THE DIGITAL PERMANENT ESTABLISHMENT CONCEPT IN INTERNATIONAL TAX LAW

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Abstract

With the digitalization of the economy, digital business activities carried out by multinational companies (MNCs) have begun to take an important place in general economic activities. Accordingly, cross-border mobility of digital goods and services has increased, and production and structuring based on intangible assets has gained importance. Importantly, it has become possible for MNCs to operate in more than one country without the need for a physical presence. This has resut in the inability of the states of sources to tax the profits derived from cross-border digital business activities. The concept of permanent establishment (PE), which tax nexus between profit and the state of source has been shown as a primary justification.

The concept of PE is used to include a fixed place where the economic activity is carried out and a dependent agent to be considered as a PE. At this point, the PE requires the physical presence of the MNCs in the source country. This leads to the conclusion that the concept of PE, which requires physical presence, does not provide an adequate tax nexus.

For the aforementioned problem of taxation of digital business activities, various proposals were made in OECD's BEPS Initiative, which was initiated in 2013, the package titled "Fair Taxation of the Digital Economy" published by the European Commission in 2018 and OECD's Two Pillar Approach (BEPS 2.0) which was introduced in 2020. The concept of the digital PE based on significant economic or digital presence are within the scope of these proposals.
With this study, it is aimed to discuss the concept of the digital PE proposed as a tax nexus in the taxation of profits from digital business activities carried out by MNCs. In line with this purpose; recommendations, proposals and determinations of international organizations and institutions, especially OECD and European Commission, national regulations and national and international tax law doctrine. In this study, it has been concluded that the current PE concept is insufficient to link tax nexus with the source country, since MNCs operate without physical presence and The digital PE concept, which is correctly defined and bordered at the point of eliminating this deficiency, will provide the needed connection, but it needs consistent national practice and international acceptance.

Keywords: Digital, permanent establishment, tax nexus, economic presence, digital presence
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1. Introduction

Nowadays, companies, whether national or multinational companies, are taxed on their profits from their activities. The sources from which companies gain profit are economically diverse. For example; profit can be gained from capital, as well as from labor or land. In MNCs where economic activities are internationalized, capital, labor, land and entrepreneurs can be located in different countries (Richter, 2019: 4). Likewise, MNCs can operate in more than one state in the process from idea and branding to marketing towards a good or service. Accordingly, MNC's profits can spread to more than one country (Ordower, 2021: 129). The spread of MNC's profits to more than one country depending on the mobility of production factors and activities may result in taxation of profits by more than one states (Christians, 2012: 1414-1415). At this point, MNCs may be faced with double taxation and international tax law should be get involved in order to prevent this situation. In the international tax law, the rules by which one of the states agrees to give priority to the other in taxation of profits come into prominence (Ault, 2013: 1197).

The traditional approach to taxing the profits of MNCs is to subject it to business taxation on returns from its investments in the jurisdictions. In this context, it is accepted that MNC's profit theoretically can be taxed in four jurisdictions: (1) country where the shareholders reside, (2) Country where the headquarters is located, (3) Country where the affiliated businesses and PE are located, and (4) Country where customers reside or goods and services are sold to final consumers (Devereux & Vella, 2018: 5). However, international tax law requires a genuine link between taxable income and the state for the allocation of taxing power, i.e. tax nexus. The tax nexus is used to refer an adequate link between the state and the taxpayer and often grouped on the basis of the taxpayer's political or economic allegiance to the state (Lang, 2021: 23-24).

Tax nexus consists in economic allegiance with source and residence principles in the taxation of profits. First of all, the principle of residence comprises the link between a resident state and the taxpayer and justification for the tax claim on the taxpayer's worldwide income (Monsenego, 2012: 76). The source principle is considered as a secondary link (especially in the taxation of profits from cross-border activity), while the residence principle refers the primary link in the taxation of profits. According to the source principle, a taxpayer (even if not resident) can be taxed on the profits gained in the jurisdiction of the source state (Nemchenko, 2021: 22). As a rule, the profits of a non-resident taxpayer in the jurisdiction is considered by way of the PE (Elliffe, 2021: 6-7).

