

Direct taxation of the digital economy

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Abstract. The objectives of the study are to analyze the future of direct taxation of the digital economy in the field of corporate income tax. Digitalization has grown steadily, spreading to all areas, especially the economic sector, i.e. the economic activity carried out by taxpayers. In this context of development of the digital economy not only at a national level, but also at the European or global level, there is a need to analyze which state is responsible for taxing the profits obtained through the digital economy. The main research tools were the legal provisions on direct taxation, the literature analyzing and interpreting this field, and the identification of conclusions from the specific practice of taxpayers who have encountered problems, have asked the same questions or perhaps have found the answers necessary for this research. The implications of the study are both theoretical and practical. The topic aims to analyze a modern direct taxation mechanism. On the other hand, companies and countries will be able to determine where the tax has to be paid by the taxpayer.

1 Introduction

This study requires in advance answers to the following questions – what is ‘direct taxation’ and what does the ‘digital economy’ mean?

1.1 Direct Taxation

Taxes are classified as direct tax and indirect tax, where the former is levied directly on the profit/income or wealth of the taxpayer, while indirect tax is imposed on the price of goods and services [1].

Direct tax, which is the subject of this paper, therefore refers to the tax levied on the profits of legal persons or on the income of micro-enterprises or on the income of individuals who are both taxpayers in the sense of payers (those who pay the tax) and payers in the sense of payers (those who bear the tax).

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A brief distinction should be made here between corporation tax, which is a direct tax, the taxpayer being both the person who pays and the person who bears the corporation tax, and VAT, which is an indirect tax paid (effectively to the state budget) by the person collecting the VAT but borne by the final consumer. Indirect tax is levied on the person who consumes the goods and services and is paid indirectly to the budget.

Thus, in what follows we will analyse direct taxation of the digital economy, referring in particular to the subject of corporate income tax, providing the opportunity for the analysis of indirect taxation of the digital economy, namely the application of VAT, to be dealt with on another occasion in a separate research.

1.2 Digital Economy

Digital economy, at a first glance, could be equated with e-commerce, but in reality, when we talk about the digital economy, we must bear in mind that economic activity is not just about e-commerce, but is carried out through several channels such as telecommunications, audiovisual, software, computer networks, computer services, online services and content.

The digital economy involves a range of economic processes, transactions, interactions and activities that rely on digital technologies, and this economic activity conducted through various digital channels should be taxed.

This paper aims to establish how to tax the profits made by corporate taxpayers through the digital economy.

2 The importance of direct taxation of the digital economy

In recent years, digitalization has grown steadily, spreading to all areas, especially the economic sector, i.e. the economic activity carried out by taxpayers. The existence of travel restrictions during the pandemic period has considerably affected economic activities carried out in physical format and has accelerated this process of digitalizing the economy, with more and more corporate taxpayers carrying out their activity online. Taxpayers, once familiar with the digital economy which offers a whole range of advantages, as they will have access to more information and will reduce costs, they will have to comply from a tax point of view [2].

It should not be forgotten that the EU Economic Recovery Plan requires each Member State to allocate at least 20% of its budget to the digital switchover [3].

In this context of development of the digital economy not only at a national level, but also at the European or global level, there is a need to analyze which state is responsible for taxing the profits obtained through the digital economy.

3 Legal framework

According to art. 13 para. (1) of the Romanian Tax Code, the following categories of persons are obliged to pay corporate income tax in Romania:

‘a. Romanian legal persons, with the exceptions provided for in art. 13 para. (2) of the Tax Code;

b. foreign legal persons carrying on business through a permanent establishment/several permanent establishments in Romania;

c. foreign legal persons resident in Romania according to the place of effective management;

(...)

e. legal entities with a registered office in Romania, established under European legislation’.

Thus, according to art. 7, item 29 of the Romanian Tax Code, a Romanian legal person is any legal person that has been established and operates in accordance with Romanian law. According to the methodological norms for applying the Romanian Tax Code, this category of legal persons includes national companies, national corporations, autonomous regions, companies - as regulated by Law no. 31/1990 on companies - regardless of the legal form of organisation, including those with foreign capital participation or wholly foreign capital.

4 Fixed establishment

A ‘fixed establishment’ includes a place of management, a branch, an office, a factory, a shop, a workshop, as well as a mine, an oil or gas well, a quarry or other natural resource extraction site.

