Significant Economic Presence laws key to fulfilling the post-pandemic social contract

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This article seeks to prove the following argument,

1. Significant Economic Presence (SEP) legislation is the most important requirement for effective taxation of the digitalized economy.
2. Effective taxation of the digitalized economy is an essential component of the fulfilment of the social contract in a post-pandemic era.

Therefore, SEP legislation is an essential component of the fulfilment of the social contract in a post-pandemic era. By logic's rules of inference, the conclusion will necessarily be true if the premises are true. Hence, only the truth-value of the first two premises needs to be examined.

Premise 1: SEP and the taxation of the digitalized economy

What is the core problem of the taxation of the digitalized economy? It is that companies can profit from a jurisdiction without physical presence. This is recognized in key international tax forums such as the UN Committee of Experts on International Cooperation in Tax Matters (UNTC) and the OECD/G20 Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS). The UN Committee states that it has "identified the crux of this complex and pressing issue as the inability of jurisdictions, under the physical presence criteria of tax treaties, to tax the business profits derived with no (significant) physical presence in the market jurisdiction." The OECD/G20 IF uses similar wording. The Action 1 report on Base Erosion and Profit Shifting (BEPS) states,

> "certain processes previously carried out by local personnel can now be performed cross-border by automated equipment, changing the nature and scope of activities to be performed by staff. Thus, the growth of a customer base in a country does not always need the level of local infrastructure and personnel that would have been needed in a "predigital" age."

Hence, the problem has been clearly identified that the key issue in taxing the digitalized economy is the need to go beyond the "physical presence" criteria of tax treaties such that highly digitalized businesses can be deemed to have nexus. However, work on the solution is proceeding at a slower pace. The UNTC has not come out with a solution thus far, though it has expressed its views on the proposal being discussed in the IF. One Committee member, from India, has independently put forth a proposal on taxing the digitalized economy which is closely linked to the G24's proposal on significant economic presence.

The IF proposal is titled, "Statement by the OECD/G20 Inclusive Framework (IF) on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy." It accepts in principle that a nexus can be established without physical presence but prescribes a large number of thresholds which restrict the scope significantly. Negotiations on the proposal are ongoing though they have been affected by the COVID-19 pandemic and the recent news of the US possibly withdrawing from the talks. In this scenario, faced with increased revenue pressures and uncertainties regarding the multilateral solution, more and more countries, including many OECD Members, have started implementing unilateral or more accurately national measures on taxing the digitalized economy. The intergovernmental South Centre has comprehensively documented these measures, of which significant economic presence (SEP) legislation is a major component.

SEP addresses the essence of the problem, in that it expands the definition of “business connection” to incorporate a new digital nexus even without physical presence to tax business profits of foreign businesses or non-residents. The non-residents would be deemed to have nexus if they cross certain thresholds.

> “This would be determined using such as ‘revenue generated on a sustained basis’ as the basic factor, and in combination with one or more of the following factors: “(1) the existence of a user base and the associated data input; (2) the volume of digital content derived from the jurisdiction; (3) billing and collection in local currency or with a local form of payment; (4) the maintenance of a website in a local language; (5) responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; or (6) sustained marketing and sales promotion activities, either online or otherwise, to attract customers”.

Thus far, this concept has been incorporated into legislation introduced in India, Indonesia, Israel and Nigeria. Nigeria has gone a step further and has even prescribed thresholds through administrative guidance. This has ensured that the digital and tech giants will now have to pay taxes in these countries and can no longer use the ‘physical presence’ argument to escape.

In international taxation, business profits are taxable in the country of residence unless it has a permanent establishment (PE) in the country of source. Profit attribution to the PE can take place only once there is nexus. Hence, the establishment of a nexus is the first and most important requirement for effective taxation of the digitalized economy, and SEP legislation addresses this issue. This concludes the exposition of the first premise.

Premise 2: Taxing the digitalized economy and the social contract

To reiterate, the second premise states that, “Effective taxation of the digitalized economy is an essential component of the fulfilment of the social contract in a post-pandemic era.” This compound statement can be better understood by examining its component parts. Let us start with the latter half, “fulfilment of the social contract in a post-pandemic era.” The social contract is an agreement between the State and the citizen to uphold certain obligations. For most States, these obligations under domestic and international law include caring for the health, safety and well-being of the citizens. In a post-pandemic era, this would imply several things and has been best summarized by the UN,

> “a well-designed fiscal stimulus package, prioritizing health spending to contain the spread of the virus and providing income support to households most affected by the pandemic would help to minimize the likelihood of a deep economic recession.”

Most States have signed up to binding international treaties that commit them to take concrete steps to guarantee these rights using a concept known as *Maximum Available Resources (MAR)*. There is wide agreement that these resources must be raised progressively and sustainably. Revenue raised through taxation must also be fair, progressive or socially equitable. This means that poorer people don’t have a heavier tax due than richer people and that the tax system doesn’t favour men over women.

This brings us to the first part of the premise on how effective taxation of the digitalized economy is essential to raising the Maximum Available Resources (MAR) needed for fulfilling the social contract in the post-pandemic era. There are two parts to this argument. The first is that it has been recognized that the “digital” economy can no longer be ring-fenced from the “real” economy. Hence, the term “digitalized” is used, and the implication is that taxing it is the same as taxing the real economy. Thus, effective taxation of the digitalized economy will help raise more revenue from the “real” economy. The second aspect is that highly digitalized businesses such as the Silicon Six (Microsoft, Google, Amazon, Facebook, Apple, Netflix) who are presently out of the tax net are “free-riding” on public goods without paying for them. Thus, they are benefiting from police protection, the judiciary, roads, water supply, electricity, port facilities and all the other public services which are essential for any business to function *and are paid for through public revenues generated inter* *alia through taxes*. Hence, by staying out of the tax net and not paying their fair share, these digitalized businesses are not contributing to their obligations to the social contract. Given the increasingly large stakes these multinational corporations have in the global economy, their corresponding obligation to pay their taxes is growing. Thus it can be argued that so is their role in undermining the social contract. Hence, this forms the exposition of the second premise.

Conclusion

With the two premises defended, the conclusion is also justified that “SEP legislation is an essential component of the fulfilment of the social contract in a post-pandemic era.” By ensuring that highly digitalized businesses have nexus, these multinational corporations will cease to be “free-riders” leeching off the domestic taxpayers. It is also envisaged that this approach will ensure that highly digitalized businesses contribute to the social contracts of the societies from where they are making profits and whose public goods they are using for this purpose.

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