". Such a threshold can be expressed as the minimum number of users of some platforms, the value of cross-border e-sales, the proportion of total revenues obtained from the supply of digital services to customers in the host country, the number of business contracts for the supply of digital services, etc.

Let us mention at least some important thresholds suggested by the European Commission to consider a company as having significant digital presence in a Member State (EU, 2018):

- It exceeds a threshold of €7 million in annual revenues from digital services in a Member State.
- It has more than 100,000 users who access its digital services in a Member State in a taxable year.
- Over 3000 business contracts for digital services are created between the company and business users in a taxable year.

These criteria are regarded just as recommendations to member states, and states, as independent fiscal entities, can define the threshold themselves. Finally, the rules should be approved by national parliaments.

One of the most discussed weaknesses of the EU proposal of a significant digital presence is subjective character of defining the thresholds and the possibility that the accepted definitions will be in conflict with the existing bilateral tax treaties. This can mainly happen in the case of tax treaties with non-EU member states. That´s why the EU Commission regards this proposal as a short-term, interim solution. In the long-run, the digitalization of economies will intensify; the quantitative criteria defined today will become obsolete, and a consensus between states to modify the thresholds will be needed. The EU Commission, in our opinion, is right in suggesting that in the long-run, criteria of the degree of digitalization should be included into the tax basis harmonization process and a common definition of the corporate income tax base will be important.

The topical issue in discussions on taxing the profits from digital activities is not only defining criteria of foreign companies being tax-obliged in other countries even if they are not physically present in the country (which is directly connected with the PE concept) but also the *distribution of profits* between countries. One (sometimes neglected) factor is the role of customers as (unconscious) data providers. A combination of the direct involvement of customers as data providers and up-to-day technologies that make possible to receive and process a limitless amount of data has completely changed the way of marketing strategy and tactics (Brauner and Pascale, 2018) and significantly contributes to profits of big digitalized players. Which country is authorized to tax this increase in profits?

While EU proposal seems to be a "common" approach, at least of EU Member states, some countries try to find a unilateral solution of the problem. In practical policy, several models of **equalization levy** (Šestáková, 2018) have been introduced. The basic idea is to equalize market conditions for domestic and foreign enterprises. An equalization levy on a digital business model could mean taxing every transaction between a domestic customer and a foreign supplier if it is performed online or through electronic means. An example of such an approach can be India, where the equalization levy was introduced in 2016. Foreign enterprises providing online advertising to Indian business customers have to pay a 6% tax on the value of such transactions. In the case of India, it is not clear whether the levy is a form of direct (income) tax or an indirect tax. (Brookings India, 2007)

Another example of a short-term solution is the **withholding tax on digital transactions** mentioned also by the EU, which can be applied on all or certain cross-border transactions connected with e-commerce. This is a form of an indirect tax that could be imposed regardless of whether the foreign supplier has a PE in the country or not.

The common weakness of the mentioned unilateral approaches is that they assume separation (ring-fencing) of digital transactions from the traditional types of transactions, which is actually impossible or very short-sighted. Practical implementation would be very difficult for tax authorities and companies as well. Banks, for example, that are performing financial

transactions, should distinguish which payment is for a digital and which for a non-digital transaction, and receiving this information would be very expensive.

Probably, the most radical unilateral approach is the **diverted profit tax,** which was implemented by the United Kingdom in April 2015. The objective of this measure has been to achieve "a behavioral change" so that large companies will "divert" their profits from foreign taxation or reinvesting abroad and declare higher proportion of their profits for taxation in the UK. (The HMRC, 2017.)

The diverted profits tax (DPT) is charged at 25% on profits that are considered to be artificially diverted from the UK. The draft legislation outlines a number of tests and thresholds to assess whether DPT will apply to any transaction or business activity. The rules are very complicated, but the following applications (which are connected with the topics of our paper) can be mentioned (Šestáková, 2018):

- a non-UK company that sells goods or services to UK customers, even if only digital products delivered via the internet;
- a non-UK company that has a UK-based entity providing services (e.g. sales, marketing or head office);
- a non-UK company with employees that perform activities in the UK; or
- a UK-based company with operations offshore.

The scope of the law is very broad, and it seems to be effective. Additional amounts of Corporation Tax (CT) collected from businesses which have changed their behavior because of the introduction of DPT, grew from £31m in the year 2015/2016 to £281 million in the fiscal year 2016/2017 (HMRC, 2017).

