European Legal Practice Integrated Studies

ELPIS

MASTER

Towards a Broader Concept of Permanent Establishment: a Study in Light of the Digitalization of the Economy and the BEPS Era.

Ricardo Sergio Schmitz Filho

University of Lisbon School of Law

Mykolas Romeris Law School

2019

"Castelos nascem nos sonhos,

para no real achar seu lugar".

Oswaldo Montenegro

Acknowledgements

Above all, I would like to express my gratitude to Holy Mary, of who I am a profound admirer, for all the opportunities in my life that culminated in the development of these studies.

In special, I wish to express my thankfulness to Prof. Dr. Ana Paula Dourado, for the supervision and for the inspiration, during all the stages of this LL.M program and for the partnership in the organization of so many great events at the University of Lisbon, together with the IDEFF. In her name, I also want to express my admiration for all my professors at the University of Lisbon, as well as at the Mykolas Romeris University, in Lithuania. I also would like to reinforce my admiration and gratitude for the Professors Dr. Cláudio Brandão and Dr. João Maurício Adeodato, for the early and fundamental support, as well as to all my professors at the Federal University of Pernambuco. Without them I would not have gone this far.

My deepest love and thankfulness go also to my family, which represents my pillar. Without them, I would not be able to overcome the difficulties along the way and, surely, without they endless support, this thesis would not have come to exist. I love you!

I could not forget to mention other very important characters that life decided to put on my way, especially since the beginning of my ‘path in law’, seven years ago. Therefore, I would like to express my deepest admiration for my friends at the academic group of the ‘Resenha’, at the Federal University of Pernambuco, and thank everyone of them for the exciting discussions and comforting friendship.

Moreover, I express my sincere gratitude for all the members of the international offices at the University of Lisbon, in the name of Dr. Eduarda Camilo, as well as at the Mykolas Romeris University, in the names of Inesa Cvetkova and Dr. Dovile Galuite, for the great help and attention during my LL.M program. I would extend my gratitude also to the International Bureau of Fiscal Affairs (IBFD) for having me at their library in two very important occasions, which was fundamental for the development of this thesis.

My gratitude also goes to the GREIT professors and assistants, for the amazing opportunities to join inspiring events all over Europe.

This work would not have been possible without you. *Obrigado!*

Abstract: The phenomenon of the digitalization of the economy, connected to the fast-growing globalization, had proven the current international tax system, in terms of business income taxation, to be faulty. Designed in the beginning of the 20th century, the existing framework is heavily based on the physical presence of companies in a certain State and, thus, it is hard to accommodate an efficient taxation of intangible, or virtual, goods and services. This misalignment facilitates several aggressive tax planning schemes, specially by MGC, as well as a harmful tax competition among jurisdictions, in the search for capturing (or maintaining) investments. With that in mind, and especially after a raising media exposition of such schemes, the international community is trying to find solutions to both the problem of the loss of tax revenues and to the need to (re)align taxation with value creation. This study aims at contributing with the current discussions, to debate the main proposals posed by the OECD and the EU and, finally, to develop an original solution, based on the creation of a 'virtual permanent establishment', to be globally implemented.

Keywords: Virtual Permanent Establishment; Taxation in the Digital Economy; (Re)Allocation of Taxing Rights; BEPS; European Union; OECD.

Resumo (Portuguese)

O fenômeno da economia digital, intrinsecamente relacionado ao rápido desenvolvimento do processo de globalização, pôs em evidência importantes problemas no atual sistema tributário internacional, especialmente em termos do imposto sobre o rendimento das pessoas jurídicas, modalidade sobre a qual se irá debruçar o estudo em epígrafe.

Desenvolvida no início do século XX, a estrutura existente baseia-se fortemente na presença física de empresas em um determinado Estado e, portanto, apresenta uma série de falhas quanto a imposição efetiva do imposto sobre o rendimento diante de bens e serviços intangíveis, virtuais, sem que haja, necessariamente, a presença física do potencial contribuinte, em forma de um estabelecimento estável.

Esse desalinhamento facilitou a disseminação de diversos esquemas de planeamento fiscal agressivo, especialmente no âmbito das multinacionais e de grupos com operações em bens e serviços altamente digitais, como redes sociais, *e-commerce*, *cloud computing*, mecanismos de busca online, assim como diversos outros modelos de negócios. As características da economia digital facilitam, ainda, a maior mobilidade das etapas de produção assim como dos ativos, o que tem sido manipulado de forma artificial por multinacionais em busca de otimização da carga tributária a nível global.

Esse contexto é agravado, ainda, pela existência de uma concorrência fiscal prejudicial entre Estados na comunidade internacional, os quais constantemente buscam pela captura (ou manutenção) de investimentos a partir, por exemplo, do fornecimento de alíquotas efetivas cada vez mais baixas.

Os principais problemas, ou desafios, frutos da economia digital são, portanto, a crescente perda de receitas fiscais e a necessidade de (re)alinhamento da tributação com a ideia de criação de valor (*value creation*).

Nosso estudo visa contribuir com as atuais discussões e debater as principais propostas apresentadas pela OCDE e pela UE para enfrentar os desafios da economia digital. Esse objetivo se concretiza, portanto, a partir do desenvolvimento de uma solução original, baseada na criação de um "estabelecimento estável virtual", a ser implementada globalmente. É parte fundamental do nosso objetivo a apresentação de uma solução que seja viável, a curto e médio prazo, de forma que a atual conjuntura das discussões políticas

sejam levadas em consideração. É ainda de nosso interesse a apresentação de uma solução o mais completa possível, de forma a abarcar, para além dos pilares teóricos, questões técnicas como os métodos de determinação de rendimentos aos novos estabelecimentos estáveis virtuais e as fórmulas para atribuição, entre os Estados da residência e da fonte dos direitos de tributar tais rendimentos.

Para tanto, em primeiro lugar, o estudo apresenta as principais características que definem a nova economia digital e alguns dos modelos de negócios, potencializados pelo avanço tecnológico e da globalização, característicos do nosso tempo. Compreender os elementos da economia digital é importante para que se compreenda a natureza (e as fontes) dos desafios a serem enfrentados.

Além de ser viável, acreditamos que uma sólida proposta deva compreender a necessidade, da qual não se pode escapar, da realização de *trade-offs* (ou ponderação) entre os princípios do direito tributário internacional, especialmente desenhados para o cenário da economia digital, encapados na chamada 'Ottawa Framework'. Toda e qualquer solução proposta deverá conter opções políticas de valorização de certos elementos em detrimento de outros.

Após considerarmos as propostas da UE e da OCDE e de analisarmos diversas opiniões provenientes da academia, acreditamos no desenvolvimento de uma solução que se encaixe e adapte o atual modelo (*framework*), com base nos mesmos elementos de conexão já conhecidos pelas autoridades tributárias e pelos contribuintes, nomeadamente, as ideias de 'residência'; 'fonte'; 'estabelecimento estável' e 'preços de transferência'.

Os desafios enfrentados são desafios globais e, portanto, uma solução efetiva deve também atingir tal dimensão. Assim, consenso torna-se um ponto fulcral para o sucesso na implementação de qualquer solução. Consenso, por seu turno, é extremamente difícil de ser alcançado fora dos limites do atual *framework*, ou seja, por meio de uma revolução no sistema tributário internacional, de mudanças dos nexos para imposição dos tributos e na própria ideia do fim dos impostos sobre o rendimento.

A opção política dos membros da OECD e da *BEPS Inclusive Framework* por 'adaptação' ou invés de 'revolução' já fora tomada, assim como também pela União Europeia.

Nossa solução, a partir da apresentação da nova modalidade do 'estabelecimento estável virtual', será capaz de atribuir o direito de tributar aos locais nos quais as atividades são desenvolvidas e nos quais as multinacionais obtêm lucros, mesmo que sem qualquer (ou com limitada) presença física. A análise da criação de valor a partir dessa nova modalidade deverá ser feita apenas através da verificação dos lucros obtidos na fonte, sem a consideração direta de elementos como número de usuários ou número de contratos celebrados.

A inclusão de elementos alheios ao 'rendimento' para a atribuição do status de estabelecimento estável virtual à determinada atividade, conforme proposto por diversos atores internacionais, culmina na alteração da natureza do tributo, que pode variar entre um imposto sobre receitas brutas ou mesmo impostos indiretos, sobre o consumo.

Por outro lado, a adoção de elementos estranhos ao rendimento pode, também, elevar o risco de se setorizar (*ring-fence*) demasiadamente as atividades com maior grau de 'digitalização' o que, em última instância, pode barrar o desenvolvimento tecnológico e da economia global, além de evocar tratamentos fiscais completamente distintos para semelhantes substratos.

Mais além, nossa proposta não apenas confere direitos de tributar aos Estados da fonte, por outro lado, desenvolvemos um sistema de atribuição proporcional dos direitos de tributar entre os Estados da fonte e da residência. Esse sistema permite uma mais fidedigna perceção da ligação económica do grupo multinacional com o Estado da fonte e a importância do último na criação de valor para o grupo, visto como uma unidade internacional. Essa ideia, ademais, nos parece favorecer o alcance do consenso global para uma satisfatória implementação, em um curto ou médio espaço de tempo, da nossa medida.

O estudo discute, ainda, questões práticas em termos de implementação da medida, com especial menção para as diferentes possibilidades no contexto da União Europeia. As consequências da adoção de nossa proposta, especialmente sobre as autoridades tributárias e os contribuintes, são também previstas, bem como algumas considerações sobre os desafios em relação à consideração de eventuais perdas incorridas nos estabelecimentos estáveis virtuais.

Para a realização do estudo, foi adotada uma metodologia comparativa, conforme se pôde observar pelos comentários já tecidos, especialmente com a análise dos pontos

comuns e divergentes das principais propostas discutidas no âmago da OCDE e da União Europeia. Em nosso corte epistemológico, para além da limitação das propostas relacionadas com a tributação direta, não analisamos as medidas, domésticas, porventura já adotadas em algumas jurisdições.

Como resultado, esperamos haver entregue um estudo sólido, capaz de acrescentar no debate internacional em torno das necessárias mudanças para o enfrentamento, efetivo, dos desafios fiscais da economia digital. A falta de uma solução global para as questões aqui debatidas ameaçam a sustentabilidade do sistema tributário internacional, a soberania fiscal dos países e a criação de barreiras para o desenvolvimento tecnológico e para o processo de globalização.

A proposta desse estudo, portanto, é de significativa relevância e ultrapassa, inclusive, os limites dos estudos sobre o direito fiscal, estendendo-se ao interesse de toda a sociedade civil.

Palavras-chave: Estabelecimento Estável Virtual; Tributação na Economia Digital; (Re)Alocação do Direito de Tributar; BEPS; União Europeia; OCDE.

Table of Contents

Abbreviations 2

Introduction 4

PART I - BACKGROUND

Chapter 1: The Tax Challenges of the Digital Economy 10

1.1: General features of the digital economy 10

1.1.1: Mobility 10

1.1.2: Reliance on data and user participation 12

1.1.3: Network effects 12

1.1.4: Use of multi-sided business models 13

1.1.5: Tendency towards monopoly or oligopoly 13

1.1.6: Volatility 14

1.2: The process of (re)allocation of business activities and taxing rights 14

1.3: The BEPS phenomenon 15

1.3.1: Action 1 (Digital Economy) 17

1.3.2: Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status) 17

1.3.3: Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) 18

1.3.4: Action 15 (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS) 19

Chapter 2: Ottawa Framework for International Taxation in the Digital Economy 21

2.1: Neutrality 22

2.2: Efficiency 23

2.3: Certainty and simplicity 24

2.4: Effectiveness and fairness 25

2.5: Flexibility 26

Chapter 3: Concepts of 'Source'; 'Residence'; 'Permanent Establishment' and Complementary Notes 28

3.1: Historic notes 28

3.2: Concepts of 'residence' and 'source' 29

3.2.1: National and international dimensions 32

3.3: Thresholds 33

3.3.1: *For* the attribution of a 'resident status' 33

3.3.2: *For* the imposition of a 'source taxation' 35

3.4 Tax liabilities 36

3.4.1: *Upon* residents ('universal liability') 36

3.4.2: *Upon* non-residents ('territorial liability') ... 37
3.5: The classical concept of permanent establishment ... 37
3.6: Types of permanent establishment ... 40
3.6.1: Fixed place of business ... 41
3.6.2: Dependent agent ... 41
3.6.3: Site of construction and installation (*or assembly*) ... 42
3.6.4: 'Service' permanent establishment ... 42
3.7: Exceptions for the existence of a permanent establishment ... 44
PART II – CURRENT PROPOSALS
Chapter 4: OECD Proposals for Taxing the Digital Economy ... 46
4.1: Pillar one (reallocation of taxing rights) ... 47
4.1.1: The 'user participation' proposal ... 47
4.1.2: The 'marketing intangible' proposal ... 50
4.1.3: The 'significant economic presence' proposal ... 52
4.2: Pillar two (BEPS issues) ... 54
4.2.1: Income inclusion rule ... 54
4.2.2: Tax on base eroding payments ... 56
Chapter 5: EU Proposals for Taxing the Digital Economy ... 57
5.1: Significant digital presence proposal ... 59
5.2: Common system of a digital services tax on revenues resulting from the provision of certain digital services proposal ... 64
PART III – OUR PROPOSAL
Chapter 6: Rationale ... 68
6.1: Virtual Permanent Establishment ... 68
6.2: Determination of profits attributable to the 'to be verified' virtual permanent establishment (Transfer Pricing) ... 74
6.2.1: Monetary thresholds for the attribution of the virtual permanent establishment status ... 76
6.3: Allocation of taxing rights upon the profits attributed to the virtual permanent establishment (Simplified Formulary Apportionment Method) ... 79
6.3.1: The need to establish a common base for the 'minimum proportional revenue' ... 85
Chapter 7: Practicalities ... 88
7.1: Implementation ... 88
7.2: Enforcement and collection ... 89

7.3: Recognition of losses 91
Chapter 8: Implications 93
8.1: *Upon* principles of the Ottawa Framework 93
8.2: *Upon* tax administrations and taxpayers 95
Conclusions 96
References 99
Bibliographic References 99
Documents and Legal Acts 104
Brazil 104
European Commission 104
European Parliament and the European Council 105
League of Nations 105
Mexico 105
Organization for Economic Co-operation and Development 106
Russian Federation 107
United Nations 107
United States of America 107
Jurisprudence 108
European Commission 108
European Court of Justice 108
Websites and Press Release 108
Deloitte 108
European Commission 108
Organization for Economic Co-operation and Development 108

To my grandfather, Nelson

Abbreviations

AI	-	Artificial intelligence
B2B	-	Business to Business
B2C	-	Business to Consumer
BEPS	-	Base Erosion and Profit Shifting
CAS	-	Construction or assembly site
DST	-	Digital Service Tax
DTT	-	Double Tax Treaty
EC	-	European Commission
EU	-	European Union
FPB	-	Fixed place of business
G20	-	Group of Twenty
Guidelines	-	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Authorities
HTVI	-	Hard to value intangibles
Inclusive Framework	-	OECD/ G20 Inclusive Framework on BEPS
LRD	-	Low risk distributor
OECD	-	Organization for Economic Co-operation and Development
OECD BEPS Action Plan	-	OECD Action Plan on Base Erosion and Profit Shifting
OECD Model	-	OECD Model Tax Convention on Income and Capital
Ottawa principles / Ottawa framework	-	Implementation of the Ottawa Taxation Framework Conditions: the 2003 report
PE	-	Permanent Establishment
Public Consultation	-	OECD Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy

STR	-	Source income to be taxed by the source State (Source Taxing Rights)
TFEU	-	Treaty on the Functioning of the European Union
TP	-	Transfer Pricing
UN	-	United Nations
UN Model	-	United Nations Model Double Taxation Convention Between Developed and Developing Countries
US Model	-	United States Model Income Tax Convention
US/USA	-	United States of America

Introduction

The digitalization of the economy is responsible for significant worldwide transformations in the way business has been conducted and for the consequent growing redistribution of value creating activities around the globe. This process is responsible for the imposition of a series of political, economic and social challenges, from which, nevertheless, we shall focus on *the tax challenges of the digital economy*.

Although these challenges could be observed, more or less, in every field of taxation, the limits on the scope of these studies are connected to the analyses on matters of *direct taxation* and, more specifically, related to *business income taxes in connection with cross-border activities*. Currently, this is the area in the field of tax that claims for more effective measures to be taken.