In international tax law, the concept of PE is defined as including all facilities or buildings needed for business purposes or employees who carry out some important activities related to the company, in other words, based on physical presence (Nemchenko, 2021: 27). However, it is stated that the current PE definition does not fulfill the needs with the digitalization of the economy. This is explained by the increase in activities called digital services and digital business models that allow MNCs to operate in markets without a physical presence (Fuest, 2020: 9). MNCs can operate without a PE, market

goods or services, and carry out international cross-border transactions virtually as a result of the use of digital technology. For example, a MNC can operate in a market jurisdiction without any physical presence through a website, as in online advertising and social networking platforms. Moreover, these activities can be operated without human interference with technological developments such as cloud computing, big data analytics and artificial intelligence (Terada-Hagiwara et. al., 2019: 3). Because current international tax rules allow the source state to tax the profits of non-residents only if it establishes a PE in the form of a fixed establishment or permanent representative (Richter, 2022: 2). Proposals for the digital PE based on significant economic or digital presence are suggested for this reason.

2. Permanent Establishment (PE) Concept in International Tax Law

It is possible to determine the definition and scope of the PE concept within the framework of the Model Tax Conventions (MTC) designed for the prevention of double taxation. However, considering the subject of the study, it would be more appropriate to consider the concept of PE only through the OECD's MTC.

The concept of PE is defined in the first paragraph of Article 5 of the MTC. Accordingly, the PE means "*a fixed place of business through which the business of an enterprise is wholly or partly carried on*". The fixed places to be considered as PE are specified illustratively in the second paragraph of Article 5 of the MTC. According to this, the scope of the PE includes "*place of management, branch, office, factory, workshop, mine, oil or gas well, quarry or any other place of extraction of natural resources, building site or construction or installation project only if it lasts more than twelve months*".

The issue of whether the permanent representative will be accepted as a PE is specified in the fifth paragraph of Article 5 of the MTC. According to this;

> "*…a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are a) in the name of the enterprise, or b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or c) for the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State…*"

In the light of this information, it can be said that the concept of PE is divided into three categories in Article 5 of the OECD's MTC. The first category is the "*physical location/situation*" criteria defined in paragraph 1 and specifically listed in paragraph 2 (place of management, branch, office, etc.). The second category is the "*deemed contract or relationship*" criterion. This includes the permanent representative rules discussed in paragraph 5 of Article 5. The third category is the criterion of "*temporary or physical presence*". This requirement is in parallel with the physical location criterion. In paragraph 2 of Article 5, it is stated that a construction site will be considered a workplace if the construction or installation project lasts at least 12 months. At this

point, it is accepted that a PE should have a certain degree of continuity and should not be completely temporary by definition (Elliffe, 2021: 92).

In this respect, it seems possible to say that the PE generally indicates a temporary, stable geographical/physical connection with a state (Nemchenko, 2021: 27). Therefore, the presence of buildings such as offices, factories or facilities and employees performing activities that clearly demonstrate that they are a crucial part of the business requires physical presence (Navarro, 2022: 3).

3. Inufficiency of PE Concept Against Digitalisation

It is stated that with the digitalization of the economy, the current international tax rules are insufficient in terms of taxation of profits. At this point, it is argued that the current PE definitions do not meet the requirements. The main reason for this is digital activities and digital business models that allow MNCs to operate in markets without a physical presence (Fuest, 2020: 9). For example; in business-to-user models, although some minor activities such as data collection, customer support, local marketing are carried out at the users location, the main link to taxation is in the country of residence of the parent company which enters into direct contractual relationships with users. While current rules attribute profit to the company that develops and maintains its information technology infrastructure and software for tax purposes, significant profits is not attributed to the parent company's PE. Moreover, there is no allocation of taxing power to market states where there is no PE. In business-to-business models, current tax rules attribute most of the profits for tax purposes to the parent company that develops, appropriates, and maintains information technology infrastructure and software. If there are businesses, a small part of the profits are attributed to them, depending on the sales agreements with the customers. Moreover, there is no allocation of taxing power to market countries where there is no PE. Solution proposals for this problem bring forward the allocation of taxing power to market states with the concept of digital PE (Elliffe, 2021: 85).