A fixed establishment involves a construction site, construction project, assembly or erection or related supervisory activities only if the site, project or activities last more than 6 months.

The fixed establishment thus implies a physical presence of the foreign legal entity on the territory of Romania, and the Romanian tax system does not currently consider that the permanent establishment is represented by an online platform, a domain with the ‘.ro’ ending, which represents not a physical presence but a digital (online) presence on the territory of Romania of the foreign legal entity.

Although a location at which automated equipment is operated by a company may constitute a permanent establishment in the country in which it is situated, a distinction must be made between the computer, which may be installed at a location so that it may under certain conditions constitute a permanent establishment, and the data and software used by or stored on that equipment. Thus, an Internet website which is a combination of software and electronic data does not constitute a tangible asset, does not have a location which can constitute a ‘place of business’ and there is no ‘location, such as buildings or, in some cases, equipment or tools’ in respect of the software and data which constitute the website. The server on which that website is stored and through which it is accessible is equipment that has a physical location and the physical location may constitute a ‘fixed place of business’ of the company operating the server.

The distinction between the website and the server on which it is stored and used is important because the company operating the server may be different from the company conducting business through the website. It is common for a website through which a company carries out activities to be hosted on the server of an Internet service provider. Although the fees paid to an internet service provider under this arrangement may be based on the size of the disk space used to store the software and data required for the website, under these contracts the server and its location are not at the company's disposal, even if the company has been able to establish that its website will be hosted on a particular server in a particular location. In this case the company has no physical presence in that location because the website is not tangible. In such cases, the company cannot be considered to have acquired a place of business by arranging the hosting of the website. If the company conducting business through a website has the server at its disposal, owns or leases the server on which the website is stored and used and operates this server, the location of the server constitutes a permanent establishment of the company if the other conditions of art. 8 of the Romanian Tax Code are met.

A computer in a particular location may constitute a permanent establishment only if it meets the condition of having a fixed place of business. A server must be located in a particular place for a particular period of time to be considered a fixed place of business.

In order to determine whether the business of a company is conducted wholly or partly through such equipment, it should be considered on a case-by-case basis whether such equipment provides the company with facilities where the business functions of the company are carried out.

Where a company operates a computer at a particular location, there may be a permanent establishment, even if no employee of the company is required to be present at that location to operate the computer. The presence of staff is not required for a company to be considered to be operating partly or wholly at a location where the presence of staff is not required to operate at that location. This situation applies to e-commerce to the same extent as it applies to other activities where the equipment operates automatically, such as in the case of automatic pumping equipment used in the exploitation of natural resources.

A fixed establishment cannot be deemed to exist where the e-commerce operations carried out by computer at a particular location in a country are limited to preparatory or ancillary activities as described in art. 8 para. (4) of the Romanian Tax Code. For the purposes of determining whether certain activities carried out in such a location are covered by Art. 8 para. (4) of the Romanian Tax Code, they have to be analyzed on a case-by-case basis, taking into account the various functions performed by the company through the respective equipment. Preparatory or ancillary activities include in particular:

- a) the provision of a communications link - much like a telephone line - between suppliers and customers;
- b) advertising goods or services;
- c) transmission of information via a mirror server for security and efficiency purposes;
- d) collecting market data for the company;
- e) provision of information.

There is a permanent establishment when these functions constitute an essential and significant part of the company's business or when other principal activities of the company are carried out by computer, the equipment constituting a fixed place of business of the company, since these functions go beyond the activities referred to in art. 8 para. (4) of the Romanian Tax Code.

The principal activities of a particular company depend on the nature of the business carried on by that company. Some internet service providers are in the business of operating their servers for the purpose of hosting websites or other applications for other companies. For these ISPs, the operation of servers providing services to customers is a component of the business activity which is not considered to be a preparatory or ancillary activity.