For the purposes of this study, which aims at achieving a *global solution* for the challenges identified, we shall focus our efforts on the analysis of cross-border situations *covered by double tax treaties* (*hereinafter*, DTT). We, therefore, will base most of our commentaries on the wording of the OECD Model Tax Convention on Income and Capital (*hereinafter*, OECD Model)[1], provided it is broadly used on the current global web of DTTs. On the other hand, we will not forget to mention aspects also from the UN Model[2], especially in relation to the 'service permanent establishment' (Topic 3.6.4). We should leave the and the US Model[3] outside the scope of our analysis.

Finally, in order to understand our object of study, we should first define the limits of the scope of 'business income'. According to the OECD Model, in its Art.7, this concept is somehow undefined. It is not our goal to extensively discuss these limits, hence, we will assume that it means '*profits from the carrying on of any business by a resident of a Contracting state*', as resumed by Sanghavi[4].

---

[1] Organization for Economic Co-operation and Development, *Model Tax Convention on Income and Capital: condensate version* (Paris, France, 2017).
[2] United Nations. *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York, USA, 2017).
[3] The Government of the United States of America. *United States Model Income Tax Convention* (Washington D.C, USA, 2016).
[4] Dhruv Sanghavi, *Structural Issues in the Income Tax Treaty Network: Towards a Coherent Framework*, (Enschede, the Netherlands: Ipskamp Printing BV, 2018.), 223-224.

The study will be divided in three main parts: 'Background' (Part I); 'Current Proposals' (Part II) and 'Our Proposal' (Part III).

Firstly, we should understand what the 'digital economy' is and to briefly discuss its main characteristics. It is a necessary step in order to understand the reasons of the emerging challenges that we should address.

These challenges are, indeed, potentialized (or exacerbated) by the new era of the digital economy[5] and the elements of globalization and *intangibility*. We know the problems. We, on the contrary, do not know exactly the extent of them and, therefore, we should come up with a broad and consistent solution, also able to pass the test of the future technological developments.

Two are the main 'categories' of challenges identified: the BEPS challenges (base erosion and profit shifting) and the need to rethink the international allocation of taxing rights among jurisdictions. Each of these challenges will be addressed at the first chapter.

In order to set the framework with which our proposed solution should deal, it is inside the scope of the first part of the study to present the principles contained at the 'Ottawa Taxation Framework Conditions'[6] (*hereinafter,* Ottawa Framework). These principles should serve as a guide during our comments on the new proposal.

Finally, Part I will be responsible for presenting the core concepts through which we believe changes have to be implemented, mainly the concepts of 'source'; 'residence' and 'permanent establishment' (*hereinafter*, PE), among other related elements.

The ideas of 'source' and 'residence' are key elements on the definition of the allocation of taxing rights and have also a significant impact in matters of base erosion and profit shifting. Moreover, as we believe in a solution to be taken inside the current framework, every attempt to deal with the challenges presented have to include considerations upon those concepts.

---

[5] Michael P. Devereux and John Vella, "Debate: Implications of Digitalization for International Corporate Tax Reform." *Intertax, 46, 6/7* (2018), 550.

[6] *Firstly*: Organization for Economic Co-operation and Development, *Electronic Commerce: Taxation Framework Conditions* (Paris, France, 1998). *Later and in reference to all the digital economy*: Organization for Economic Co-operation and Development, *Implementation of the Ottawa Taxation Framework Conditions: the 2003 report* (Paris, France, 2003). For an overview on the historical development: Marie Sapirie. "Permanent Establishment and the Digital Economy." *Bulletin for International Taxation*, 72, 4a, Special Issue (2018).

Finally, the ideas of 'source' and 'residence' are also of fundamental importance to the delimitation of the broadness of the concept of permanent establishment, provided that the extension of the later usually determines the extension of taxation in the source State. For over a century, the idea of PE is, therefore, responsible for capturing the degree of 'materialization' of the activity of a non-resident in order to set the thresholds for the taxation of business income derived from its activities connected to the source State.[7]

As there can be several types of manifestation of the 'material' business presence from a non-resident in a foreign country, there are several types of permanent establishments, every one of them characterized by some peculiarities, but gathered around the same general idea. Fixed place of business, agent permanent establishment, site of assembling and/or construction are classical examples of what we have just said.

Finally, this material presence was not considered enough for creating a bond sufficiently string with the source country as to authorize the taxation therein if these activities were, in general wording, of a preparatory of auxiliary character. Until not very long ago, the 'digital activities' were mostly always seen as part of this 'weak bond', and, therefore, did not use to pose relevant issues.

This is not the scenario of the 21st century. Some activities beforehand seeing as preparatory or auxiliary are now of core importance to their business models. The need of physical/material presence for there to be enough substance of an enterprise in the source country has now significantly lowered. The economic model changed. The thresholds for taxation of business income must adapt to it[8].

Part II of the paper will be responsible for presenting some of the ongoing effort, at several instances around the world, to tackle the identified challenges. This part will be mainly composed by three sessions. At a first moment, we will analyze the proposals in discussion at the OECD, especially relevant after the Public Consultation held in Paris, in March 2019[9].

---

[7] The term "physical" has been used by some authors in the same meaning we provide for the expression "material". Ex.: Vishesh Dhuldhoya, "The Future of the Permanent Establishment Concept." *Bulletin for International Taxation*, 72, 4*a*, Special Issue (2018), 18 p.

[8] Wolfgang Schön, "Ten Questions about Why and How to Tax the Digitalized Economy." *Bulletin for International Taxation, 73, 4/5* (2018), 278.

[9] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019).

Therefore, the work of the OECD Task Force on the Digital Economy, connected to the BEPS Inclusive Framework sets possible solutions to be adopted in relation to both the present challenges (divided by the Organization into two pillars). We strongly believe that the mechanism for implementation of a considerable part of the proposals have to include changes in the current PE definition (or its *broadness*).

Secondly, we should turn our attention to some of the ongoing proposals of the European Union in relation to 'taxing the digital economy'. These proposals although facing political issues, are in a stage of technicality more developed than the yet incipient proposals of the OECD. Besides, also inside the scope of these EU proposals are changes in the PE idea.

The last part of the paper presents our proposed solution, based on the information and experience gathered from the exposed at Part II and with usage of a comparative methodology.

The main goal of this study, therefore, is to suggest a solution based on the creation of a subsidiary type of permanent establishment to the classical 'fixed place of business', which we will assume to be characterized by the wordings of Article 5(1) of the OECD Model Convention. The new type of permanent establishment should be able to 'capture' not the relevant 'material' activity of the non-resident in a source country. We should now focus on the idea of 'significant' activity (or 'significant economic presence'[10]) regardless of their physical mass.

Hence, this paper will build up an idea based on the need of the inclusion, in the tax treaty network, of a concept of 'virtual' permanent establishment[11]. This, we hope, will be able to help tackling two of which we believe to be the biggest tax issues countries are concerned in this digital world: the (re)thinking about the allocation of taxing rights and, therefore, the wealth derived from the business activity around the world, first. Secondly, we hope to tackle the enlargement of the use of aggressive tax planning by companies, which leads to the phenomenon of the growth of 'stateless income'. The

---

[10] As will be discussed, this expression appears in several international documents from the OECD and the EU, but also in the work of scholars such as: Marcel Olbert and Christoph Pengel. "International Taxation in the Digital Economy: Challenge Accepted?" *World Tax Journal*, *No.1* (2017), 3-46 and Vishesh Dhuldhoya. "The Future of the Permanent Establishment Concept." *Bulletin for International Taxation*, 72, 4*a*, Special Issue (2018), 18 p.

[11] This same rationale is defended by Hongler and Pistone. Peter Hongler and Pasquale Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of Digital Economy." *IBDF Whitepapers* (2015), 2.

proposed multilateral approach should also tackle the undesirable adoption of unilateral measures by some jurisdictions that are ultimately leading to one big 'race to the bottom' of the effective corporate tax rates.

Again, *hopefully*, our solution will help to solve the issue of the 'where to tax'. Questions on the idea of a broader concept for permanent establishments, therefore, will not only change some current rules on the allocation of taxing rights, but will also 'shift' before 'stateless' income to *a* country.

By this mean, we believe that the international community is indeed capable of reaching consensus (the so dreamed 'consensus-based solutions'), exactly to the extent that countries that may lose some taxing rights (therefore, revenues) by 'losing' these rights to other jurisdictions, may, as well, 'gain' rights upon revenues that were, before, lost in time and space for the 'taxing world'.

That is one of the main scopes our proposal: to answer 'where to tax'.

Nevertheless, the study should provide a solution as more comprehensive as possible. A 'partial' solution, mostly likely, will not have a successful implementation. Thus, connected to the idea of the 'where to tax', lies the idea of 'how much to tax' or, in the wording of the fashion nowadays 'what size of the pie to attribute to a given permanent establishment'.

This issue is of the greatest relevance and seems to be a fundamental point to be discussed in order to help countries in reaching consensus. It is especially true when dealing with highly digitalized business, or highly fragmented multinational groups of companies (MGC). How to know how much of the revenue obtained by a final product can be attributed to jurisdiction A or B in a world where, perhaps, the MGC does not even have a physical structure in neither of them?

We believe, thus, that the key to the 'how much' question lies, if one thinks about using the tools already at our disposal, on transfer pricing (TP). The adaptation of the guidelines provided by the OECD can help to deal with the attribution of a 'quantum' to both residence and source countries, connected to the new vision on permanent establishments.

Of course, on the other direction, one could argue in favor of a complete change of settings. Letting go the usage of the traditional nexus, forgetting the old idea of

permanent establishment or even putting aside what we have from transfer pricing rules and guidelines. *Maybe*, it could also be de departure point for the development of interesting ideas.

Nevertheless, countries did not opt for this sort of change. Better: for this sort of 'revolution'. Since the adoption of the BEPS Project (2013)[12] in a more or less comprehensive way, countries made a political choice not to revolution the tax system. They want changes and that is clear, but they want to use the tools we already have. Today, 129 jurisdictions are part of the BEPS inclusive framework[13]. To propose a solution outside of this scenario, now, would culminate in very little practical effect. That is not our goal.

Without further initial considerations, we do hope this work contributes to the efforts currently undertaken by the international community, especially on the energies connected to the elaboration of a consensus-based solution to be publicly presented by the end of 2020, by the OECD.

---

[12] Organization for Economic Co-operation and Development. *Action Plan on Base Erosion and Profit Shifting* (Paris, France, 2013).

[13] "Members of the Inclusive Framework on BEPS." Organization for Economic Co-operation and Development, accessed 2019 April 27, https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf

Part I

Background

Chapter 1: The Tax Challenges of the Digital Economy

1.1: General features of the digital economy

The first step towards the presentation of a solution to the contemporary challenges of the digital economy is to understand, in fact, what characterizes the new business models. Therefore, the OECD Final Report on BEPS Action 1 identifies the following key features: mobility; reliance on data and user participation; network effects; use of multi-sided business models; tendency towards monopoly or oligopoly and volatility.[14]

Surely, as also stated by the work of the OECD, not every feature above may be present at every single business model of the digital economy[15]. Instead, these are the features that tend to characterize the economy of the 21th Century in general. As we shall discuss ahead, it seems that it is already impossible to 'ring-fence' the digital economy from the economy itself[16] and, thus, these key features tend to become stronger in the following years.

1.1.1: Mobility

The first aspect that reflects the increasing in mobility in the digital economy is the raising in value of intangibles. Nowadays, immaterial property represents a large amount of a companies' value, as represented by the heavier reliance on software, royalties, trademarks and other elements[17].

---

[14] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015). *See*: Ana Paula Dourado, *Governação Fiscal Global* (Lisbon, Portugal: Almedina, 2017), 63. Marcel Olbert and Christoph Pengel. "International Taxation in the Digital Economy: Challenge Accepted?" *World Tax Journal, No.1* (2017), 6-7.

[15] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015).

[16] Michael P. Devereux and John Vella, "Debate: Implications of Digitalization for International Corporate Tax Reform." *Intertax, 46, 6/7* (2018), 550.

[17] Films and music are also mentioned by Oddleif Trovik, "Chapter 25: The Allocation of Residual Profits from Unique and Valuable IP to Permanent Establishments *in* Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains (IBFD 2019)," *IBFD Doctoral Series, 45* (2019), 11.

These intangibles can be easily transferred from country to country, especially by the 'reallocation' of assets between related parties in a MGC. The facility with which intangibles move in the current days makes it possible to optimize (for economical and tax reasons, for instance) the production by shifting the location of these intangibles to lower tax jurisdictions, even for smaller companies acting in a regional or worldwide market.

The mobility, nevertheless, does not operate only with the opportunities for shifting the location of intangible assets. Also, the business functions of a company can now be more easily fragmented, provided the evolutions in communications and transport technologies and the consequent drastic decrease in the cost related to operate more complex international activities. Therefore, it is common today that a company, even when dealing with physical products, to assembly it in a jurisdiction that may differ from both the country of residence of the company and the country where the consumers are located. This is easily noticed in e-commerce business models, for instance.[18]

A little bit less exacerbated, though, is the mobility of users and consumers[19]. Of course, today, users or consumers from one country can easily purchase something online from another jurisdiction, or just purchase while in a trip to another country. It is also perceptive that users and consumers, especially in online activities, are able to deliberately or not change their real location or simply block this identification by a given server from a company.

Hence, this mobility can also impose challenges to taxation, nevertheless, we are more concerned with the first two points of the 'mobility' feature. Firstly, because they are more generally applicable also to companies operating in a more physical market, secondly, because they involve more B2B operations that, for income tax proposes, tend to be connected to higher amounts of revenues that could be artificially shifted. Finally, is seems clear to us that it is harder to move a hole 'consumers/users market base' as they tend to be much more fixed than the company's activities.

---

[18] A. Hemmelrath & E. Wilcox, "Chapter 8: AOA, BEPS, E-Commerce" in "*Permanent Establishment" in Flux in Practical Problems in European and International Tax Law* (the Netherlands: IBFD, 2016), 6.

[19] The fact that users and consumers tend to be more fixed is an argument used for by Devereux and Vella in order to shift the object of taxation to the place of the latter or, alternatively, to the place where the shareholders (another less mobile element) are located. We are against this approach, as it is going to be further detailed in Part III. Michael P. Devereux and John Vella, "Debate: Implications of Digitalization for International Corporate Tax Reform." *Intertax, 46, 6/7* (2018), 550.

1.1.2: Reliance on data and user participation

Reliance on data and information and user participation were always present in the business activity and, therefore, do not represent a novelty from the digital economy. Nevertheless, as happened with the feature of 'mobility', briefly analyzed above, the digitalization of the economy provided for an entire new way of dealing with data and user participation.

Nowadays, companies are able to collect a much higher amount of data from users and consumers. This increase in the facility and in the amount of data lead it to become not simply a sided element for the business activity, but for it to be actually a core element for it. The reliance on data can be expressed either by the huge amount of value it can generate for companies interested in selling it or, on the other hand, because with the 'reading' (processing) of these data, companies are able to 'outsource' to consumers and users some functions of the business activities, like quality control or product description.[20]

Ultimately, this feature reinforces the idea of the process of dematerialization of the economy.

1.1.3: Network effects

Connected to the idea of user participation lies the feature of the network effect, potentialized by the digital economy. Therefore, it is clear that in some business models, products can increase their value depending on the number of users or consumers to that specific product. The classical example to this effect is the fax machine[21], in the sense that the product would be useless if only one user acquires it.

Today, other important examples can be pointed out, like the use of more disseminated software or social media. On the other hand, also platforms that offers transports or accommodation services, performed by third and independent parties relies, usually, on the existence of several users sharing their experiences and encouraging or

[20] In this regard, we found interesting the intervention of Dhruv Sanghavi during the Public Consultation event on the Tax Challenges of the Digitalisation of the Economy, held by the OECD, in Paris, March 2019. This intervention can be watched at https://oecdtv.webtv-solution.com/5524/or/Public-Consultation-Tax-Challenges-of-Digitalisation.html, accessed 2019 July 16.

[21] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 71.

discouraging others to acquire the given products or services, without an exact compensation for that.

The network effect, therefore, is responsible for creating the so-called 'externalities', that may, then, be either positive or negative.