In principle, the diverted profit tax is more an anti-avoidance measure than a concept of what the international taxation system should look like in the digitalization era.

5 Is the discussion on the PE concept relevant also for Slovakia?

The traditional PE concept has been internationally accepted for many years and included in bilateral tax treaties, which is true also for treaties concluded by Slovakia. The Slovak Republic is a small country with an important role of foreign investors. Tax revenue from taxing their profits (corporate income taxes) achieved by activities in the Slovak territory forms an important source of funds for the government fiscal policy. Taxation is a topical issue, and international competition, which is reflecting also the impact of digitalization, makes adjustment of the tax system to the modern era an imperative also for Slovak authorities.

However, the sectoral structure of FDI in Slovakia (an important role of manufacturing and energy supply) leads to a situation when majority of foreign investors *have a physical presence in Slovakia* – as required by the traditional PE concepts. It may seem that the question of the irrelevance of the PE concept is just a hypothetical one for Slovakia and can be topical only in the future. Slovakia participated in the EU discussion on the impact of digitalization, including the impact on taxation, and principally agreed with the EU documents mentioned above. However, in the country, these questions are not publicly raised; no discussion occurs, and no radical changes in the taxation due to the digitalization process are suggested.

Even if foreign investors maintain their physical presence in Slovakia, they are adjusting their business processes in a similar way as anywhere in Europe, and the increasing digitalization plays a very important role in these adjustments. Many issues mentioned above –

e.g. the increasing role of auxiliary and supporting processes, multisided business platforms, fragmentation, etc. – are topical also in Slovakia. However, the question how to measure them and include them in the tax base of corporate income taxes is not raised. E-commerce is rapidly increasing also in Slovakia, but the development of prices in this commerce is not monitored and its repercussion in the VAT scheme is not discussed - which is quite understandable due to a lack of available data about the actual degree of digitalization in Slovakia.

Data provided by users (customers) and then processed and used in multinational companies´ strategy have their source also in Slovakia. However, due to the size of the country, they are not as important as the data collected in large countries. Nevertheless, some of those data are sold to other companies and used to increase their profitability (which can be a potential tax base somewhere).

A key role of intangible assets in the digitalized business processes is a common tendency in all developed countries, and Slovakia is not an exception. However, reporting on the structure of intangibles in accounting documents is very poor (Bernadič, 2016), and in Slovakia it is probably worse than in some other EU countries. In this area, there is a lot of problems to be (collectively) solved in connection with the potential CIT tax base harmonization.

Probably, the main reason why a discussion on macroeconomic impact of digitalization (in the field of fiscal policy, possible inflation behavior, etc.) is not developed in Slovakia is the lack of statistical data on the actual situation (Fabo, 2018). Sometimes this role is underestimated and sometimes overestimated by mechanical transfer of tendencies and proportions from large developed countries. A lot can be done in collecting the necessary statistical data.

6 Conclusions

The concept of permanent establishment is one of the key issues in international taxation, very important not only for the practical fiscal policy but also for the theory. Knowledge management is a discipline where the theoretical contribution of these discussions can be valuable. Although achieving an international consensus on the basic principles of taxation in the digitalized era can be a long-term process, some theoretical and "knowledge" lessons from these discussions can be learnt immediately. Perhaps the most important are *the knowledge increasing and knowledge sharing lessons*.

Taxation itself is a knowledge-based activity - both from the government taxing authorities' point of view and from the point of view of companies that are continuously looking for new ways of tax optimization. Sharing of this knowledge between governments is very important. Moreover, the discussion on the (ir)relevance of the PE concept itself provides a lot of information about the recent approaches of the global business players in the field of digitalization.

Another important theoretical lesson (actually of an interdisciplinary character) is *the role of human capital* - its skills, extreme mobility, new types of motivation, etc. It can be said that a *new type of a knowledge worker* is formed in digitalized business models (or digitalized organizations in general). Companies are making use of the new talent grown anywhere in the world and realize that it is important to adjust their HR policies and sometimes even organizational structure and organizational culture to new demands. However, knowledge workers of a new type do not appear automatically. They are to be educated by the formal education system, different forms of training courses in the companies, "learning by doing" and

practical experience. The role of governments in supporting the digitalization process within their countries means not only creating the digital infrastructure but also creating such an institutional and economic environment in the country that will motivate new types of knowledge workers to stay in their (home) country or come back after gaining some international experience.

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