In the case of a company called an 'e-tailer' or 'e-merchant' whose business is the sale of products over the internet and whose business is not the operation of servers, the performance of services at a location is not sufficient to conclude that the activities carried out at that location are more than preparatory and ancillary activities. In such a situation it is necessary to consider the nature of the activities carried out from the perspective of the activity carried out by the company. If those activities are strictly preparatory or ancillary to the activity of selling products over the internet and the location is used to operate a server hosting a website which is used exclusively for promotion, for the presentation of the product catalogue or for providing information to potential customers, it applies. art. 8 para. (4) of the Tax Code and the location shall not constitute a fixed establishment. If the typical sales-related functions are carried out at that location, such as by concluding the contract with the customer, processing payment and delivering the products which are carried out

automatically by equipment located at that location, these activities cannot be considered strictly preparatory or auxiliary.

An Internet service provider who provides the service of hosting the websites of other companies on a server shall not be subject to the provisions of article 8 (5) of the Tax Code, because ISPs are not considered agents of the companies to which the websites belong, do not have the authority to enter into contracts on behalf of these companies and do not normally enter into such contracts, they are considered independent agents acting in accordance with their normal business activity, which is also evidenced by the fact that they host websites for different companies. Since the website through which a company carries out its business is not in itself a 'person' as defined in art. 7 of the Romanian Tax Code, art. 8 (5) of the Tax Code cannot apply to deem a fixed establishment to exist by virtue of the website being an agent of the company within the meaning of that paragraph, if no employee of the company is required to be present at the location to operate the computer. The presence of staff is not required for a company to be regarded as carrying on business partly or wholly at a location where the presence of staff is not required to carry on business at that location. This situation applies to e-commerce to the same extent as it applies to other activities where the equipment operates automatically, such as in the case of automatic pumping equipment used in the exploitation of natural resources.

An example would be the company that owns the furniture brand Videnov which had a showroom, a shop in Bucharest, but decided that it preferred to close this shop - permanent headquarters - and to continue to carry out economic activity in Romania through digital channels (having a website for this purpose) as the corporate tax in Bulgaria is 10% as opposed to the corporate tax in Romania which is 16%.

5 Place of effective management

Art. 13 para. (1) letter c) of the Romanian Tax Code establishes that foreign legal persons having their place of effective management in Romania shall also pay corporate income tax in Romania. According to art. 7 item 18 of the Romanian Tax Code, the place of effective management is 'the place where, unless proven otherwise, the foreign legal person carries out operations corresponding to real and substantial economic purposes and where at least one of the following conditions is fulfilled:

- a) the economic-strategic decisions necessary for the management of the activity of the foreign legal person as a whole are taken in Romania by the executive directors/members of the board of directors; or
- b) at least 50% of the executive directors/members of the board of directors of the foreign legal person are residents'.

The place of effective management, according to tax provisions, refers to the place where strategic economic decisions are taken by the directors/members of the Board of Directors, this concept coming from international taxation which qualifies the tax residence of a company according to the place where key decisions are taken (e.g. management, commercial policy).

Thus, the place of effective management is a different concept from the permanent seat.

Foreign legal entities are required to declare by 30 June each year that their place of effective management is in Romania so that the tax authorities can recognise their tax residence on Romanian territory and apply to them the corporate income tax regulated by the Romanian Tax Code.

Basically, in order to apply the corporate income tax, it must be demonstrated that the place where economic-strategic decisions are taken is in Romania. This proof is possible by

providing supporting documents such as: corporate documents of the foreign entity, proof of operation of the place of management in Romania and contracts concluded with the executive directors, together with the questionnaire (to be submitted by 30 June).

6 Tax residency

Why is it important for companies to establish their tax residency? Firstly, to know exactly what rate of corporation tax is payable. Thus, legal entities with a Romanian tax residence may be subject to 1% turnover tax (if they have at least 1 employee) for micro-companies with an annual turnover of up to €500,000 or 16% profit tax for companies whose turnover exceeds €500,000. Secondly, establishing the tax residency is important in order to avoid possible fines, penalties and interest for late payment if a company with tax residence in Romania does not fulfil its obligations for tax registration, declaration and payment of taxes.

If a foreign legal person is deemed to be resident both in Romania and in a state that is a signatory to a double taxation convention to which Romania is a party, the residence of this person will be established according to the provisions of the double taxation convention.

According to art. 7 of the OECD Model Convention (valid with Spain, Turkey), ‘The profits of an enterprise of a Contracting State shall be taxed only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business in that manner, the profits of the enterprise may be taxed in the other State, but only that part of them which is attributable to that permanent establishment’.