Finally, thou, we must understand that this feature of the digital economy is more closely connected to B2C operations, but, of course, not exclusively so.

1.1.4: Use of multi-sided business models

The digital economy enables a broader usage of the multi-sided model strategy, where different 'parts' or 'components' of a given business can be located in different jurisdictions and even provided by different undertakers. Hence, the same idea of positive and negative externalities analyzed in the topic above (1.1.3) applies to this feature.

This can be easily exemplified by the great number of internet free online news websites, social medias, virtual games and others that have the investment made upon them covered by the selling of advertisement space to be view by the ultimate user of the given online product. The externality verified here is usually a positive one, where business can split the costs of an investment and where consumers can have free access to the products desired.

On the other hand, negative externality can derive when the provider of the 'free service' collects and distributes data of the users in an illegal way.

This feature is also closely connected to the idea of the increase in business mobility (1.1.1), provided that also the placement of the sides of the business in jurisdiction A or B can easily be determined by economical and tax reasons, with fewer material barriers than ever before.

1.1.5: Tendency towards monopoly or oligopoly

A combination of several of the features above, especially in connection to the raise of importance of the network effect and the importance given to innovation and creation of new technologies, tends to lead to a monopoly or oligopoly in several markets.

Once a new product is made available at the market and quickly reaches a significant number of users (software, social media, mobile application for several

purposes, etc.) other users tend to look for the same product, instead of a possible competitor, given that they could extract a higher value from their usage of the main market player (lower prices, more inputs from other users, more connectivity with other products, etc).

This, therefore, creates barriers to the entrance of new players in the same market, but, on the opposite direction, it also seems to create an incentive for the development of new products which could be seen as better alternatives for the so far dominant in the market. Thus, new products can also reach their position in the market and grow extremely fast in a short time.

1.1.6: Volatility

Finally, as a natural consequence of technological development, several companies in a dominant market position lose their monopoly in a relatively short time, provided that new and more efficient products are being developed in a faster way all around the world.

1.2: The process of (re)allocation of business activities and taxing rights

The globalization and the development of the digital economy are responsible for a complete change in the organization of the economic activity around the world. All the elements described at topic 1.1 above contribute to the reallocation of business activities among a wide-ranging of jurisdictions, therefore, shifting the performance of activities from certain traditional countries to others, especially emerging countries, countries with a big potential market or even to low-tax jurisdictions.

Imagine, for instance, a business model where the company of a certain digital service is incorporated in Germany, but, due to the technological facilities available and tax and economic opportunities, decided to move its software and engineers to Ireland and, from there, to offer products to users/consumers in India, from whom the company extracts, processes, uses and resells valuable data to other companies interested.

This example shows how the process of generating business revenue can be complex and spread between several jurisdictions. Therefore, it is crucial to understand that the new organization of the economic features around the international community has posed questions on the need to rebalance the taxing rights derived from these

relocated activities or, in the terminology adopted by De Wilde: the need to rethink the way states divide the 'international tax pie'.[22]

We thus believe that the dynamic of the international taxation should be adapted in order to adequately reflects taxation where value is created. Nevertheless, it is not only sufficient to identify that a given value is created in a certain country. It is also needed to determine how much of value is effectively being created and if that the particular nature of value creation should be subject to income taxation therein.

These issues will be addressed at Chapter 5, provided that any adopted theory on how to deal with the new framework of value creation should be reflected in the new thresholds for the configuration of a permanent establishment, capable of 'capturing' this value creation and translating it into a taxable presence in the country where it is being generated.

1.3: The BEPS phenomenon

Another considerable tax challenge of the digital economy is to fight the *base erosion and profit shifting* phenomenon, also extensively addressed by the OECD, especially since the launching of the BEPS Project, in 2013[23], related to direct taxation. Again, the features presented at Topic 1.1 are responsible for increasing the opportunities for aggressive tax planning and the consequent artificial rearrangement of business activities, specially by MGC, in order to avoid or significantly reduce income taxation at a global level.

The OECD BEPS Action Plan identified 15 points that should be addressed by the international community in order for there to be the conservation of a global income tax base, in contrast with a scenario where large multinational companies are paying just a

[22] Maarten de Wilde, "Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy." *Intertax, 38, 5* (2010), 281.
[23] Organization for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris, France, 2013).

small fraction of the tax they are expected to pay[24]. It is a matter of tax sustainability, as we defend[25].

Understanding this project is crucial to comprehend the political framework at which our proposal of a new 'virtual permanent establishment' should be located. Therefore, we begin by saying that the OCDE, together with the G20, opted for a project to 'fix the current framework' instead of one that could ultimately modify the very core of the system.

With that in mind, we have to conclude that, in a short to mid-term, the solution for the tax challenges of the digital economy should comprehend the maintenance of direct taxes on business income[26]. Therefore, it seems that the idea of permanent establishment, as it is going to be discussed ahead, should continue been of significant importance to cross-border taxation.

For the purpose of this study, we will consider mostly Action 1 (Digital Economy); Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status); Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) and Action 15 (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS)[27]. Both the first and the last actions are view by the OECD as transversal measures and, hence, influences directly all situations addressed by the Plan. Our proposed solution, therefore, should be able to tackle the challenges of the digital economy and to be implemented in a global (multilateral) level.

---

[24] *See* commonly debated cases such as: FIAT (EU Commission Case No. SA38375); Starbucks (EU Commission Case No. SA.38374); Apple (EU Commission Case No. SA.38373) and Amazon (EU Commission Case No. SA.38944).

[25] Ricardo S. Schmitz F., "The challenges of sovereignty, justice and representation related to the movement towards multilateralism in international taxation," paper presented at the 29th IVR World Congress, Lucerne, Switzerland, July 2019.

[26] It is interesting to notice that some scholars advocate in the sense that direct taxation is incompatible with the digital economy and that efforts should be taken to substitute it, in a global level, by a broader application of indirect taxes such as the VAT. Noticeable, because of the characteristics of the VAT, this type of tax is better adaptable to the challenges of the digital economy and it has been already a target of interesting and successful experiences, namely at the European Union. Moreover, even today, indirect taxes respond, in general, for a bigger portion of tax revenues in many jurisdictions. Nevertheless, countries are not politically willing to give up on direct taxes and, therefore, a practical solution to the challenges faced, as we believe, most follow that 'political agreement' made around the BEPS Project and the so-called BEPS Inclusive Framework, with all non-OECD G20 members together. Finally, the adopted solution may also be able to reestablish a balance between state revenues deriving from indirect and direct taxation, with the increase in the effective collection of the latter in a global level.

[27] An overview of the BEPS Actions and the documents related to them can be found at: http://www.oecd.org/ctp/beps-actions.htm, accessed 2019 April 20.

1.3.1: Action 1 (Digital Economy)

After the presentation of the Final Report on BEPS Action 1[28], the G20 and the BEPS Inclusive Framework renewed the mandate of the Task Force on the Digital Economy, due to the fact that Action 1 did not provide for a concrete measure to be implemented[29]. This new mandate shall culminate in the presentation of a 'consensus-based solution' to be published by the end of 2020[30].

Recently, the Task Force on the Digital Economy has published an Interim Report[31] (2018) as well as a Public Consultation (2019) in order to reach a consensus-based solution on how to address the tax challenges of the digital economy. The latter, by the way, received several inputs from both taxpayers and tax authorities, as well as from other stakeholders and these inputs, to some extent, will be confronted ahead at this study.

These discussions are taken not only in related to fighting BEPS, but also in related to what OECD calls the 'broader' tax challenges – namely connected to the issue on the (re)allocation of taxing rights. Surely, these two sets of challenges are connected to the extent that the recovering of tax revenues, expected from the successful implementation of the BEPS Plan, leads to questions on where to allocate the recovered revenue among jurisdictions.

1.3.2: Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status)

The Action on Permanent Establishment promoted a series of changes at both the wording and, mainly, the commentaries to the OECD Model Convention in order to fight the artificial avoidance of the constitution of a permanent establishment. In due course, this artificial avoidance also represents the 'escaping' of a taxable presence in a given jurisdiction.

---

[28] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015).
[29] Aleksandra Bal, "(Mis)guided by the Value Creation Principle – Can New Concepts Solve Old Problems." *Bulletin for International Taxation, 72, 11* (2018): 6 p.
[30] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019).
[31] Organization for Economic Co-operation and Development, *Tax Challenges Arrising from Digitalisation. Interim Report, Inclusive Framework on BEPS* (Paris, France, 2018).

Therefore, the work of the OECD, especially until the publication of the Final Report on Action 7[32], in 2015, focused on trying to tackle issues related to the artificial avoidance of the permanent establishment status by the use of intermediaries performing certain activities, especially by means of an artificial fragmentation of cohesive operating business.

Besides that, Action 7 also provided for a revision in the exceptions applicable for the constitution of a PE, by reducing the scope of the terms 'preparatory' and 'auxiliary' activities, mainly through changes in the commentaries of Art.5 of the Model Convention. Changes on Art.5(5) and the scope of the application of the concept of 'dependent agent' were also introduced.[33]

Although we believe in interesting upcoming results from the adoption of the measures from Action 7, it is a fact that the OECD has a lot to work on the concept of permanent establishment. Firstly, with a stronger effort in broadening the idea of PE and adding a 'virtual' presence threshold but, apart from that, it is clear that companies can now create formal PEs with very limited risk, asset and functions that do not correspond with the income connected to the activities developed. The OECD should also take that it into account.

1.3.3: Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation)

The goal of Actions 8-10 of the BEPS Project is to align the transfer pricing outcomes with the already mentioned idea of value creation. Therefore, the investigation carried out by the OECD in matters of transfer pricing is, as stated above, intrinsically connected to the idea of permanent establishment.

Due to the evolution of the features of the digital economy, the Actions in evidence focus mainly in transfer pricing issues related to HTVI (hard to value intangibles); contractual arrangements for reallocating risks and profits and funding inside MGC (financial activities). Issues on business restructuring seem also important in relation to the scope of Actions 8-10.

---

[32] Organization for Economic Co-operation and Development, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report* (Paris, France, 2015).

[33] Ana Paula Dourado, "Editorial: Is There a Light at the End of the Tunnel of the International Tax System?" *Intertax, 46, 8/9* (2018), 607.

As we should discuss when dealing with the ongoing proposals designed by the Task Force on the Digital Economy, there are quite reasonable possibilities from which the application of transfer pricing rules would be set aside, giving space for a 'residual profit slit method'. The OECD itself, especially when developing the proposals discussed at the Public Consultation, in Paris, March 2019, opened the possibilities for the substitution of the arm's length principle[34], which was, by the publication of the Final Report on Actions 8-10 of the BEPS project, a 'hard nucleus' for international taxation of MGC.[35]

Several scholars, as we are going to discuss further ahead, questions the suitability of transfer pricing / arm's length ideas in the current scenario of the digital economy. For instance, Ana Paula Dourado discuss about the existence of several financial schemes that would not be performed among independent companies, such as cash pooling[36].

It is interesting, thus, to highlight the certain dubious view of the OECD upon this subject and its uncertain next steps. Therefore, although it is not inside the scope of this section of our study, it is also relevant to question what will be the future of the worked carried out (and delivered) by Actions 8-10.

1.3.4: Action 15 (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS)

We should now make some comments on Action 15.

Firstly, the practical feasibility of this Action was putted in doubt by many tax experts by the time of the release of the BEPS Action Plan, in 2013. Nevertheless, after the publication of the Final Report[37], in 2016, a mandate was issued for the OECD to carry-on the work towards the actual implementation of such a multilateral instrument (MLI).

---

[34] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019).
[35] Organization for Economic Co-operation and Development, *Aligning Transfer Pricing Outcomes with Value Creation: Actions 8-10: 2015 Final Reports* (Paris, France, 2015).
[36] Ana Paula Dourado, "Editorial: The OECD Financial Transactions Discussion Draft and BEPS Actions 8-10." *Intertax, 46, 10* (2018), 740.
[37] Organization for Economic Co-operation and Development, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report* (Paris, France, 2015).

Thus, in a surprisingly short period of time, the MLI was adopted (2016)[38] and has now been signed for already 87 jurisdictions[39]. For some of the countries, the MLI entered into force in the 1st of July 2018, while we still wait for the majority of countries to actually implement it, what can that longer depending on the necessary legal procedures to be domestically adopted by them.

Currently, the importance of the MLI lies, essentially, in the symbolism it brings in the sense that it is actually possible for countries to gather together in global tax solutions, acting in consensus. Nevertheless, the stage of development of the MLI is still very early and needs to be improved. By now, countries are only 'obliged' to comply with minimum standards, with the possible adoption of several reservations to the full application of the multilateral instrument (by ways of opts-in and opts-out).

Besides that, the MLI carried the idea of bringing a higher level of global harmonization to the web of bilateral tax treaties. This would help dealing with the practice of harmful tax competition[40] among countries and, more than that, would help in the implementation of more standardized solutions, helping with compliance and administration.

The problem is that both the 'low scope' of the minimum standards and the high number of possible reservations that can be applied differently in every specific bilateral treaty, makes the MLI still a 'shy instrument'.

On the other hand, as we are going to further develop, we do believe that the MLI is the right instrument for the implementation of our proposed idea and that it contains a great potential that must be explored.

[38] Organization for Economic Co-operation and Development, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (Paris, France, 2016).
[39] This data is updated until 2019 April 20. *For updated numbers*: http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.
[40] In terms of defining what would be considered a 'harmful tax competition' we adopt the considerations brought by Maarten de Wilde, according to whom the this form of competition would be more connected to the artificial shift of business activities, for tax reasons, while a fair tax competition would deal with the attraction of real business activities. Maarten de Wilde, "Tax Competition within the European Union – Is the CCCTB Directive a Solution?" *Erasmus Law Review, 24, 1* (2014), 26.

Chapter 2: Ottawa Framework for International Taxation in the Digital Economy

The first step towards the elaboration of a new consensus-based solution for the challenges of the digitalization of the economy must be the identification that changes perpetrated inside the web of tax treaties around the world, *as we suggest that must be done*, tend to cause relevant implications at the level of the current framework for international taxation.

So far, we do not believe on the possibility of developing a solution without affecting the practical application of the principles of international tax law. Therefore, a responsible solution to these challenges must consider (and balance) the effects upon them.

By means of this study, we shall adopt the so called 'Ottawa principles' or 'Ottawa Framework'. These principles were elaborated by the work of the OECD and were embodied firstly at the 'Ottawa Taxation Framework Conditions' (1998)[41] and in the following 'Implementation of the Ottawa Taxation Framework Conditions' (2003)[42], both in regard to e-commerce and, later, in 2015, at the Final Report on BEPS Action 1: 'Addressing the Tax Challenges of the Digital Economy'[43], connected to the whole international taxation in a digitalized world.

As stated right at the introduction to this paper, we aim at achieving a practical and feasible solution to our problem. In our understanding, therefore, the adoption of new principles or the performance of substantial changes on the existing framework would require a much higher effort from the international community and would probably fail to be a consensus, at least in a short-term analysis.[44]

---

[41] Organization for Economic Co-operation and Development, *Electronic Commerce: Taxation Framework Conditions* (Paris, France, 1998), 4.

[42] Organization for Economic Co-operation and Development, *Implementation of the Ottawa Taxation Framework Conditions: the 2003 report* (Paris, France, 2003).

[43] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 20-21.

[44] The Task Force for the Digital Economy of the International Bureau for Fiscal Affairs (IFBD) expressed the same opinion in its comments to the Public Consultation held in Paris, 2019 March, by the OECD. Pasquale Pistone; João Félix Pinto Nogueira and Betty Andrade. "Comments submitted by The International Bureau of Fiscal Documentation (IBFD) Task Force on the Digital Economy" (OECD, Paris, 2019), 11.

We start, hence, with a brief analysis of the main principles that guide the international taxation framework, from the wording of the 2015 Report, and that should, as well, guide the solution we should propose.

2.1: Neutrality

> 'Taxation should seek to be neutral and equitable between forms of business activities.'[45]

The first part of this characterization is strictly connected with the idea of *non-ring fencing* the digital economy for tax purposes.

This approach is heavily defended by the OECD[46], as well as by the majority of academics and practitioners[47]. We believe that there is no such as thing as the `digital economy` as a branch of the economic activity. Nowadays, it is hard to deviate from the view that the digital economy is the economy itself: every business is affected by it in some way. Hence, there should be a neutral tax incidence on similar activities (*substantially speaking*), regardless of the more or less digital form they assume.