4. Theoretical Basis of Digital PE

Theoretically, it is stated that a state can tax non-residents in terms of two basic principles/approaches, even if it does not have a physical presence. The benefit principle and value creation based on the economic allegiance of non-residents. First of all, The benefit principle necessitate the allocation of taxation authority to a state if it contributes to the conduct of business activities in its jurisdiction (Li et. al., 2019: 13). It is recognized that a state contributes to be carried out digital activities in three areas:

(1) C*ontribution to technological infrastructure*: This includes individuals with appropriate devices such as appropriate telecommunications infrastructure, Wi-Fi and broadband, and computers and smartphones.
(2) *Contribution to the legal system*: This includes payment for business transactions, promoting intellectual property rights such as trademarks and ensuring a competitive and favorable business environment.

(3) *Contribution of users to digital activity*: This includes users' utilization of social media such as designing or providing content and their contributions to direct and indirect network effect, such as utilization of user datas by companies in activities such as targeted advertising (Elliffe, 2021: 33-34). In the light of this information, when a non-resident company benefits from the areas where it contributes to the market state, it can underpin for the taxation based on the benefit principle.

Secondly, value creation is accepted as a new version or view of the benefit principle (Hey, 2018, 204). As a rule, value creation is used to refer profit, and it is stated that the factors that play an active role in the creation of profit in terms of allocation of taxing power should be taken as a basis in taxation. These factors can be attributed to the activities undertaken by the employees, the effect of the market, legal, physical and technological infrastructure. At this point, it allows connection without physical presence in the taxation of digital MNCs, especially due to the effect of the market/customers/users (Elliffe, 2021: 37).

5. Proposals for Digital PE

5.1. OECD's BEPS Initiative

In its final reports on BEPS Action Plans in 2015, the OECD did not directly include a proposal for the digital PE. However, in the draft of discussion of BEPS Action 1 dated 24.03.2014. It was suggested that fully dematerialized digital activities could generate a (digital/virtual) PE if digital MNCs do not have a physical presence in a country but maintain their digital presence in that country's economy. According to this approach, factors such as the frequency of digital transactions and the number of users can be considered in the acceptance of digital presence, and a website can be considered as a digital/virtual PE (OECD, 2014).

5.2. European Commission: "Fair Taxation of the Digital Economy"

The European Commission published a package titled "*Fair Taxation of the Digital Economy*" in 2018 in order to harmonize the taxation of profits and value creation. This package mainly consists of two proposals. The first proposal includes the realization of a joint reform of the corporate tax rules for the creation of significant digital presence in addition to the existing PE rules. In this context, the concept of digital PE in article 4 of the proposal is based on the acceptance of an important digital presence as a new nexus for corporate tax. In this context, all companies that are taxpayers anywhere in the world are considered to have a significant digital presence if they provide digital services through a digital interface and meet one or more of the following conditions (thresholds):

(1) The proportion of annual revenue from the supplied of digital services to users in a Member State exceeds EUR 7.000.000,

(2) The number of users of one or more of those digital services who are located in a Member State exceeds 100.000,

(3) The number of business contracts for the supply of any such digital service that are concluded by users located in a Member State exceeds 3 000.

Finally, in terms of the thresholds set in 1 and 2, if a user uses a device to access the digital interface where digital services are provided and the state in which the device is used can be determined by that device's IP address or any more accurate geolocation method, the user is deemed to be resident in that state (European Commission, 2018).

