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ISSUES OF ATTRIBUTING TAXABLE PROFITS IN THE FIELD
OF ELECTRONIC COMMERCE

E.V. Rybakova (a), M. A. Nazarov (b)*, V. S. Charikov (c)

*Corresponding author

(a) Samara State University of Economics, 443090, Soviet Army Str., 141, Samara, Russia, e_ryb@bk.ru

(b) Samara State University of Economics, 443090, Soviet Army Str., 141, Samara, Russia, good_mn@mail.ru

(c) Samara State University of Economics, 443090, Soviet Army Str., 141, Samara, Russia, nalogi_audit@mail.ru

Abstract

The purpose of this paper is to study the issues of attributing profit related to permanent establishment for companies engaged in e-commerce sector. In recent years, issues of reforming the e-commerce taxation have caused widespread discussion both at the Russian and international levels. Given that the economic processes in Russia are going in the same direction as in other countries, in the near future we can expect rapid development of e-commerce, and the aggravation of problems associated with its taxation. Therefore, now it is necessary to assess the consequences and take measures to minimize possible budget losses. To minimize base erosion and profit shifting, profits have to be taxed in the jurisdiction where value is created. The main problem here is the fact that the category of “value” is subjective and as a result sensitive to manipulation. The paper discusses the methods of attributing profits to a permanent establishment which are used in international practice and conducts a comparative analysis. The question is being examined whether it is possible to find an optimal approach to taxation of permanent missions in the digital sector of the economy within the framework of existing approaches. The research is based on both academic and practical literature.

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1. Introduction

The category of permanent establishment is the basic one when taxing the income of organizations operating in the territory of other states which is used both in the national legislation of countries and international agreements. The rapid development of e-commerce results in the fact that the approaches existing in international taxation do not meet the realities of the economy.

E-commerce is a set of technical and organizational forms of financial and trade transactions carried out using electronic systems (Komarov & Prokopyev, 2017). One of the most difficult questions in taxing e-commerce transactions is how to determine their role in the formation of the tax base and the necessary extent of bringing them to tax liability. The tax authorities are faced with some problems such as erosion of the tax base and shifting of profits to low-tax jurisdictions, as well as insufficient taxation of companies engaged in the digital sector of the economy due to the inconsistency of existing concepts with the realities of modern business.

2. Problem Statement

The main feature of a permanent establishment is the physical presence in the country of operation which sometimes may be difficult to identify in electronic commerce. This feature creates the greatest difficulties in relation to taxation of a business located in the digital space.

The modern tax system has faced the problem of inconsistencies in the interpretation of the permanent establishment concept with the modern economic realities. A key problem in taxing e-commerce transactions is that corporations can make a profit in a jurisdiction using digital business tools without physical presence in that jurisdiction. The most common model is the sale of various digital products such as books, music, photographs, software on the websites (Nazarov, Mikhaleva, & Fomin, 2019).

In this context, there arises a question regarding how the profits received by multinational corporations should be distributed between the countries on which territory this profit was received, and how to determine the share of profit attributable to jurisdiction in conditions when the amount of value created on the territory cannot be clearly defined.

3. Research Questions

This study explores the following issues:

- Definition and review of the methodology for classifying profits to a permanent establishment according to the arm's length principle;
- Consideration of the possibility of applying the method of profit distribution to the permanent establishment in the digital economy;
- Consideration of the formula-based profit distribution method in the context of permanent establishment in the digital economy;
- Proposing measures to reform international legislation regarding e-commerce taxation.

4. Purpose of the Study

The purpose of this study is to examine the modern approaches to the distribution of profits to permanent establishment which are used in Russian and international legal practice. The article provides a comparative analysis of these approaches in the context of taxation of companies engaged in the field of electronic commerce. The question examined is whether the existing methods for attributing profits are suitable for modern business models based on the use of digital technologies.

5. Research Methods

The following research methods are used in the article:

- Empirical methods (comparison, observation)
- Theoretical research methods (analysis, abstraction, induction)
- Diagnostic methods (diagnostic analysis of the condition and causes).