> 'A neutral tax will contribute to the efficiency by ensuring that optimal allocation of the means of production is achieved. A distortion, and the corresponding deadweight loss, will occur when changes in price trigger different changes in supply and demand than would occur in the absence of tax. '[48]

Furthermore, this principle should apply in way to guarantee that the tax system would not be considered as an aspect more important than pure economic reasons while companies deciding how to offer their products in a given market. A different tax treaty for more physical or digital products can lead to an economical distortion and, therefore,

[45] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 20.
[46] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015). *See*: Ana Paula Dourado, *Governação Fiscal Global* (Lisbon, Portugal: Almedina, 2017), 62.
[47] For a recent argument in favor of this idea, *see*: Pasquale Pistone; João Félix Pinto Nogueira and Betty Andrade. "Comments submitted by The International Bureau of Fiscal Documentation (IBFD) Task Force on the Digital Economy," (OECD, Paris, 2019), 12.
[48] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 20.

to the existence of a deadweight loss that could ultimately even harm the increase in the collection of future income taxes.

> 'In this sense, neutrality also entails that the tax system raises revenue while minimizing discrimination in favor of, or against, any particular economic choice. This implies that the same principles of taxation should apply to all forms of business, while addressing specific features that may otherwise undermine an equal and neutral application of those principles.'[49]

Given the extract above, we believe that the principle of neutrality is not against the existence of the application of specific procedural rules on how to effectively tax more digitalized business models. As stated by the Report, there should be no worse or better treatment for more digitalized activities. Therefore, the application of identical measures, sometimes, could not comply with this requirement. On the other hand, the 'final tax result', to say so, must be as neutral as possible.

In terms of what we aim to highlight for our proposal is that, besides there appear to be the need of implementation of new thresholds rules for the configuration of a 'virtual' permanent establishment, these thresholds must not substantially change the final tax burden of a given tax payer, compared to similar activities developed in a more physical or traditional economic model.

Moreover, one should realize that, even in face of the classical 'types' of permanent establishments, there are already some different approaches to the verification of thresholds for each case.

We will come back to this discussion.

2.2: Efficiency

> 'Compliance costs to business and administration costs for governments should be minimized as far as possible.'[50]

---

[49] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 20.
[50] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 20.

The short description of this principle provided also by the Final Report on BEPS Action 1 has, nevertheless, several implications.

One of the functions of our idea on 'virtual' PE, as already mentioned, it to make it possible for countries to recover the so called 'stateless' income. Therefore, it should only be economically valid for those states to implement the new changes if the costs related to it do not overcome the amount of taxable revenue that the new rules should generate.

Moreover, it is also important that the new rules do not impose an extra high compliance cost for taxpayers. It is clear that high compliances costs are generally connected with the increase of intentional and non-intentional tax avoidance. Other possible consequence of the increase of compliance costs for taxpayer is the increase of price of the final products, harming the normal functioning of the economy and, ultimately, the tax collection as well.

2.3: Certainty and simplicity

This is probably one of the most challenging principles to be observed while developing any new idea on how to tackle our problem. It has also been demonstrated that it is a huge concern for both taxpayers and tax authorities, as observed at most of the commentaries delivered to OECD during its Public Consultation on the 'Tax Challenges of the Digital Economy, in Paris, March 2019.'[51]

According to the Final Report on BEPS Action 1, the principle of certainty and simplicity could be described as follows:

> 'Tax rules should be clear and simple to understand, so that taxpayers know where they stand. A simple tax system makes it easier for individuals and businesses to understand their obligations and entitlements. As a result, businesses are more likely to make optimal decisions and respond to intended policy choices.'[52]

[51] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019).
[52] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 20.

It is very important not to mistakenly confuse `simplicity` with a simplistic approach for the challenges ahead. The adopted solution must be complex enough not to ignore differences in different situations and not to leave aspects of the problem uncovered. On the other hand, it must be simple enough so that, firstly, it can be understandable and, second, that it can be complied with.

> ‘Complexity also favors aggressive tax planning, which may trigger deadweight losses for the economy.’[53]

Of course, as more complicated and filled with exacerbated details or formulas and based on very subjective components the bigger the chance that the proposed solutions will not be able to tackle one of the main challenges of the digitalization of the economy: the increasing opportunities for tax avoidance. By adding complexity, one adds also more space for aggressive tax planning.

On the other hand, the attention to simplicity and certainty is also important to guarantee the applicability of the implementation of the new rules by the tax authorities themselves. In the words of IBFD`s Task Force for the Digital Economy:

> ‘(*it is important*) that the proposed rules can be implemented by any jurisdiction, regardless of its degree of development (namely by those that often lack suitable skills to manage sophisticated tax rules).’[54]

2.4: Effectiveness and fairness

> ‘Taxation should produce the right amount of tax at the right time, while avoiding both double taxation and unintended non-taxation. In addition, the potential for evasion and avoidance should be minimized.’[55]

Based on the statement above, it is possible to connect the idea of effective and fairness also to a system that functions in the same way for taxpayers in similar situations, avoiding unintended consequences, such as double or non-taxation. In that regard, it is

---

[53] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 20.
[54] Pasquale Pistone; João Félix Pinto Nogueira and Betty Andrade. “Comments submitted by The International Bureau of Fiscal Documentation (IBFD) Task Force on the Digital Economy,” (OECD, Paris, 2019), 12.
[55] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 20.

also important that the taxpayers, in general, perceive the system as a fair and functioning one, as it contributes to compliance and, therefore, effectiveness.

Of course, the more efficient the system, the thinner are the gaps for both tax avoidance and evasion.

> ‘Prior discussions in the Technical Advisory Groups (TAGs) considered that if there is a class of taxpayers that are technically subject to a tax, but are never required to pay the tax due to inability to enforce it, then the taxpaying public may view the tax as unfair and ineffective. As a result, the practical enforceability of tax rules is an important consideration for policy makers. In addition, because it influences the collectability of taxes, enforceability is crucial to ensure efficiency of the tax system.’[56]

Connected to the idea of effectiveness and fairness is the degree of enforceability of taxes in a given system. Therefore, in practical terms, there will be no efficiency or fairness in a scenario where there is no collection upon a given number of taxpayers. Several problems are identified with the enforceability element.

It is important, therefore, to highlight that a proposal based on the creation of a ‘virtual’ PE threshold, as ours, will have to be able to face challenges on how to enforce tax: a) without a physical presence in the source country and b) with a possible increase of complexity of norms, lower sophisticated tax authorities may find difficulties applying and enforcing them.

We shall discuss more on that latter.

2.5: Flexibility

> ‘Taxation systems should be flexible and dynamic enough to ensure they keep pace with technological and commercial developments. It is important that a tax system is dynamic and flexible enough to meet the current revenue needs of governments while adapting to changing needs on an ongoing basis.’[57]

---

[56] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 20.
[57] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 21.

Furthermore, we believe that the element of flexibility is also important when analyzing the chances of a consensus on the solution to be adopted at an international level. It is crucial, therefore, that smaller practical details and 'formula numbers' do not become a hard part of a future solution to the tax challenges of the digitalization of the economy.

> 'This means that the structural features of the system should be durable in a changing policy context, yet flexible enough to allow governments to respond as required to keep pace with technological and commercial developments, taking into account that future developments will often be difficult to predict.'[58]

Hence, any change in the current framework of the concept of PE, inside the scope of reaching a consensus-based solution, should not focus on a handful of particular business models and, based on them, develop a countless number of specific details. The past models of permanent establishment, for instance, were sufficiently applicable for over a century. The solutions to be adopted in the next few years must also be thought to last a significant amount of time, being able to encompass future technological developments.

As we are going to detail further ahead, we believe the details should be left to be developed by the treaty partners in the field of the DTTs, while the core of the `virtual` PE idea should be somehow included in the Multilateral Instrument (MLI) as a kind of a minimum standard.

[58] Organization for Economic Co-operation and Development, *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris, France, 2015), 21.

Chapter 3: Concepts of 'Source'; 'Residence'; 'Permanent Establishment' and Complementary Notes

3.1: Historic notes

In the context of international tax law, 'source' and 'residence' are the basic connecting factors, or 'nexus', for taxation of income derived by business activities, ultimately because they are the key elements for determining the allocation of taxing rights among interested jurisdictions in a cross-border situation.

According to Ana Paula Dourado:

> "Residence and source are indicative of different levels of economic allegiance to a jurisdiction, but both mean that in the presence of economic allegiance, taxation is legitimate. Economic allegiance to a state could be based on mere consumption, or on business activities and passive investment".[59]

The application of the nexus of 'source' and 'residence' date back to the beginning of the 20th century, with the development of the first studies on modern international tax law, as a consequence of the growth of regional and global trade and the need to manage the attribution of taxing rights among jurisdictions, notably in the process of eliminating/attenuating the emerging juridical double taxation[60]. Thus, in an international perspective, the attribution of taxing rights upon a given income to one state prevents (or limits) the other state to tax the same revenue or, at least, demands the latter to provide elimination or mitigation of the double-taxation.[61]

Historically, academics consider the treaty between Prussia and Austria-Hungary, from 1899[62], to be the first modern tax treaty and, even though we have much broader and detailed treaties nowadays, the bedrocks are still pretty much untouched: principles

---

[59] Ana Paula Dourado, "Editorial: In Search of an International Tax System in a Post-BEPS Tax Competition Setting." *Intertax, 47, 1* (2019), 2.

[60] Stjepan Gadžo, *Nexus Requirements for Taxation of Non-Residents' Business Income – A Normative Evaluation in the Context of the Global Economy* (Amsterdam, The Netherlands: IBFD Doctoral Series, 41, 2018).

[61] The 'juridical' double taxation to be prevented can arise both from a dual residence conflict, as well as when both the residence and the source contry tax the same income. *See*: Vikram Chand and Robert Danon, *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties (with special references to the BEPS project)* (Lausanne, Switzerland: Université de Lausanne; Schulthess, 2018), 8-9.

[62] Robert Williams, *Fundamentals of Permanent Establishments* (Second Ed., Wolters Kluwer, 2014).

such as 'source', 'residence' and 'permanent establishment' kept their importance[63]. These 'nexus' continued to be the essence of tax treaties and were broadly used specially after the World War I, when model tax treaties started being drafted, firstly by the League of Nations, in 1928[64]. Today, more than 3.500 DDT are in force[65], most of them with the common language of the OECD Model Convention[66] or, in some more restricted situations, based on both the UN and US Models.

Therefore, since the launching of the BEPS Project, the OECD has recognized that the solutions to the challenges of the digital economy, connected to the base erosion and profit shifting problem and the issues on the reallocation of taxing rights, lie closely related to the application of changes based on the concepts of source and residence. This idea is strongly present, for instance, at the reports on BEPS Action 1 and the further rounds of discussion lead by the Task Force on the Digital Economy that should deliver a consensus-based solution by the end of 2020.

In summary, therefore, **the existence of such nexus delineates the limitation of the right to tax[67] from a certain jurisdiction in a cross-border context**, especially when covered by a double tax treaty.

3.2: Concepts of 'residence' and 'source'

63 Robert Williams, *Fundamentals of Permanent Establishments* (The Netherlands: Wolters Kluwer, 2nd Ed., 2014). Oddleif Trovik, "Chapter 25: The Allocation of Residual Profits from Unique and Valuable IP to Permanent Establishments *in* Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains (IBFD 2019)," *IBFD Doctoral Series, 45* (2019), 9-10.

64 In fact, the drafting of the first Model Tax Convention, by the League of Nations was preceded by the 1923 Report: League of Nations, *Economic and Financial Commission, Report on Double Taxation Submitted to the Financial Committee* (Geneva, Switzerland, 1923). The actual inaugural model tax convention was, as mentioned, published in 1928. League of Nations*, Draft Model Treaty on Double Taxation and Tax Evasion* (Geneva, Switzerland, 1928).

65 Robert Williams, *Fundamentals of Permanent Establishments* (The Netherlands: Wolters Kluwer, 2nd Ed., 2014).

66 Organization for Economic Co-operation and Development, "Tax treaties: update to OECD Model Tax Convention released", accessed 2019 April 27, https://www.oecd.org/tax/treaties/tax-treaties-2017-update-to-oecd-model-tax-convention-released.htm.

67 It is important to highlight that the 'right to tax' does not, in general, means the 'obligation to tax'. Certainly, tax treaties do not impose material norms based on the ideas of `source` and `residence`. On the contrary, they provide the grounds for the attribution of competence among signatories. *See*: Ekkehart Reimer; Stefan Schmid and Marianne Orell, *Permanent Establishment: Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th Edition, Wolters Kluwer, 2016), 6.

The term 'resident', for tax purposes, is responsible for establishing a 'personal attachment' between a potential taxpayer and a particular State[68]. The establishment of this connection can be done through the application of either domestic or international sets of rules and it represents the strongest connection (or bound) possible between a juristic person and a country.

Furthermore, depending on the rules analyzed, the thresholds for the constitution of a 'resident' bound can significantly vary. The delimitation of such thresholds is of fundamental importance to the entire system of cross-border taxation of business income, provided the existence of practical differences in terms of the tax liability of a resident and a non-resident.

Moreover, meeting the threshold for the attribution of the status of a 'resident' is the 'most important criteria for a tax treaty entitlement'[69]. For matters of our studies, nevertheless, one other function of this term must be highlighted: the concept of 'resident' is applied in order to determine the allocation of taxing rights among jurisdictions in cases covered by DTTs[70]. Article 4(1) of the OECD Model Convention embodies the principle of single residence and, therefore, this expression should have the practical impact in avoiding the existence of a double resident liability, which would culminate in a case of double taxation.

We should turn our attention to the application of the concept of 'residence' (and, thus, of a 'resident') at an international level. Article 4(1) of the OECD Model Convention, thus, is responsible for that task. *In verbis*:

> 'For the purpose of this Convention, the term 'resident of a contracting state' means any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of similar nature (…). This term, however, does not

[68] Organization for Economic Co-operation and Development, "Commentary on Article 4 Concerning the Definition of Resident" in *Model Tax Convention on Income and Capital: Condensed Version 2017* (Paris, France, 2017), I, Paragraph 2.
[69] Dhruv Sanghavi, *Structural Issues in the Income Tax Treaty Network: Towards a Coherent Framework* (Enschede, the Netherlands: Ipskamp Printing BV, 2018.). This idea is also shared by Gustavo Lopes Courinha, *A Residência no Direito Internacional Fiscal: do Abuso Subjectivo de Convenções* (Lisbon, Portugal: Almedina, 2015), 66-67. *See*: Organization for Economic Co-operation and Development. *Model Tax Convention on Income and Capital: condensate version* (Paris, France, 2017), Art.4.
[70] Roland Ismer & Katharina Reimer. "Chapter 2, Article 4" in *Klaus Vogel on Double Taxation Conventions*, Klaus Vogel (The Netherlands: Ekkehart Reimer and Alexander Rust, Vol 1. 4th Ed., 2015), 220.

include any person who is liable to tax in that state in respect only of income from sources in that state or capital situated therein.'[71]

Consequently, in general, DTTs do not prescribe a definition of what would constitute a resident for the purpose of the treaty[72]. On the contrary, DTTs usually provide solutions for the case of a given person being considered a resident from the perspective of both tax authorities. Therefore, once facing a practical case, one should first identify the limits for the concept of 'tax residence' prescribed by the domestic laws of both the treaty partners.

Moreover, Article 4(3) of the OECD Model Convention states that:

> 'Where by reason of the provisions of paragraph 1, a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavor to determine by mutual agreement the Contracting State to which such person shall be deemed to be a resident for the purpose of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.'[73]

Therefore, in case there emerges a dual residence from the application of both the domestic laws, the issue must be solved by using the tools brought by the DTT in concrete. If no case of 'dual-residence' were verified, then, the domestic rules on attribution of this status are maintained.

On the other hand, deriving from the extract above (Art. 4(3)) it can be said that the 'source country' is the jurisdiction where a person, not considered to be a resident, perform any kind of activity from which there may derive some income.

