Switzerland – The new concept of the Permanent Establishment in the digitalized economy

The present article is based on one of the subjects treated during the 2020 Annual tax conference of the International Association of Young Lawyers (AIJA) which was called "Keeping up with the tech - Is technology a friend or a foe for tax payers and tax practitioners?" and took place in Malta from 5 to 7 March 2020 in the context of the panel **"Latest developments in the taxation of digital economy: user value creation and taxation".**

The tax challenges of the digitalisation of the economy were identified years ago, as one of the main areas of focus for the OECD's Base Erosion and Profit Shifting (BEPS) project, since digitalisation has created opportunities for aggressive tax planning through the shift of profit of multinational entities (MNE) to zero or low tax jurisdictions, leading to tax avoidance and loss of tax revenue by the governments.

One of the most far-reaching outcomes of the BEPS project is the modification of the definition of a permanent establishment (PE). The present article deals with the key changes brought to the definition of the PE in the new digitalized world.

A permanent establishment is a presence of an enterprise in a foreign state which is sufficiently significant that the foreign state is allowed to tax the profits generates by such permanent establishment,

The most distortive feature of the digital economy is that physical presence is no longer needed to address customers in another country and the traditional international tax principles originated in the era of bricks and mortar have become obsolete in dealing with the modern global economy.

This issue is addressed at various levels on an international scale, namely:

- **By the OECD:**

- Through the Action 1 BEPS: the OECD's Final Report on Action 1 identified several routes to address the taxation issues raised by the digital economy business models, including a new "nexus" definition relying on significant economic presence. However, no recommendation was issued in this respect.

- Through the Action 7 BEPS: the Final Report recommended amendments to the PE definition implemented through the Multilateral Instrument (MLI) in all covered tax treaties, but countries can issue reservations, notably on the implementation of PE clauses. Cf. amendments to art. 5 MC OECD below.

- **By the EU through two Directives (2018):**

The EU Digital Services Tax: would introduce a 3 percent tax based on revenues of digital service providers with annual worldwide revenues and annual taxable revenues in the EU exceeding certain threshold amounts. This tax is designed as an interim measure to be implemented until the second comprehensive long-term measure is implemented:

The EU Significant digital presence concept: addresses a digital PE. A new taxable nexus would be introduced to address the situation of digital businesses operating across border in case of a non-physical commercial presence. There is a list of conditions concerning the total revenues, numbers of users, etc. to be

met to fall under this concept. The Profit Split Method is also advocated by the EU Proposal in this respect.

- **Through various country level initiatives:** for instance, Israel, India, Italy, etc. (other example: deemed PE in Thailand or Indonesia: deeming a PE for overseas providers of digital services into the country);
- **Indirectly** addressed through the BEPS Actions on **Transfer Pricing:** Actions 8 to 10 on Aligning Transfer Pricing Outcome with Value Creation and Action 13 on Transfer Pricing Documentation.

The OECD considered the following specific taxing options for the digital economy:

- taxing nexus in the form of **significant economic presence**, i.e. creating a virtual PE: even if it does not have an office, store or physical presence, a business may be eligible to pay tax by virtue of an online and/or economic presence;
- a **withholding tax** on certain types of digital transactions; and
- an **equalisation levy**, i.e. a tax imposed on the turnover of non-resident businesses with a significant economic presence as a means of ensuring equal treatment for domestic and foreign businesses.

The following key amendments to **art. 5 of the OECD Model Convention** were developed through the work on the Action 7 and included in the MLI:

- *Specific activity exemptions and anti-fragmentation rules*

Under the previous regulations, a PE was deemed not to exist when a place of business was engaged solely in certain auxiliary activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing of goods or merchandise, collection of information).

Now, the exclusion will apply only when these activities are **preparatory or auxiliary** in relation to the business as a whole. A preparatory activity can be described as "carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole", whereas an auxiliary activity is described as *"carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole"*.

It is thus important to assess whether the activity carried out by the place of business in itself forms an essential and significant part of the overall activity of the enterprise and if the general purpose of the activity performed by the place of business is the same as the general purpose of the whole enterprise. For companies operating in the Retail & Consumer industry, activities such as purchasing or warehousing typically correspond to the company's core business activities and thus these companies may no longer benefit from the existing activity exemptions.

Anti-fragmentation rules have also been introduced to prevent the breakup of an operating business into several small business units in order to benefit from the preparatory or auxiliary exemptions, i.e. the activities performed by different related parties are to be analysed on an aggregated basis when assessing whether they can be regarded as of a preparatory or auxiliary nature.

- *Dependent agent PE / Artificial avoidance of PE establishment status through commissionnaire arrangements*

Under the previous rules a PE existed when an agent acting on behalf of a foreign enterprise habitually exercised authority to conclude contracts in the name of the enterprise, unless the agent was an independent agent (legally and economically) acting in the ordinary course of its business.

The definition was subsequently widened by the OECD and also included situations in which an agent habitually played the principal role leading to the conclusion of contracts that were then routinely concluded

without material modification by the enterprise, i.e. the case of a person who convinced the third party to enter into a contract with the enterprise and acted as the sales force, unless the commissionaire performed these activities in the course of an independent business.

The requirements for an agent to be considered “independent” were narrowed, such that this will not be the case where the agent acts exclusively or almost exclusively (90% or more) for one or more enterprises to which it is closely related. Specific examples of possible independent agents: the broker and general commission agent have been removed.

All in all, it is important for MNEs to review their group structure in order to make sure whether entities present in certain countries risk to be qualified as PEs, in view of the changes described above, with all the tax consequences which this would entail. Indeed, in some recent court cases (e.g. India vs. MasterCard Asia Pacific Pte. Ltd, June 2018, AAR No. 1573 of 2014) the tax authorities showed themselves quite aggressive in this regard and set a worrying precedent for multinational companies operating in the country.

We regularly advise our clients on these current international tax issues and are happy to discuss any questions or comments you may have in this regard.

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