5.3. OECD's Two-Pillar Approach

The Two Pillars Approach (BEPS 2.0), which was discussed by the OECD in January 2020, essentially follow the goal of reallocating taxing powers across jurisdictions on a global scale (Schön, 2019: 1). BEPS 2.0 essentially contains a two-pillar structure. Pillar One focuses on the allocation of taxing powers on MNC's profits at the international level, and focuses on reviewing the tax nexus rules. Therefore, it is possible to say that the Pillar One is directly related to this study (OECD, 2019a).

The Pillar One under BEPS 2.0 deals with the introduction of new criteria (thresholds) for the taxation of (digital) MNCs to determine the economic allegiance with jurisdictions and the allocation of taxing powers to market jurisdictions. This approach aims to transcent the requirement of physical presence. Regarding the Pillar One, OECD came up for discussion three different proposals regarding the allocation of powers (OECD, 2019b):

(1) *User participation proposal*: It focuses on the value created by MNCs having a relevant and significant user base and requesting data and content from users. This offer applies to highly digitized MNCs where user participation is a critical component of value creation: For example; such as social media platforms, search engines, online marketplaces.

(2) *Marketing intangibles proposal*: This proposal which focuses on all MNCs, whether highly digitized or not, addresses situations where a group of MNC to reach a jurisdiction through a remote or limited local presence to develop a user base and marketable intangibles. At this point, it envisages the allocation of taxing power to jurisdictions where intangible assets linked to a foreign company's customer base generate profits.

(3) *Significant economic presence proposal*: This proposal recognizes that a non-resident MNC has a significant economic presence based on factors that attest to its interaction with a jurisdiction through digital technology. At this point, it is considered sufficient (1) existence of a user base and related data entry, (2) the capacity of digital content produced in the jurisdiction, (3) billing and collecting in local currency; (4) maintaining a website in the local language; (5) responsibility for the final delivery of goods to customers or providing other support services such as after-sales service, repair and maintenance by the

business, or (6) ongoing marketing and sales promotion activities, online or otherwise, to attract customers for the acceptance of an important economic presence.

In the light of these proposals, OECD has proposed a new nexus rule for the allocation of taxing power to market states: If the MNCs gain at least EUR 1.000.000 in profit from the market jurisdiction, the profit is allowed to be allocated to the jurisdiction, but for jurisdictions with a GDP less than 40 billion euros, the nexus rule is set at EUR 250.000. While calculating the profit, the last market jurisdiction where the goods or services are used or consumed are considered (OECD, 2021).

6. Conclusion

With the digitalization of the economy, MNCs add a new dimension to their business activities with new digital business models: MNCs can carry out its activities without the need for a fixed place such as a building, facility or a person such as a permanent representative in a state. Depending on this situation, the current PE concept in international tax law, which establishes the tax nexus between the state and the taxpayer, becomes disputable in the taxation of non-resident taxpayers. Because the concept of PE is defined and its scope is determined based on physical presence in current international tax law rules. Therefore, states cannot tax profits from business activities carried out without a physical presence in their jurisdictions.

This problem, which arises in terms of taxation of profits, brings with it digital PE proposals based on significant economic or digital presence in terms of certain thresholds/factors. Primarily significant economic or digital presence refers to the purposeful and continuous interaction of a MNC with a jurisdiction through digital services provided by digital technology or the users to whom the services are provided. The acceptance of an economic or digital presence as a digital PE is determined according to predetermined thresholds (based on profit from jurisdiction or users in jurisdiction) that refer to digital business activity.

In the light of this information, the concept of digital PE can be defined as a workplace that is considered to exist (virtually) for taxation purposes, but it does not exist physically, if a company's digital business activities for users in a jurisdiction reach a certain weight and importance depending on the threshold and factors such as the number of users, total revenue, website, etc.

At this point, it should be emphasized that the tax thresholds and factors required for the acceptance of the digital PE have been determined differently by the OECD and the European Commission at different times, and each one is open to discussion. However, it would be appropriate to state that the concept of the digital PE needs stable national practices and international acceptance. Also the dimension that the OECD BEPS 2.0 Initiative brings and will bring to the concept of the digital PE, depending on negotiation and analysis, is important.

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