---

[71] Organization for Economic Co-operation and Development. *Model Tax Convention on Income and Capital: condensate version* (Paris, France, 2017), Art.4(1).
[72] Organization for Economic Co-operation and Development. *Model Tax Convention on Income and Capital: condensate version* (Paris, France, 2017).
[73] Organization for Economic Co-operation and Development. *Model Tax Convention on Income and Capital: condensate version* (Paris, France, 2017), Art.4(3).

Note that 'source country' and 'source taxation' may as well have different meanings, given that not every activity developed by a non-resident in the 'source country' will be subject to 'source taxation'. The broadness of the thresholds for the latter to be possible will depend on both national and international law, as detailed in topic 3.2.1 *infra*.

3.2.1: National and international dimensions

The practical analyses on how to determine a country of 'residence' or 'source' can be expressed, as already mentioned, by two levels or sets of rules: national and international.

The first layer, therefore, is composed of concepts provided by domestic laws of the countries (unilateral rules). As a corollary of the principle of legality, common to most of the jurisdictions, countries can only impose tax when authorized by law. Among other elements, the law must specify who can be taxed and in face of which exact income. The broadness of the definitions of 'residence' and 'source', therefore, is usually seeing in the text of the laws as forms of delimitation to the extent of the power to tax.

Generally, countries impose low thresholds for both the attribution of the status of 'resident' and, even more so, to the attribution of taxing rights upon activities developed by non-residents in connection with that country (thus, with broad application of source taxation[74]). The scope of the 'unilateral rules', therefore, is generally in line with the idea of assuring a higher collection of income taxes.

Of course, the broadness of both the concept of residence and the range of activities developed by non-residents that would be subject to tax will differ from country to country, provided they have a relatively wide field of freedom to determine their domestic tax laws. It is noticeable, on the other hand, that there are some limits to the *fiscal sovereignty* of countries, on the extent that there must be a minimal identification (or connection) between a potential taxpayer and the particular jurisdiction for residence

[74] This is especially true when dealing with traditional capital import countries, such as most Latin American jurisdictions. *See*: Stjepan Gadžo*, Nexus Requirements for Taxation of Non-Residents' Business Income – A Normative Evaluation in the Context of the Global Economy* (Amsterdam, the Netherlands: IBFD Doctoral Series, 41, 2018).

to be verified[75] and also for a given source activity to be subject to tax at the source country. (*See Topic 3.3, 'Thresholds', bellow*).

On the other hand, a second layer of conceptualization of the terms 'source' and 'residence' exists in virtually every modern tax treaty (bilateral rules) and should prevail in face of the national laws of the treaty partners in the case a 'dual-residence' (conflict) situation arises, as it is the primarily goal of DTTs to eliminate double-taxation.

Well, the international tax law is a branch of the public international law[76] and the DTT are indeed subject to the framework of the Vienna Convention[77]. Therefore, no difficulties should arise in understanding that a treaty signed by a given country cannot be deemed to have its application barred because a national law deals with the problem differently.

Regarding the broadness of source taxation, nevertheless, the indications contained in the DTT should always be seeing in first place, otherwise, it would be extremely likely that every cross-border activity of a non-residence would end up been taxed exclusively at source states.

Finally, remember that, as the scope of double tax treaties is primarily the elimination/attenuation of double taxation, it is easy to foresee that the extent of the concepts of 'source' and 'residence' tends to be narrower (expanded limitations upon taxable situations).

3.3: Thresholds

3.3.1: *For* the attribution of a 'resident status'

With that being said, it is important to outline that countries generally adopt one of these two tests (sometimes, both) in order to classify a jurist person as a resident: 'place

[75] Stjepan Gadžo, *Nexus Requirements for Taxation of Non-Residents' Business Income – A Normative Evaluation in the Context of the Global Economy* (Amsterdam, the Netherlands: IBFD Doctoral Series, 41, 2018). The author also debates this idea in: Stjepan Gadžo, "The Principles of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law: A Reappraisal." *Intertax, 46, 3* (2018), 208-209.
[76] Reuven S. Avi-Yonah, "International Tax as International Law." *Tax Law Review*, 57*, 4* (2004), 483.
[77] Pistone especially defends the use of the rule son interpretation of treaties, present at the Vienna Convention, Articles 31; 32 and 33. Pasquale Pistone, *Diritto Tributario Internazionale* (Giappichelli, Italy, 2017), 180. A comprehensive analysis of this idea can be found in Frank Engelen, *Interpretation of Tax Treaties under International Law* (Amsterdam, the Netherlands: IBFD Doctoral Series, 7, 2004).

of incorporation' or 'place of effective management' of the company. These concepts are of fundamental value to our future considerations.

In the first case, a person is considered to be a resident of a given country when it was incorporated, established, in that country, following the laws therein. It is rather a simple verification test and, by itself, does not usually create practical problems. Other nomenclature for this test can be read in the doctrine as 'legal seat' theory.

Notice that, nowadays, the straight use of the term 'nationality', as a connecting element instead of 'residence', has very little practical application, even because many jurisdictions "cover" the idea of nationality under the usage of the 'legal seat criteria', as part of a test for determining residence. Moreover, also the term 'domicile' is not very much used, provided it has a more limited broadness in comparison to 'residence'.

Some jurisdictions can also adopt a criterion based on the residence of the shareholders of the company to identify its residence, at least when dealing with tax treaty covered situations and in where there is an analysis of the ultimate beneficial owner, in order to verify, for instance, the possibly of a given company to benefit from a DTT. Nevertheless, these more specific rules are out of the scope of this study.

The second and more elaborate test is based on the place of effective management of the company (or 'real seat' theory). This assessment considers where the decisions for the functioning of the company really lie. Besides that, elements such as where the business risks are undertaken and where most assets and labor force are located are usually considered in order to identify the effective place of management of the company. Surely, this is a more complex test and can more easily culminate in arguable practical decisions.

Despite its practical complexity, this is the recommended approach by the OECD, especially within the framework of its efforts in fighting artificial business strategies, like the incorporation of 'mailbox companies', without relevant substrate, mostly for aggressive tax planning purposes.

Hence, we come back to the idea that the cross-border interaction between national rules embodying each one a different test for attribution of the status of 'resident' can lead to situations of dual-residence. This can be easily exemplified as follows:

Company X is incorporated in country A and has its effective management in country B. The internal legislation of the first country (Country A) adopts the criterion of the place of incorporation as element of determination of residence. Therefore, Company X is views as a resident therein. On the other side, Country's B domestic law adopts the place of effective management as the decisive criterion for attribution of residence to a given person. Hence, for the tax authorities of Country B, Company X is also a residence of that jurisdiction.

In this case, Company X would be seeing as a resident from the perspective of both tax authorities. This is an issue that international tax law tries to deal with via the existence of specific provisions in treaties designed to attribute the sole residence status to one jurisdiction (principle of the single residence).

3.3.2: *For* the imposition of a 'source taxation'

Besides the tax liability of the residents, also the state of source can be able to tax activities developed in connection to its jurisdiction, even if by some jurist person not incorporated thereof and without any effective management at the source state. This possibility is evaluated in connection with some other thresholds.

Hence, considering the layer of unilateral limitations, countries are relatively free to establish their own rules on attributing this nexus and, so, to develop their thresholds in order to impose tax upon a non-resident. According to Gadžo, four broad categories of thresholds are usually adopted, varying from different ideas of permanent establishment to widely applicable withholding taxes with very low thresholds[78]. Nowadays, nevertheless, the OECD PE 'model' has been influencing more and more domestic legislations.[79]

On an international level, nevertheless, these thresholds are usually connected to the idea of a permanent establishment, reflected at the wording of most of the DTTs.[80]

---

[78] Stjepan Gadžo, *Nexus Requirements for Taxation of Non-Residents' Business Income – A Normative Evaluation in the Context of the Global Economy* (Amsterdam, the Netherlands: IBFD Doctoral Series, 41, 2018).

[79] Ekkehart Reimer; Stefan Schmid and Marianne Orell, *Permanent Establishment: Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th Edition, Wolters Kluwer, 2016), 5.

[80] Stjepan Gadžo, *Nexus Requirements for Taxation of Non-Residents' Business Income – A Normative Evaluation in the Context of the Global Economy* (Amsterdam, the Netherlands: IBFD Doctoral Series, 41, 2018).

Although different from jurisdiction to jurisdiction, when adopted domestically (at a national dimension) or from DTT to DTT (at an international level), the idea of PE embodies the way countries defines the existence of a significant enough *material presence* of a given non-resident business in its territory. This idea, as further discussed, is outdated and most be rethought.

Therefore, so far, we have reached the conclusion that the elements of 'source' and 'residence' work as nexus for attribution of taxing rights among jurisdictions in a cross-border situation. By attributing taxing rights to one jurisdiction, when analyzed through the perspective of DTTs, these concepts impose limits to the taxing impulse of the other country. Hence, the importance of this distribution lies in the interest of countries (and international commerce) to eliminate or, at least, to attenuate the phenomenon of double-taxation and to better allocate the tax revenues among the global community.

3.4 Tax liabilities

3.4.1: *Upon* residents ('universal liability')

In virtually every national legal system, the tax liability of a resident is broader than a non-resident, exactly because, as stated above, the connection (or nexus) for taxation is stronger between a resident and its country of residence. In practical terms, therefore, the resident usually has an unlimited tax liability, which means that it is taxed in a worldwide basis, or, in other words, it is taxed on the income received anywhere in the world and not only in face of a 'domestic income'[81]. Besides, this income is usually taxed in a net basis.

Thus, the determination of the residence of the company is of fundamental importance to delineate its tax liability and, therefore, it is easy to identify that, in most cases, it is not ideal to be a 'dual resident'. With that in mind, basically every DTT have provisions on how to solve cases of dual residence involving a jurist person connected to the treaty partners.

[81] Dhruv Sanghavi, *Structural Issues in the Income Tax Treaty Network: Towards a Coherent Framework*, (Enschede, the Netherlands: Ipskamp Printing BV, 2018), 209. Maarten de Wilde, *Sharing the Pie: Taxing Multinationals in a Global Market*, (Amsterdam, the Netherlands, IBFD, 2017), 3.

3.4.2: *Upon* non-residents ('territorial liability')

On the other hand, a non-resident can still exercise economic activities and generate income in a particular State, both passive and active, of course. Therefore, the non-residents can also be subject to tax in that foreign state being, thus, considered bound by a 'secondary nexus'.

Nevertheless, as bonded by a weaker nexus than the one of the residents, the source State can only tax the person's deriving income from its territory if certain thresholds are met. If these thresholds are met, then, the non-resident will also bear a tax liability in the source state.

Of course, this tax liability would still be narrowly, as it should be connected only to the income derived from activities develop in connection with that particular source country. Again, this form of liability is more restricted than the one bore by the residents and is, thus, usually called as a "territorial" liability.

The determination of the source of a given income may, nevertheless, be an extremely complicated task, especially with the current development of the global and digitalized economy. As stated in Chapter 1, in the scenario of a digital economy is hard to determine where value is being created, especially when dealing with highly digitalized business of extremely fragmented production models.

On the other hand, not every 'source activity' is deemed to create sufficient nexus between the jurist person and the country where the activity is being performed as to justify the imposition of income tax from the latter. As already mentioned, the 'secondary nexus' is a rather weaker one and, therefore, the thresholds evaluated at the topic 3.2.1 ahead must be met in order to enable source taxation.

3.5: The classical concept of permanent establishment

According to what we have analyzed, despite the attribution of the so called 'resident status', it is also important for enterprises, as well as for tax authorities, to determine if there should also lie a tax liability of the juristic person in the source state. That should be clear by now.

Firstly, because, where no treaties apply, there can be a case of unavoidable double-taxation over that income. Secondly, and more importantly for our study, because,

in case the situation is covered by a DTT, the taxing rights of the particular business income may be attributed to the source state, provided the thresholds contained at the DTT are met.

To sum up what has already been said, on a tax treaty basis, therefore, these thresholds are usually connected with the idea of the existence of a so-called **permanent establishment** of the non-resident in the source country and, where such DTTs exist, their limitations on attributing taxing rights to the source state must prevail the limitations imposed by domestic law. Moreover, it is important to notice that, in general, the attributions of taxing rights to the source countries is considered in a more restricted and conservative way in DTTs than it is in national legislations.

Therefore, in a cross-border situation covered by a double tax treaty, the final delineation of whose is the right to tax will derive from the analysis of the concept of permanent establishment, given the fact that there lies the threshold for the attribution (or not) of the mentioned rights to the source state. It is also important to notice that, due to the profound changes by which the global economy is undergoing, the actual *material* approach to this element (permanent establishment) is undeniably in crises and must be debated. This is study aims to contribute in that matter.

Finally, the importance of the idea of permanent establishment is not only by 'positive' means (the attribution of taxing rights to the source country) but, consequently, also by a 'negative' way (excluding the right to tax of the residence state or obliging it to give a tax credit to eliminate double-taxation)[82]. **Thus, no doubts shall arise in saying that changes in matters of reallocation of taxing rights, inside the current framework, should be thought around the concept of permanent establishment**.

At the very beginning of this study we were able to conclude that 'residence' and 'source' are the decisive connecting factors for the attribution of taxing rights in cross-border situations. We have also understood that, according to the current framework of the web of double tax treaties, the taxation at the level of the source is a 'subsidiary' or rather 'exceptional' taxation.

Hence, according to the words of most tax treaties in force today, the taxing rights of a given income should be allocated to the country of residence, unless there can be

[82] Carlo Garbarino, "Permanent Establishments and BEPS Action 7: Perspectives in Evolution." *Intertax, 47, 4*. (2019), 366.

verified the existence of enough 'material' connection between the non-resident and the source country. We have also seeing that this idea of enough connection and the thresholds for its measurement are embodied at the concept of permanent establishment[83].

Therefore, in our point of view, any proposal for the changing of the international taxation dynamic, based on our current framework (*change without revolution*), the consequent reallocation of taxation rights and the actual taxation of stateless income must deal with changes in this concept.

Art.5(1) of the OECD Model Convention states:

> "For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which business of an enterprise is wholly or partially carried on".[84]

The first important characteristic of a permanent establishment, therefore, is the notion of habituality, mainly derived from the use of the term 'permanent'. Of course, it is not demanded, *nor it could be*, that the activity developed by a non-resident lasts forever, undefined in time. Nevertheless, a certain time threshold must be met for the activity developed to gain the quality of a 'permanent establishment'. Otherwise, if no time limit was required, mere occasional interference from a non-resident in the source country economic life would generate a tax liability therein. Ultimately, this would raise compliance challenges and could limit international trade.

To deal in a more concrete way with the generality of problems related to the term 'permanent', the OECD Model Convention adopts a minimum time of presence in the source country, as a necessary element for the constitution of a PE. This minimum temporal requirement is of 12 months, according to Art.5(3) of the abovementioned document. Nevertheless, some treaty partners preferred to lower this time requisite to 6 months, which can also be influenced by the specific kind of permanent establishment in study.

The second term that must be analyzed is 'establishment'.

---

[83] Carlo Garbarino, "Permanent Establishments and BEPS Action 7: Perspectives in Evolution." *Intertax, 47, 4*. (2019), 366.

[84] Organization for Economic Co-operation and Development, *Model Tax Convention on Income and Capital: Condensate Version* (Paris, France, 2017), Art.5(1).

For over a century, since the beginning of the adoption of such a term, the idea of establishment was closely connected to a material presence of the non-resident in the territory of the source country. Even today, when reading Article 5 of the OECD Model Convention, the material element is strongly present. Our study will try to modify this approach.

Therefore, permanent establishment, according to the basic ground of its classical concept, can be said to be a material activity developed by a non-resident, lasting a minimum time threshold (habitual activity).

Nevertheless, the classical concept of permanent establishment provides a set of exceptions, where cases of material presence lasting a sufficient among of time is still not considered as a PE. These exceptions can be seeing in Art.5 (4) of the Model Convention and we will deal with them, individually, ahead at our studies. For now, it is important to underline that the idea behind the exemptions is that such activities are of a 'auxiliary' or 'preparatory' character.

Therefore, we could amplify the classic concept of permanent establishment now to: 'a material activity developed by a non-resident *in the core of its business rationale*, lasting a minimum time threshold'.

Finally, the Article 5 of the Model Convention provides the indication of special types of permanent establishments, namely the agency PE and the construction and installation (or assembly site) (*hereinafter*, CAS PE). These provisions are responsible, therefore, to enlarge the idea of a PE, which would, thus, go beyond an office, a placed fixed in the soil, and could be deemed to be even a single person acting on behalf of the company.