6. Findings

Countries exercise its right to tax income depending on the jurisdiction of the source of the income. If a non-resident has a permanent establishment in the source country, then the income becomes the object of taxation in such a source country.

Article 5 of the OECD Model Double Taxation Avoidance Agreement sets two ways to create a permanent establishment: either through a “fixed place of employment” or through the activities of a dependent agent. Double taxation avoidance agreements usually state that an entity’s profits attributable to a foreign permanent establishment may only be taxed in the state in which the permanent establishment is located. The way in which profits related to the permanent establishment should be determined is the subject of a long discussion that has not yet been resolved. The Organization for Economic Co-operation and Development (OECD) seeks to clarify this issue through its “Authorized OECD Approach”, known as the AOA or “Independent Enterprise Method” (OECD, 2014).

The following simplified example illustrates how using of AOA can affect the distribution of profits between the permanent establishment and the head office.

A permanent establishment in a country of a head office located abroad develops new products for the head office. Earlier, for the purpose of calculation the profits of a permanent establishment, the expenses actually incurred as a result of such development activities had been considered. In accordance with the AOA, the terms of an arm’s length principle (ALP) apply for the purpose of pricing transactions between the head office and the permanent establishment. Thus, a permanent establishment does not carry out development activities simply in exchange for reimbursement of expenses incurred as a result of such activities. Instead, the compensation payment should be calculated in accordance with the transfer pricing rules (Koomen, 2015).

E-commerce allows to achieve a very high level of integration between scattered around the world individual business units or groups of enterprises that perform various production and trading functions. This circumstance, in turn, significantly complicates the use of traditional methods of transfer pricing and income distribution between enterprises and their divisions. Today, neither the OECD nor individual

states have developed special transfer pricing rules for e-commerce. In this regard, it should be recognized that e-commerce has not yet presented a fundamentally new problem for transfer pricing, but it definitely has exacerbated the existing ones. At this stage, we should talk more about adapting the practice of applying the existing transfer pricing rules to the realities of the “new economy”, and not about developing fundamentally new rules specifically for e-commerce. As an example of such an adaptation, we can cite recommendations on taxation of global trade in financial instruments. In relation to this type of activity, the OECD gives priority to the method of splitting (distribution) of profit, while traditionally this method is used last (Morse, 2018).

Firstly, PSM, being a bilateral (or multilateral, if there are more than two participants) method, allows you to take into account the features of closely integrated business models in which the contribution of each of the participants is unique and highly valuable. In this case, the transaction (a set of interconnected transactions) is analyzed as a whole, in contrast to most traditional methods, in which only the execution of one of the parties is artificially distinguished and subjected to study.

Secondly, PSM can be used in the analysis of such types of transactions that, in principle, are unusual for the relations between independent participants. In such cases, data on comparable transactions is usually not available, which makes it impossible to use other methods. The method under consideration is, in principle, applicable in case of the absence of information on market prices or profitability.

As for the weaknesses of the method, they include, first of all, the relative subjectivity inherent in it, which is caused by the fact that PSM tends to use the internal taxpayers' data as well as the data of its dependent persons, in contrast to other methods, which are designed mainly for external data.

An alternative to ALP is the concept of a formulary apportionment of the tax base. This concept provides a proportional distribution of the tax base of a transnational group of companies between its members located in different jurisdictions. The profits are distributed on the basis of a pre-established formula, which, as a rule, includes such indicators as assets, labor costs, revenue, etc. For the purposes of distributing the tax base of a group of companies, the use of FA is possible only in the case of calculating the total tax base for the group as a whole, i.e. for tax regimes of groups based on tax consolidation (Sánchez, 2018).

However, to date, in practice, FA is used more often for the purpose of distribution the one company's tax base between its separate divisions. In particular, the FA mechanism is used to distribute the tax base for regional corporate income tax in the United States and Canada, as well as for other corporate taxes with a similar taxable income object in Japan, Italy and Germany (Larking, 2018).