7 EU Law on direct taxation on digital economy

The European Commission has issued a proposal for a Directive on a tax on digital services, a proposal for a Directive on the introduction of a digital permanent establishment concept and recommendations to Member States to implement this concept in their double tax treaties.

The new Digital Services Tax (DST) was supposed to apply from 1 January 2020, but its application has been postponed. DST will be levied at a flat rate of 3% of gross revenue.

The digital services tax applies to certain digital services, such as services relating to the provision of virtual spaces for advertising, services relating to the provision of common digital ‘marketplaces’ facilitating direct transactions between users, services relating to the sale of user data, while services relating to digital content or payment services, as well as trading venues for financial instruments and platforms facilitating investment services, covered by Directive 2014/65/EU, would be excluded from the scope of this tax.

Businesses that would cumulatively meet the following thresholds would be subject to the digital services tax: total annual global revenues of more than €750 million at the level of the multinational group to which the company belongs, and annual revenue from the provision of digital services in the EU of at least €50 million. If the entity is part of a consolidated group, these thresholds will be analyzed at group level.

The digital services tax should be payable in the Member State where the users are located. If users are located in different Member States, the proposal states that the tax base should be distributed in the Member States concerned on the basis of allocation keys.

The notion of ‘significant digital presence’ is based on the existing concept of a permanent establishment and covers any digital platform such as a website or a mobile application that meets one of the following criteria: the annual revenue from the provision

of digital services in a Member State exceeds €7 million, the annual number of users of such services exceeds 100,000, the annual number of online contracts concluded with users in a given Member State exceeds 3,000.

The Directive would apply to EU taxpayers as well as companies established in a non-EU jurisdiction with which there is no double tax treaty with the Member State where the taxpayer is identified as having a significant digital presence. However, this measure does not affect taxpayers established in a non-EU jurisdiction where a double tax treaty exists, unless such treaty includes a similar 'digital permanent establishment' provision.

The aim of taxing digital activity is to structure tax reform on two pillars, in order to allocate basic taxing rights between the countries from which income is extracted.

Pillar I aims to introduce taxing rights for countries where taxpayers have market jurisdictions, even if the company has no physical presence there. For some businesses, such a measure could mean taxing part of their profits in the jurisdictions where the users are located. As regards the conditions and the amount of profits to be allocated to these jurisdictions, a definitive formula has not yet been reached, but in principle at least part of the residual profits earned by the group is taken into account. Another approach proposed by Pillar I is the introduction of a standard level of remuneration for basic marketing and distribution activities carried out for affiliated persons (companies within the same group) and the introduction of mechanisms to ensure efficient resolution of potential disputes on profit allocation between tax authorities in different jurisdictions [3].

Pillar II, for its part, introduces the novelty of imposing a minimum level of taxation on profits at global level. This involves, on one hand, reaching a consensus on the harmonisation of reporting systems and on the other hand, introducing mechanisms to allow the taxation at a minimum level of profits which, in some jurisdictions, are now taxed at very low rates or not at all. It is important to note that the proposals included in Pillar II cover groups in all industries, with certain exceptions - investment funds, pension funds, government bodies and non-profit organisations. In addition, the rules are to apply to groups with annual revenues above €750 million, so that Pillar II is in line with the value threshold described in the country-by-country reporting requirements [4].

8 If Taxpayers don't declare tax anywhere?

In 2021, the Council adopted new rules aimed at improving administrative cooperation in the field of taxation and addressing the challenges of the digital platform economy.

An increasing number of individuals and businesses are using digital platforms to sell goods or provide services. However, income from digital platforms often goes unreported and leads to unpaid taxes, especially when digital platforms operate in more than one country. As a result, Member States lose tax revenue and traders using digital platforms have an unfair advantage over traditional businesses.

These new rules regulate the situation of economic activities carried out on digital platforms and will apply from 1 January 2023, when digital platform operators will be obliged to report the revenue made by sellers on their platforms and Member States will be obliged to exchange such information automatically.

9 Conclusions

There is a need to obtain a reasonable balance between the reallocation of corporate tax liability between net exporting and net importing countries and between producer and

consumer countries, so as not to jeopardise, *inter alia*, the ability of countries to meet their social and environmental objectives.

In addition, the entry into force of the new Digital Services Tax (DST) could solve the problems concerning the competence of Member States' tax bodies to tax the digital economy.

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