As already mentioned at Topic 1.3, the BEPS project, especially throughout Action 7, tried to revisit issues on the attribution of the 'auxiliary' or 'preparatory' character to a given activity and to limit the possibilities of avoidance of the PE status by the design of highly artificially fragmented activities[85].

3.6: Types of permanent establishment

[85] Carlo Garbarino, "Permanent Establishments and BEPS Action 7: Perspectives in Evolution." *Intertax, 47, 4*. (2019), 371.

3.6.1: Fixed place of business

The FPB PE is the standard type of permanent establishment and should be the first one to be searched both by tax authorities performing an audit as well as by businesses when understanding and organizing their activities. All other PE are said to be subsidiary forms. We shall come back to that later, even because, as we are going to discuss, we believe that, especially when adopted an idea of virtual PE, there can be a parallel existence of more than one PE type at the development of the same business by a given non-resident.

This principal type of PE, therefore, is the classical image of the wording of Art.5 of the OECD Model Convention.

3.6.2: Dependent agent

The need for a 'mortar and brick' structure on the source country, nevertheless, may be unnecessary if the requirement of 'habituality' is met by means of the presence of agents of the company acting in that state.

Certainly, not every agent would constitute a permanent establishment, as not every 'building' would. The main condition for it to happen is that the agent acts as a 'dependent agent' and, thus, that acts on behalf of the company. Surely, all sorts of situations may influence the analyses of the actual 'dependence' of the agent in face of the company and a detailed analysis of this kind of PE would go beyond the scope of this study. Nevertheless, we shall provide some commentaries about the most important points of this topic.

The first point, which was reinforced by the work developed within the Action 7 of the BEPS Action Plan is that the substance of the conduct of the agent most prevail in face of any formal, mainly contractual, evidence. Therefore, a agent maybe contractually deemed to be independent, but, in fact he has no authority to bound the company or to negotiate on his own terms.

Other forms of verifying the practical (in)dependence of the agent is to identify if the latter is acting with or without exclusivity to the company and inside or outside the normal course of the business. The economic (in)dependence of the agent is also an indicative to be look upon.

Finally, nowadays countries have much broader tools to actually identify and 'look beyond' artificial arrangements for fragmenting coherent business activities into various formally dependent agents to avoid the constitution of a PE.

3.6.3: Site of construction and installation (*or assembly*)

The idea behind this form of permanent establishment, provided by the OECD Model Convention at its Art.5(3), is to also include the non-habitual enterprise of constructions and/or assembly, given that they actually represent a relevant presence at the economy of the source country.

This is a very particular kind of permanent establishment and we should also raise questions on the future inclusion, for instance, of high capacity productive 3D Printers or IA capable of developing constructions activities without (or with very limited) human presence on the scope of its concept.

3.6.4: 'Service' permanent establishment

This other form of permanent establishment is expressly mentioned by the UN Model Convention[86], but cannot yet be seen at the OECD Model Convention, apart from some commentaries in that regard, introduced by the Organization in 2008.

One explanation to this fact lies in the point that the UN Model is mostly designed to be implemented in DTT celebrated between developed and developing countries, provided the fact that it tends to give more taxing rights for capital-import countries, or source countries, to adopt the terminology we are already used to.

According to Art.5 (3) (b) of the UN Model Convention, the Service PE could be described as:

> 'The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than

[86] United Nations. *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York, USA, 2017), Art. 5(3).

> 183 days in any 12-month period commencing or ending in the fiscal year concerned.' [87]

In our understanding, nevertheless, this type of permanent establishment appears to be similar to the figure of an Agent PE provided by Art.5 (5) (c) of the OECD Model, *in verbis*:

> 'Art.5 (5): Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where 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 the contracts are:
>
> c) for the provision of services by that enterprise,
>
> that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise (…).'[88]

With the inclusion of this new type of permanent establishment in the wording of the UN Model, several developing countries have reinforced their wish to tax the provision of technical services, even without a classic PE qualification at the source.[89]

Moreover, also several of these countries do not believe on the sustainability of the concept of permanent establishment, in terms of safeguarding taxation at the source level and, therefore, are qualifying the provision of technical services as royalties, even if no IP is transferred, such as in Brazil, which contributes to enlarge the taxable base therein.[90]

Nevertheless, we believe that our proposal, discussed in Part III, would be able to align the concept of 'permanent establishment' to an significant taxation at the source level, without adding to the complexity of attributing the 'status' of a royalty to some payments, as observed above.

---

[87] United Nations. *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York, USA, 2017), Art. 5 (3) (b).

[88] Organization for Economic Co-operation and Development, *Model Tax Convention on Income and Capital: condensate version* (Paris, France, 2017), Art.5 (5) (b).

[89] João Francisco Bianco and João Tomazella Santos. "A Change of Paradigm in International Tax Law: Article 7 of Tax Treaties and the Need to Resolve the Source versus Residence Dichotomy." *Bulletin for International Taxation, 70, 3* (2016), 12 p.

[90] Brazil, Receita Federal, "Interpretative Declaratory Act RFB 5/2014" (2014).

3.7: Exceptions for the existence of a permanent establishment

The analyses of the exceptions for the constitution of a permanent establishment is crucial for our study. With the advent of the digital economy, as already addressed by the study, the possibilities of aggressive tax planning had rapidly grown.

Because of the evolution of the business models, the situations designed to represent exceptions to the formation of a permanent establishment are now mostly outdated. They were designed to exclude from the thresholds of source taxation the activities merely auxiliary or preparatory, that, thus, would not represent a strong presence in the economic life of the given source jurisdiction.

Nevertheless, as already mentioned, those activities are no more merely preparatory of auxiliary. Besides, it has also became easier for businesses to just adapt their multinational structures to meet the 'auxiliary' or 'preparatory' character in several jurisdictions by fragmenting cohesive activities into several small parts.

Before moving on with the critics of the current model, at another part of this study, lets understand the actual scenario.

According to Art. 5(4) of the OECD Model Convention, the following exceptions should apply to the constitution of a Permanent Establishment:

> Art. 5(4): 'Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
>
> a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
>
> b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
>
> c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
>
> d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
>
> e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.'[91]

[91] Organization for Economic Co-operation and Development, *Model Tax Convention on Income and Capital: condensate version* (Paris, France, 2017), Art. 5(4).

Part II

Current Proposals

Chapter 4: OECD Proposals for Taxing the Digital Economy

Provided that the OECD was not able to deliver a definitive solution to tackle the tax challenges of the digital economy, within the scope of BEPS Action 1 and that, therefore, the Final Report was not sufficiently conclusive, the G20 renewed the mandate for the Task Force on the Digital Economy to carry on the work on finding a consensus-based solution.

This new mandate is for the Organization to provide the details of a consensus-based solution to be widely implemented in a global level. Therefore, the OECD has focused on trying to exercise an inclusive development of this solution, embracing delegates from all the 129 jurisdictions currently engaged at the BEPS Inclusive Framework.

Moreover, not only countries are able to participate in this construction, but also further stakeholders, such as the taxpayers, academics, other NGOs and the civil society in general. Here, thus, lies the scope of this Public Consultation: to offer for this general set of stakeholders an early opportunity to provide inputs and to help designing the desired solution.

We say ‘early stage’ because, in fact, the OECD has not yet chosen the basis for the new method to be implemented. In the words of the Organization itself, this Public Consultation is inserted into a ‘non-prejudice’ framework, which means that any of the suggested methods (or even new methods proposed) are still in an equal foot position and must be considered.

Although in theory the inclusiveness of the work carried out by the OECD seems to be unquestionable, some stakeholders claim that, in fact, countries are not in an equal footing position at the rounds of discussions.

We stand with what seems to be the majority (considering the opinions delivered by several classes of stakeholders at the public consultation event, held in Paris) and we do believe that the work of the OECD is fairly inclusive. Of course, in a political point of

view, is utopic to imagine that the influence of the positions of big economies can be at the same level of those from smaller economies. Moreover, as countries with more sophisticated tax authorities and with higher tradition on the studies of the subjects are more likely to provide for more developed inputs and, therefore, to shape the possible solutions.

To sum up, we believe that the OECD is the right forum to discuss the measures aimed, if we think on implementing them in a worldwide basis. Our idea on including the changes in the PE concept at the OECD Model Convention and to include it at the MLI, confirm our position.

We should now advance towards the technicalities of the proposals or, at least, the design models of them, contained at the consultation document. This document, as already briefly mentioned, is divided into two main pillars, which coincides with the two sets of challenges that we have covered: BEPS and reallocation of taxing rights.

4.1: Pillar one (reallocation of taxing rights)

4.1.1: The 'user participation' proposal

Basically, the first proposal to by consulted aims to shift the taxing rights (partially or entirely) to the jurisdiction where the users are located. This proposal is aimed at targeting only highly digitalized business models that relies on the active participation of users as an essential mechanism for creating value.[92]

Therefore, the OECD highlights that this new method for attribution of taxing rights might only provide for changes in the nexus rules for companies such as (and, maybe, limited to) online social medias, marketplaces or search engines[93]. As for the rest of the businesses, the current nexus would be maintained.

Initially, we believe that the scope of application of this proposal is extremely limited and unable to tackle the tax challenges in a comprehensive manner. As already discussed, it should be clear that the value created by users is not economically significant in all the new business models of the digital economy, especially when dealing with B2B

[92] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019), 9-11.
[93] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019), 9-11.

operations. Besides, also several digital services do not count on such an active participation of users and derive their value from other elements, such as massive IP holdings and operations (cloud computing, for example).[94]

In other words, the 'user participation' idea would be responsible for ring-fencing some of the new business models[95]. This could have implications in terms of neutrality issue, when looking at the Ottawa Framework, for instance. In another perspective, it could also ultimately distort the nature of the tax itself (from an income tax to an earning tax).

In this regard, as from what we can anticipate in terms of this proposal, a tax burden at the user jurisdiction can arise even when no revenue is yet derived from there. The example would be, for instance, the simple collection (or processing) of data, without been used to direct advertisement or without been sold. We believe that the collection and processing of information should not, *per se*, be subject to income taxation in digital businesses, simply because they are outside of the scope of the nature of this tax and, ultimately, because it is not taxed inside more traditional business models that also collects and process data in large amount.

The extent of these implications, nevertheless, would depend on the exact way on which the proposal would be applied.

Besides, the 'user participation' proposal would be responsible for linking taxation with a very subjective nexus. It is indeed complicate to establish the exact (or even approximate) value that user A or B would create for the company. In order to objectify the user contribution, the formula will have to be extremely complex and able to accommodate, for instance, the numbers of other users reached by that participation, the degree of acceptance (or enjoyment) proportionated to other users, etc. Nevertheless, the 'math' would still struggle to capture if the externality was positive or negative for the company.

---

[94] Pasquale Pistone; João Félix Pinto Nogueira and Betty Andrade. "Comments submitted by The International Bureau of Fiscal Documentation (IBFD) Task Force on the Digital Economy," (OECD, Paris, 2019), 26.
[95] Pasquale Pistone; João Félix Pinto Nogueira and Betty Andrade. "Comments submitted by The International Bureau of Fiscal Documentation (IBFD) Task Force on the Digital Economy," (OECD, Paris, 2019), 21.

The OECD and some scholars, therefore, discuss the idea of a 'fixed rate' to be applied in substitution of an actual attempt to measure the contribution of each and every user. Countries would create a determined threshold (based on the number of users, for example) and then shift the taxing rights for the user jurisdiction in a portion of the revenues obtained by the company or the group (10, 20, 30%...).[96]

There is also a strong debate in terms of considering the application of a 'residual profit split' method to the jurisdiction of the users. That would, of course, require the analyses of the routine profit made by the company, with the usage of the actual (or adapted) transfer pricing rules. The difference between the total profits of the company and the routine profits would indicate the residual profits to be shifted to the market jurisdiction.

The first problem, in our point of view, is that there is not merely one exact transfer price 'mark' and, thus, when analyzing all the routine transactions of the companies, there will be a more or less large margin of values to be attributed to these 'routine transactions', opening more space for inter-nations disputes.

Moreover, it would require a fairly advanced level of cooperation and integration among countries as well as a high degree of sophistication of tax authorities to evaluate all the routine transactions conducted, probably, in several jurisdictions.

Finally, it would also be hard to find consensus in determining what would be considered a routine profit or not. It surely depends on the nature of the business conducted. The rapidly changing on business models, as well, could represent an extra difficulty for this determination and, therefore, the feature of 'flexibility', inside the Ottawa Framework would probably be compromised by the adoption of this 'quantum attribution' idea. More on that at the following topic.

Another issue that concerns us is related to the positions of the OECD in relation to the design of this proposal. In paragraph 20 of the Public Consultation Document[97], the Organization defends the possibility of imposing a tax burden even where the company

[96] This method of attribution of a *quantum* to be taxed at the user's jurisdiction is usually called as 'formulary apportionment'. *See*: Pasquale Pistone; João Félix Pinto Nogueira and Betty Andrade. "Comments submitted by The International Bureau of Fiscal Documentation (IBFD) Task Force on the Digital Economy," (OECD, Paris, 2019), 38.
[97] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019).

has no ‘taxable presence’. We are completely against this statement and, moreover, we think this represents a contradiction with all the work been developed by the OECD, especially if taken into account the outcomes of BEPS Action 7 and all the expressed political will to maintain the current framework of international taxation.

In other words, no tax burden shall arise where there is no ‘taxable presence’. The solution here, as we have been defending, is to create new (and broader) thresholds for this ‘taxable presence’ to be verified, through changes in the concept of permanent establishment and the inclusion of a virtual PE. This would help to secure the observance of the principle of certainty, defended at the Ottawa Framework scenario.

Moreover, it is important to understand that user participation can be measured (and taxed) in a different and more efficient way, at the jurisdiction of the users (source state). As more engagement of users to a given business, more attractive it would be to advertisements and, therefore, more contracts can be celebrated between the non-resident digital company and local companies interested in advertising their products. The source state will, therefore, be able to catch the tax revenue derived by this engagement through the application of VAT. It is more efficient and still secures tax revenues.

Hence, we are against the application of the OECD ‘user participation’ proposal.

4.1.2: The ‘marketing intangible’ proposal

The ‘marketing intangible’ proposal has a similar rationale as of the ‘user participation’ and, in our point of view, is based on a undesirable premise: to link the income taxation with the location of the users (or costumers, to better adapt the language to the new proposal on focus).

Before going further on the analysis of the technicalities and design issues of this proposal, we should explain our last paragraph.

Since the beginning of this paper, we have highlighted our desire to develop a feasible solution, capable of tackling the problem in the most comprehensive way we could. In order to do so, we have reached the conclusion that this proposed solution must feet within the margins of the current framework for international taxation.

We say that not because there would be no ideally better solutions outside of it, but simply because consensus among the international community is key and countries

have already clearly stated that they want to perpetrate changes inside the current rules, but they do not want to revolution the system.[98]

Therefore, one should notice that the state of the market (or of the user base) is a concept that not necessarily match with the concept of 'source state'. We have extensively addressed the evolution and the role of the latter concept as a nexus for cross-border income taxation. If a proposal wants to be practicable enough, at this stage, we believe that it should aim at solving the reallocation issue by treating states as either of source or residence, as it would enables consensus to be reached much easier.

Furthermore, as already ventilated, the nexus of user base or market state (consumers base) are more adequate to be taken into account in terms of indirect taxation, consumption taxes, like the VAT.

After these parentheses, therefore, we should advance in the analyses of the technicalities of this second proposal inside pillar one of the OECD Consultation Document.

Although we disagree on the premises, the first feature to be analyzed is the broadness of this proposal, which is certainly more comprehensive than the previous one. Here, a much broader spectrum of business models would be affected, creating a less ring-fencing solution. Even because more traditional business models also use marketing intangibles.

This proposal would, therefore, work also with the usage of some sort of 'residual profit split' method, as there would be a similar calculation format from the one observed in the previous proposal ('user participation'). The problems, here, would be more or less the same.

Looking the influences of an eventual adoption of this proposal in face of the principles of the Ottawa Framework, we would see that, although less ring-fencing, the 'marketing intangibles' proposal would probably raise even more problems in terms of certainty, simplicity and efficiency.