In recent years, the question of the possibility of FA concept application has been reflected in several papers which are dedicated to the issues of group taxation and the search for the optimal approach to control over transfer pricing.

Using the FA concept has several advantages over ALP, in particular:

- 1) FA is more universal, because, unlike ALP, it does not require the elaboration of detailed methods and approaches to each type of operations performed between associates;
- 2) FA is more stable and less susceptible to manipulation, since it is usually based on indicators whose value is difficult to distort (number of employees, labor costs, value of tangible assets);

3) FA is more efficient and less costly in practical use, since it does not require a resource-intensive comparative analysis and a detailed study of the approach for each type of operation.

A significant drawback of this concept in relation to electronic commerce is the complexity of an objective assessment of the role of intangible assets. Thus, the European Commission proposed to exclude intangible assets from the calculation formula, without proposing a satisfactory solution in return. It should be noted that if the market valuation of intangible assets became part of the distribution formula, it seems unlikely that such an approach would be easy to comply with.

Three main solutions to the problem which are possible at the nearest future can be noted:

- To oblige companies to show part of the profit in the countries of residence of users, even if they do not have an office there. The problem is how to determine precisely what proportion of the profit falls on a country.

- Recognize intangible assets as created in the country where the company operates. A country will be able to tax all or part of the profits from such assets. The remaining will be distributed among the company divisions according to the transfer pricing rules.

- Determine the degree of economic presence of the company in a particular country depending on the size of revenue, availability of a local user base, support for the site in the national language, online sales, etc. Incomes of companies with significant economic presence may be taxed at the source of payment, but so that double taxation does not occur.

Until the OECD (2018) has developed a common approach to regulate the rapidly growing digital economy, some countries make their independent decisions.

The European Commission in 2018 proposed the introduction of a three percent digital tax on the local revenue of digital giants in the EU. France became the first country to introduce such a tax (retrospectively from January 1, 2019). Tax at a rate of 3% is paid by digital companies with total revenues worldwide from € 750 million, more than € 25 million of which were brought by French users. Not all global income is taxed, but only that part that is generated by the clients of a particular digital service in France. To determine the location of users, digital companies must track their IP addresses.

In the UK, digital tax will begin to be levied from April 2020, in Italy - from January 2021.

Another tool to solve this problem may be the international exchange of data on the operations of transnational companies CbCR (Country-by-Country reporting). These reports are designed to disclose financial indicators by country of presence. However, countries exchange reports only on the activities of groups with a total annual turnover of more than € 750 million. This is a huge threshold, and the data of many digital companies do not fall into the reports.

7. Conclusion

The above analysis suggests that the optimal approach to solving the problem of attributing profits to permanent representation in the digital economy can be found within the framework of existing transfer pricing and profit distribution methods based on the formula.

The use of ALP as a way of distributing the group's tax base is useful for group taxation regimes based on approaches that do not require determining the total tax base for the group as a whole, i.e. models based on the autonomous calculation of the tax base and the transfer of financial results. ALP is

organic when considering a group of companies as a whole without taking into account the synergistic effect obtained by the group from joint functioning.

Despite the distinct advantages of the formulaic method, the possibility of its application to the distribution of profits of multinational companies is limited due to the practical complexity of implementing a single approach that would suit many countries at the same time. Nevertheless, the use of this method significantly reduces the possibilities of manipulating profit and transferring assets to low-tax jurisdictions. For example, the company can freely decide where to place rights to intangible assets, but it cannot move the location of its users without harming the business.

The proposals put forward by both the OECD and the EU Commission cover a much wider spectrum and raise the question of the need to change the balance between the source and tax at the place of registration of the company, which is currently used to distribute profits.

Thus, by the end of 2020, a comprehensive development is expected to address the issue of taxation of the digital economy. It is expected that a final solution to these issues will be ideal to ensure a coherent, promising international tax system that will not impede investment and growth while ensuring fair taxation.

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