---

[98] Also noticing the practical difficulty in obtaining consensus for revolutionary solutions: Adolfo Mantín Jiménez, "BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties." *Intertax, 46, 8/9* (2018), 637-638.

A major problem, identified, for instance, by the IBDF Task Force on the Digital Economy is in relation to the terms or conceptualization (definition) of what would constitute a marketing intangible and what would be outside of this concept, been merely trading intangibles. Even today, with concepts with a similar importance in the current system (namely dividends, royalties and interests) states struggle in finding similar concepts.

The solutions available for this problem, at least in a short to mid-term would be either to establish a closed list of which activity should be included in each of the category (marketing or trading intangible), according to each business model. This list would hardly be a consensus and, even if it did become one, the constant need to update it would bring this challenge of consensus over and over again. The feature of flexibility would be severely harmed.

If the analyses were to be left for a case-by-case analyze, then the aspects of certainty and fairness would be compromised, and we would probably face an increase in cross-border tax disputes.

In any of the cases, compliance costs for both taxpayers and tax authorities would increase, without a corresponding satisfactory final result. Therefore, we believe that this idea, apart from our conceptual divergence, is also fairly too complex and hard to be implemented, specially by low sophisticated tax authorities.

Moreover, although we have recognized a broader scope of application and a less ring-fencing character, this proposal is still unable to tackle the non or low taxed digital presence of companies in states other than where they maintain they consumers base.

Imagine, for example, that company A, provider of a given digital service, is incorporated and managed from country X. This same company installs and maintains, even without (or with very restricted) work force, a huge software installation in jurisdiction Y. Nevertheless, the users of this digital service are mainly located in countries W and Z. By the terms of the marketing intangible proposal, we would still be unable to tackle the problem of the avoidance of taxable (or, at least, significant taxable) presence in country Y, while, in our example, countries W and Z would still be able to obtain VAT tax revenues.

4.1.3: The 'significant economic presence' proposal

Finally, the pillar one of the Public Consultation Document introduces a third possible design for a new solution to the allocation problem, based on a significant economic presence. Our reader may remember that, we ourselves, already made use of this expression when introducing the scope of our studies.

It is important to notice, nevertheless, that this expression is too broad and can by translated into several (or no) things. We will elaborate more on that from this moment.

In the Public Consultation Document itself, this proposal is the less developed one and clearly represents the thought of the Organization to bring the 'significant economic presence' back to the discussions. This proposal was more elaborated at the 2015 Final Report on BEPS Action 1 and, therefore, we should base some of our commentaries also on the latter document.

According to the Public Consultation Document proposal, this significant economic present would be measured by a combination of revenue with one or more elements, in principle, from six options provided:

> '(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.'[99]

In our point of view, nevertheless, none of the above-mentioned elements would desirably be applicable. The first falls into the problems, already extensively discussed, about attributing taxing rights in connection to the number of users. Even further, this

[99] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019), 16.

first point connects taxation with data input (raw data) something that our proposal should reject (*see* Part III).

The second element would be the volume of digital content derived from the jurisdiction. The problem, of course, is that this volume can significant vary in value, being, therefore, an extremely subject element to be taken into account.

The third bullet point seems to be ‘born’ already outdated. Already today, especially in the European Union, payments are made in a common currency. Also, in business celebrated with big countries or involving giant MGC, payments can usually be made in standard currency, such as American Dollars. In a not very far future, probably, payments could also be made in standard crypto currencies.

As for the maintenance of a website in the local language, we do not believe it would effectively work. Most companies adopt a website in English or other regionally relevant languages, not necessarily adopting the national language of the source State but been perfectly accessible by users on that particular jurisdictions (e.g. Russian in central and eastern European countries). This can also impose problems when several neighboring countries adopt the same language (e.g. Spanish in Latin America) but the company is not actually engaged in significant activities in some of these countries.

The 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 also does not seem like an interesting link.

The last point, by its turn, works in the direction of replacing the nexus of ‘source jurisdiction’ to ‘market jurisdiction’.

We thus conclude that, although the OECD defends a cumulative threshold, between revenue and one (or more) of the above discussed elements, revenue should be the only element, as it is in the ‘material economy’.

4.2: Pillar two (BEPS issues)

4.2.1: Income inclusion rule

According to the Public Consultation Document, the two measures under this second pillar are suggested to be adopted as complements to the efforts undertaken in pillar one. Moreover, the two proposals under this pillar are suggested to be adopted together, in order to tackle the remaining BEPS problems that would still be found. The OECD is, therefore, concerned with the possibility of MGC shifting operations to low or no tax jurisdictions, simply for tax purposes.[100]

With that in mind, the purpose on the creation of an 'income inclusion rule' would work as the fixation of a minimum tax rate to which a controlled company would have to pay when operating abroad. If this company, therefore, is conducting business in a low or no tax jurisdiction, the profit obtained from that enterprise would have to be taxed at the level of the parent company, a 'normal' or 'high' tax jurisdiction (in a form of 'switch-over')

The OECD itself recognizes a series of elements that should be observed in order for a proposal like this to effectively work.[101] Besides, it was a surprise for us not to see the concern, at the body of the Public Consultation Document, of discussions on how to harmonize the *tax base*.

Even today, some countries have a nominal high tax rate but, due to other elements in their domestic tax laws and the rules on the determination of the base, the *effective* tax rate turns out to be low or zero[102]. Without a minimum harmonization of the norms on the determination of the tax base, the 'income inclusion rule' would be ineffective.

Furthermore, we are against such a proposal. We believe that other instruments under the BEPS Action Plan, such as the rules against treaty abuse (Action 6[103]) or the rules against artificial arrangements (contained in several of the Actions) could more efficiently deal with this problem, without adding unnecessary complexity and without raising questions about tax sovereignty, for instance.

---

[100] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019).

[101] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019).

[102] Malta is a very good example of our statement, *see*: "Taxation and Investment in Malta 2014: Reach, Relevance and Reliability", Deloitte, accessed 2019 July 16, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-maltaguide-2014.pdf.

[103] Organization for Economic Co-operation and Development, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report* (Paris, France, 2015).

4.2.2: Tax on base eroding payments

This proposal is to be compared with an 'equalization levy' and has been included into several domestic (unilateral) measures to tax the digital economy. It consists, basically, on a protection measure to be taken by one jurisdiction, when the other involved in the company`s operation, does not comply with the standards for preventing base erosion and profit shifting. According to the proposal, would include:

> 'an undertaxed payments rule that would deny a deduction for a payment to a related party if that payment was not subject to tax at a minimum rate; and
>
> a subject to tax rule in tax treaties that would only grant certain treaty benefits if the item of income is sufficiently taxed in the other state.'[104]

This proposal also faces important theoretical issues. Firstly, the 'minimum rate' described at the first bullet point would have to be set in a consensus base and would undermine the tax sovereignty of countries[105]. More than that, we believe that this proposal would also affect real (substantial) business, not only artificial arrangements, as there are businesses been performed with real economic reasons in low tax jurisdictions.

The same negative effect upon substantial business would be verified with the type of 'limitation of benefits' clause based merely on the nominal (or even effective) tax rate applicable.

---

[104] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019), 28.

[105] We strongly believe that this is a very relevant issue to consider and that, in accordance with De Wilde, we believe that without fiscal sovereignty a country simply cannot function. See: Maarten de Wilde, "Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy." *Intertax, 38, 5* (2010), 281-281.

Chapter 5: EU Proposals for Taxing the Digital Economy

Differently from the perspective of the proposals developed by the OECD (see topic above), the ones on the table of the European Union counts on the bounding effects of the EU law upon its Member States. Of course, the TFUE does not precisely define que extent of the Union's competence in matters of direct taxation, nevertheless, as solidly established in case law[106], the 'competence with preemption'[107] of EU in this regard is connected to safeguarding the internal market, as defined in Art.4(2)(a) of the TFEU.

Therefore, the interference of the EU in the tax policy of the member states occurs, mainly, by the adoption of directives (secondary source of the EU law[108]) as to harmonize the tax system inside the block. On the other hand, also decisions (case law; 'negative integration') constitute an important source of EU law, especially in terms of direct taxation, nevertheless, this sphere lies outside the scope of our studies.

We should use these inaugural considerations on the topic related to the implementation issues of our proposal (Topic 7.1).

Nowadays, the EU (mainly through the work of the EC) has several ambitious proposals to adjust the international tax system (or the Unions tax system), highly connected to the development of the BEPS Project, as several of the main players at the OECD/G20 are European countries.

---

[106] *See*: Case C-446/03, *Marks & Spencer*, EU:C:2005:763 and Case C-279/93, *Schumacker*, EU:C:1995:31.

[107] Rita Szudoczky and Dennis Weber, "Chapter 2: Constitutional Foundations: EU Tax Competences; Legal Basis for Tax Integration; Sources and Enactment of EU Tax Law" in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen (Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018).

[108] Rita Szudoczky and Dennis Weber, "Constitutional Foundations: EU Tax Competences; Legal Basis for Tax Integration; Sources and Enactment of EU Tax Law" in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen (Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018), 12.

Besides the already adopted directives[109], the EC have proposed directives to implement the (C)CCTB[110], although facing some political barriers. For our studies, after these brief considerations, we should look upon the EC proposals specifically design to face the challenges of the digital economy. These proposals are, to say so, the parallel of the proposals analyzed at Chapter 4.

On an interesting press release, the EC summarized the two ongoing (and complementary) proposals that we should now focus. Please, notice the wording below:

> 'What is the Commission proposing?
>
> The Commission has made two legislative proposals:
>
> The first initiative aims to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels. This forms the Commission's preferred long-term solution.

[109] European Parliament and the European Council, "Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States"; European Parliament and the European Council, "Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States."; European Parliament and the European Council, "Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States."; European Parliament and the European Council, "Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market". *For a comprehensive study of the main directives*: Otto Marres, "Chapter 6 (Update): The Parent-Subsidiary Directive." In *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen (Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018); Frederik Boulogne, "Chapter 7 (Updated): The Tax Merger Directive" in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen (Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018); Pasquale Pistone, "Chapter 8: EU Cross-Border Tax Disputes Settlement" in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen (Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018); Axel Cordewener, "Chapter 10 (Updated): The Intertest and Royalty Directive" in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen (Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018); Daniël Smit, "Chapter 12: The Anti-Tax Avoidance Directive (ATAD)" in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen (Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018).

[110] European Commission, "Proposal for a Council Directive on a Common Corporate Tax Base, Strasbourg, 25.10.2016 COM (2016) 685 final, 2016/0337 (CNS). (Strasbourg, France, 2016). European Commission, "Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), Strasbourg, 25.10.2016 COM (2016) 683 final 2016/0336 (CNS). (Strasbourg, France, 2016).

> The second proposal responds to calls from several Member States for an interim tax which covers the main digital activities that currently escape tax altogether in the EU.'[111]

We should now concentrate in the discussions of each one of these proposals.

5.1: Significant digital presence proposal

The European Commission presented a proposal to implement a common policy to face the tax challenges of the digital economy among all its Member States, which the final document was presented in Brussels, 2018[112]. According to the Explanatory Memorandum of the Directive Proposal, the rationale of the policy in study is the following:

> 'This proposal aims at addressing the issues raised by the digital economy by setting out a comprehensive solution within the existing Member States' corporate tax systems. It provides a common system for taxing digital activities in the EU which properly takes into account the features of the digital economy.
>
> First, this proposal lays down rules for establishing a taxable nexus for digital businesses operating across border in case of a non-physical commercial presence (hereinafter: a "significant digital presence"). New indicators for such a significant digital presence are required in order to establish and protect Member States' taxing rights in relation to the new digitalised business models.
>
> Second, this proposal sets out principles for attributing profits to a digital business. These principles should better capture the value creation of digital business models which highly rely on intangible assets.'[113]

[111] "Fair Taxation of the Digital Economy", European Commission, accessed 2019 July 14, https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en. For an overview of the two proposals, *see*: Aleksandra Bal, "(Mis)guided by the Value Creation Principle – Can New Concepts Solve Old Problems." *Bulletin for International Taxation, 72, 11* (2018): 6 p.

[112] European Commission, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM (2018) 147 final; 2018/0072 (CNS) (Brussels, Belgium, 2018).

[113] European Commission, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM (2018) 147 final; 2018/0072 (CNS) (Brussels, Belgium, 2018), 2.

In comparison to the proposals presented by the OECD, the EU's has a more developed stage of technicalities, although based on a similar idea of 'significant economic presence' (Topic 4.1.3). Therefore, this presence would be measured according to the elements described in Article 4(3), *in verbis*:

> 'A 'significant digital presence' shall be considered to exist in a Member State in a tax period if the business carried on through it consists wholly or partly of the supply of digital services through a digital interface and one or more of the following conditions is met with respect to the supply of those services by the entity carrying on that business, taken together with the supply of any such services through a digital interface by each of that entity's associated enterprises in aggregate:
>
> (a) the proportion of total revenues obtained in that tax period and resulting from the supply of those digital services to users located in that Member State in that tax period exceeds EUR 7 000 000;
>
> (b) the number of users of one or more of those digital services who are located in that Member State in that tax period exceeds 100 000;
>
> (c) the number of business contracts for the supply of any such digital service that are concluded in that tax period by users located in that Member State exceeds 3 000."[114]

The proposal is based on the existence of at least one of the three elements described in letters (a), (b) and (c). The first element is connected to the verification of the revenue obtained by the non-resident in another (source) Member State, through the exercise of a 'covered' activity (a digital service). This element seems the most adequate to be taken into account when dealing with income taxation, because of the nature of the tax itself.

The problem, we believe, lies connected to the 'absolute' value imposed by the directive. On the one hand, we understand the goal to archive simplification and, more importantly, to provide for uniformization inside the EU. On the other side, though, we believe that this digital tax presence should be measured in proportional terms – on the

[114] European Commission, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM (2018) 147 final; 2018/0072 (CNS) (Brussels, Belgium, 2018), Art.4(3).

percentage of the global (or European, for the purposes of the directive) revenue that the company obtain in the source state. Our proposal should walk in that path.

Finally, if thinking on the creation of a global solution, the application of a fixed and unique value could bring problems in terms of the possibility to accommodate national and regional economic differences.

Although we agree with the first element, we are against the application of any of the other two. The second one is linked to the number of users of the given digital service. The EU, when stating that only one of the three elements is necessary for the application of a digital service tax, managed to escape from the mistake made by the OECD (in our point of view) in the 'user participation' proposal, because the former is able to 'understand' that not every digital business relies on user participation.

The problem of letter (b), nevertheless, lies in the presumption that every single user contributes to the creation of value for the enterprise in the same way. Of course, any feasible solution to be adopted must deal with simplification or objectification, nevertheless, the levels of contributions provided by each user can drastically differ.

Firstly, the Proposal does not provide for instruments capable of distinguishing 'active' and 'passive' users. Secondly, even inside the same jurisdictions, active users can have significant different impact in the value creation, simply imagine a famous football player and a common student.

Thirdly, because of the large economic differences between countries (and, also, Member States, inside the scope of the Proposal) 100.000 users in country A can provide for much more value created than the same 100.000 users in jurisdiction B, where, for instance, paid online advertising would be cheaper. Last but not least, the application of an absolute number of users raises huge distortions. Imagine that country A has a population of 10.000.000 and that country B has a population of 1.000.000. The idea of 'significant', in this case, would be considered to be of only 0,01% of the population of Country A, while of 0,1% in country B.

In regard of letter (c), the problem would be more or less the same, especially in regard to the first, second and third commentaries above. In this point, the thing that most called our attention, though, is the lack of importance of the values of the contracts, which is only mitigated by the presence of the threshold of letter (a).

For a second step, the EU Commission Directive Proposal also tackles the issue of the attribution of taxing rights upon these new 'captured' activities. Although we shall present some disagreement with the strategies adopted, we believe that the approach of the EU is, to say so, in the correct direction. We will come back to that question in Part III, while presenting our proposal.

Article 5 states that:

> '1. The profits that are attributable to or in respect of a significant digital presence in a Member State shall be taxable within the corporate tax framework of that Member State only.
>
> 2. The profits attributable to or in respect of the significant digital presence shall be those that the digital presence would have earned if it had been a separate and independent enterprise performing the same or similar activities under the same or similar conditions, in particular in its dealings with other parts of the enterprise, taking into account the functions performed, assets used and risks assumed, through a digital interface.
>
> 3. For the purposes of paragraph 2 the determination of profits attributable to or in respect of the significant digital presence shall be based on a functional analysis. In order to determine the functions of, and attribute the economic ownership of assets and risks to, the significant digital presence, the economically significant activities performed by such presence through a digital interface shall be taken into account. For this purpose, activities undertaken by the enterprise through a digital interface related to data or users shall be considered economically significant activities of the significant digital presence which attribute risks and the economic ownership of assets to such presence.
>
> 4. In determining the attributable profits under paragraph 2, due account shall be taken of the economically significant activities performed by the significant digital presence which are relevant to the development, enhancement, maintenance, protection and exploitation of the enterprise's intangible assets.
>
> 5. The economically significant activities performed by the significant digital presence through a digital interface include, inter alia, the following activities:

> (a) the collection, storage, processing, analysis, deployment and sale of user-level data;
>
> (b) the collection, storage, processing and display of user-generated content;
>
> (c) the sale of online advertising space;
>
> (d) the making available of third-party created content on a digital marketplace;
>
> (e) the supply of any digital service not listed in points (a) to (d).
>
> 6. In determining the attributable profits under paragraphs 1 to 4, taxpayers shall use the profit split method unless the taxpayer proves that an alternative method based on internationally accepted principles is more appropriate having regard to the results of the functional analysis. The splitting factors may include expenses incurred for research, development and marketing as well as the number of users and data collected per Member State.'[115]

According to the Proposal, therefore, all the profit attributable to the digital service provide in a given Member State should be taxed by the latter. In other terms, there would be full taxation of that given profit at the level of the source country, in a similar way to what is now a practice in terms of physical permanent establishments. Our proposal deals with the problem differently, therefore, we should leave this discussion for Chapter 6.

The second important aspect, from Article 5, is that it defends the maintenance of the application of the arm's length principle and, consequently, the idea of transfer pricing. It is also stated that the determination of the profit attributable to these new activities should also respect the analysis of functions, assets and risks assumed. Although we believe it is implicit from the context of the Proposal, no direct mention was made, in Article 5, about the possibility to disregard the evaluation of the number of employees as an indicator of substance inside the functional analysis. We believe that, in the eyes of the Proposal, this 'number' should not necessarily be taken into account.

[115] European Commission, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM (2018) 147 final; 2018/0072 (CNS) (Brussels, Belgium, 2018). Art.5.

Although we agree, in general, with the wording of this Article and the option for the maintenance of the arm's length principle, we do not see how it would be applied to some of the 'digital activities' in the scope of the Proposal, namely the mere collection of data and user-generated content (Art.5(5)). In this regard, especially in the cases of letters (a) and (b), we believe that taxing the mere collection or storage of data or user-generated content, to the extent it is not been negotiated to any third party or to any other company inside the group, is outside the scope of an income tax.

Our proposal should deal with this apparent problem (Topic 6.1). Although, in a nutshell, we are against taxation of raw data and we believe that, if countries actually decide to tax it, they will have to face extra challenges in terms of transfer pricing application.

Finally, it is also important to highlight that Article 5 above expressly mentions a hierarchy in the choosing of a TP method, namely, with the preference for the adoption of the 'profit split method'[116]. We believe, therefore, that in practice, if adopted, the Proposal would impose a 'burden of prove' to the taxpayer that, for some reason, decides to adopt another TP method, namely be saying the reasons why not choosing the 'profit split method'.

This approach differs from the current wording of the OECD Transfer Pricing Guidelines, but some countries, domestically, already impose a hierarchy among applicable transfer pricing methods, such as Russian Federation[117] and Mexico[118]. On the opposite way, countries, such as Brazil[119], can provide for a wider range of freedom in the determination of methods to be adopted by the taxpayer (broader than those provided at the Guidelines[120]).

5.2: Common system of a digital services tax on revenues resulting from the provision of certain digital services proposal

[116] For a deeper understanding of the 'profit split method': Organization for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris, France, 2017), 133-145.

[117] Russian Federation, "Tax Code of the Russian Federation.", Art.105.7-105.13.

[118] Mexico, "Mexican Income Tax Law", Art.180.

[119] Brazil, "Law No. 9.430/1996", Art. 18, 18-A, 19, and 19-A.

[120] Organization for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris, France, 2017).

This Proposal, presented at the same context (and day) as the previous one, can be compared to the proposals elaborated under pillar two of the OCDE Public Consultation Document, provided that they are inserted into the context of directly counter attacking BEPS.

As explored in the previous topic, this proposal is also at a more technically developed stage, in comparison to the work done so far by the OECD. The scope of this activity is to tax the provision of digital services, especially those relying on the importance of user participation. According to Article 3(1), the following digital services would fall into the scope of the Directive:

> 'services consisting in the placing on a digital interface of advertising targeted at users of that interface; as well as the transmission of data collected about users which has been generated from such users' activities on digital interfaces;
>
> services consisting in the making available of multi-sided digital interfaces to users, which may also be referred to as "intermediation services", which allow users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users.'[121]

Additionally, high minimum thresholds would apply in order to qualify a given provider of digital services as a taxable person in terms of the new digital service tax (DST). According to Article 4 of the Directive proposal, these thresholds would be, combined:

> 'The total amount of worldwide revenues reported by the entity for the latest complete financial year for which a financial statement is available exceeds EUR 750 000 000; and
>
> the total amount of taxable revenues obtained by the entity within the Union during that financial year exceeds EUR 50 000 000.'[122]

---

[121] European Commission, Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM/2018/0148 final - 2018/073 (CNS) (Brussels, Belgium, 2018), Art. 3(1).

[122] European Commission, Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM/2018/0148 final - 2018/073 (CNS) (Brussels, Belgium, 2018), Art. 4.

The application of such high thresholds translates into what we believe to be a significantly ring-fencing measure, provided that the tax would exclusively apply to highly digitalized and successful enterprises. This could ultimately harm future developments of digital innovation and does not seem to be a reasonable strategy to be adopted.

Moreover, the proposal aims at establishing a fixed rate, to be applied by all EU Member States (3%)[123]. This last element makes the EU proposal even more problematic in terms of tax sovereignty than OECD`s Income Inclusion proposal, under Pillar II (Topic 4.2.1). Although already hard to be implemented in the EU territory, a similar fixed rate proposal would most likely be reject at a global level.

Besides, in accordance with Article 3(2), the tax would be levied in a gross base, which give raise to problems relating to neutrality, provided that less digitalized business may be subject to net taxation, specially under the laws in force in the EU.

It could also be argued that this proposal creates a tax designed specifically for a determined (and fairly small) group of taxpayers and, thus, not been general. Even beyond the several theoretical problems identified, this proposal would have a very limited scope and, therefore, would be incapable of addressing the issue it is supposed to in a satisfactory comprehensive manner.

Finally, the nature of the DST would definitely escape from the 'income taxation' and would be a tax on turnover[124]. This issue was also identified by Hohenwarter, Kofler, Mayr and Sinnig[125], who states that it would cause this tax to be outside of the scope of most DTT, provided the wording of Article 2 of the OECD Model Convention.

Ultimately, it would lead to an uncoordinated international implementation of the tax and several problems related to it. It would also be difficult to combine its application

---

[123] European Commission, Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM/2018/0148 final - 2018/073 (CNS) (Brussels, Belgium, 2018), Art. 8.

[124] Yariv Brauner, "Editorial: Taxing the Digital Economy Post-BEPS, Seriously". *Intertax, 46, 6/7* (2018), 462. Also, Roland Ismer and Christoph Jescheck, "Debate: Taxes on Digital Services and the Substantive Scope of Application of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model?" *Intertax, 46, 6/7* (2018), 573.

[125] Daniela Hohenwarter, Georg Kofler, Gunter Mayr and Julia Sinnig, "Guest editorial: Qualification of the Digital Services Tax Under Tax Treaties". *Intertax, 47, 2* (2019), 140.

through the MLI, as we believe should be an interesting way of implementing the changes needed.

The fact that this proposal is aimed to be an interim measure does not substantially change our opinion in its regard. Specially if thinking in a global level adoption of a similar proposal, probably, the difficulties in implementing it would be even greater than implementing an 'nexus-based' solution, as we advocate.

Part III

Our Proposal

Chapter 6: Rationale

6.1: Virtual Permanent Establishment

The first element to be considered is the need to **establish a taxing right upon the development of non-physical activities** in countries besides the residence of the company[126]. This need comes as a consequence of the observed concerns of the international community to adequate the international tax system to the new reality of the digital economy.

Although not all scholars believe in the success of a proposal based on the idea of (re)aligning taxation with value creation, our proposal should follow that goal, for the reasoning built during this study.

Nevertheless, we recognize that, even among those several scholars and international institutions in favor of aligning taxation with value creation, there are divergences on matters of which activities should have the 'rules changed' and which tools to use in order to change the tax treatment of these activities[127]. Of course, this divergence is also highlighted on the divergence on the determination of a precise meaning (and length) of the idea of 'value creation'.

We have explored some of these new ideas and identified proposals posed by relevant stakeholders, especially connected to the OECD and the EU.

Therefore, based on the analysis made upon these other proposals, we suggest to tackle the tax challenges of the digitalization of the economy through the elaboration of changes inside the scope of the corporate income tax and, thus, we do not believe on a successful application of measures, even if interim, based on the equalization levy (low

[126] This need appears connected to a modern interpretation of the 'benefit theory', as an assimilation to the idea of economic allegiance, as mentioned by us in topic 3.1. *See* Ana Paula Dourado, "Editorial: In Search of an International Tax System in a Post-BEPS Tax Competition Setting." *Intertax, 47, 1* (2019), 2.
[127] Ana Paula Dourado, "Debate: Digital Taxation Opens the Pandora Box: The OECD Interim Report and the European Commission Proposals." *Intertax, 46, 6/7* (2018), 565.

rates turnover taxes[128]) specifically applicable to some digital services. The reasons underling our opinion can be found at Topic 5.2 above. Consequently, we also do not believe on the feasibility of the abandonment of income taxes and the 'take over' of indirect taxation.

As we are going to debate in Topic 7.1 (Implementation), the introduction of measures to deal with the challenges presented through an 'income tax' would make it much easier to be globally adopted and effective, provided the mechanisms to include them in the web of DTT, especially because of Article 2 of the OECD Model Convention.

After advocating in favor of the maintenance of the income taxation, we defend that it should also continue to be 'nexus-based'.

With that in mind, our solution must be found on the **creation of another type of permanent establishment** which does not require a physical presence at the source country. Therefore, every corporate income tax imposed would rely on the existence of a 'taxable presence', in line with the principle of legality and certainty.[129]

Contrary to this position are Devereux and Vella, who suggest the application of a more 'fixed element' based taxation, such as attributing the taxing rights to the jurisdiction where the shareholders are located[130]. We disagree with this opinion both on a theoretical and practical standpoint. Firstly, because it distorts the idea of economic allegiance and the benefit theory[131], thus, does not align taxation with value (income) creation. Secondly, because it would ultimately empty the taxable income in developing countries, leading to an unsustainable global share of taxing rights.

Therefore, we reinforce our idea on the need to maintain the *existing* 'nexus', to maintain the application of the concept of permanent establishment and, besides, to link

[128] Yariv Brauner, "Editorial: Taxing the Digital Economy Post-BEPS, Seriously". *Intertax, 46, 6/7* (2018), 462.

[129] The exceptions would be maintained for the particular cases of royalties and interest, for example, as provided for in current tax treaties, but these are considered to be capital income and not technically business income, therefore, lying outside of the scope of this study.

[130] Michael P. Devereux and John Vella, "Debate: Implications of Digitalization for International Corporate Tax Reform." *Intertax, 46, 6/7* (2018), 550.

[131] According to Hongler and Pistone, even without a physical presence, a company acting in a given state benefits from structures such as internet infrastructure, energy supply, a functioning legal system, etc. Peter Hongler and Pasquale Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of Digital Economy." *IBDF Whitepapers* (2015), 24. As for Ana Paula Dourado, the idea that taxes must be connected to the obtention of a benefit lies in matters of justice, as can be read in the author's early writings. Ana Paula Dourado, "Justiça e Redistribuição Financeira" in *Ética e o Futuro da Democracia* (Lisboa, Portugal: Edições Colibri, 1998), 330.

the latter with the idea of 'source'. Consequently, we are in favor to exclude the use of expressions such as 'market jurisdiction' or 'user jurisdiction', for the reasons we have already debated in Chapter 3[132].Therefore, for example, our proposal is more able to also capture the digital presence of intermediary functions of a MCG, generating value not at the residence country nor at the 'market' or 'final user' jurisdiction.

We call this new type of permanent establishment a '**virtual permanent establishment**'.

The threshold for the acquisition of the virtual PE status would be based on an idea of a **significant economic presence**[133]. This significant economic presence, nevertheless, should be as more objectified as possible, otherwise, we could end up increasing tax uncertainty, litigation and administrative costs, as well as failing in the prevention (or reduction) of aggressive tax planning possibilities.

On the other side, this objectification will also have to deal properly with the danger of turning into an oversimplification and a disregard of the factual situation in practical cases (we will address this concern while discussing the implementation issues).

The early challenges that we should begin with are related to how to determine the nature of the activities that would be included in the concept of 'economic presence' and, therefore, which activities would have the tax regime modified[134]. We must also bear in mind that the nature of these activities must be in line with the nature of the tax in study (business income tax).

---

[132] Surely, the determination of the significant economic presence, as discussed in the following, should include some elements related to the market or user/consumers base, nevertheless, one cannot mistakenly assume that market and/or user/consumer jurisdiction will always coincide to be the source state. This misuse appears, for instance, in the work of Spinosa and Chand, where the authors defend a short-term maintenance of the current nexus but constantly refers to the expression of 'market jurisdiction' as synonymous to 'source jurisdiction'. Lisa Spinosa and Vikram Chand, 'A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should the Focus Be on a Shared Taxing Rights Mechanism?', *Intertax, 46, 6/7* (2018), 476.

[133] Differently than Chand and Spinosa, we believe that both the 'new virtual permanent establishment nexus' and what the authors call a 'significant economic presence test' can (and should) be implemented together as part of a comprehensive solution. Lisa Spinosa and Vikram Chand, 'A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should the Focus Be on a Shared Taxing Rights Mechanism?', *Intertax, 46, 6/7* (2018), 476.

[134] Chapter 7 will elaborate on our though that the modified rules to be applied to the 'virtual permanent establishment' should not be extended to the current physical PE types.

In this regard, the OECD 'significant economic presence proposal', when dealing with the drawing of the nature of the activities to be 'captured' by the new rules, gives six elements which could be considered individually or combined:

> '(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.'[135]

We have already discussed these elements when focusing on the mentioned proposal. Please, refer to Topic 4.1.3.

The IBFD Task Force on the Digital Economy, in their input to the Public Consultation held by the OECD in Paris, March 2019, expressed the support to a cumulative use of such indicators, or elements[136]. We, on the opposite direction, reject the use of any of these methods to verify the nature of the activities to be captured by the new permanent establishment type.

In our opinion, we reinforce, revenue should be the central element guiding the development of the 'virtual permanent establishment', otherwise, inevitably, we would be leaving the field of corporate income tax or, at least, we would be ring-fencing the digital economy beyond what is needed or even desired.

Therefore, the activity should be **digital (virtual) and capable of directly generating revenue**.

---

[135] Organization for Economic Co-operation and Development, *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy* (Paris, France, 2019).
[136] Pasquale Pistone; João Félix Pinto Nogueira and Betty Andrade. "Comments submitted by The International Bureau of Fiscal Documentation (IBFD) Task Force on the Digital Economy," (OECD, Paris, 2019), 44.

The first requirement, for our selected 'nature determining' element is that the activity should be virtual, even if connected to a physical permanent establishment. This is in line with our idea that the new rules must not be extended to physical permanent establishments (*see* Chapter 7).

Secondly, we used the expression 'capable' because it may actually not generate a revenue, but the activity, in a given period, may be seen as loss making. As in regular 'physical permanent establishments', the new 'virtual' threshold should be able to accommodate the acceptance and distribution of losses. This particular point is surely one full of challenges and practical obstacles, therefore, Topic 7.3 will make some brief considerations in this regard.

Besides, the term 'directly' means that the activity itself may generate the revenue and not, for instance, an indirect creation of value via user participation or network effects.

The activity deemed to create a 'virtual permanent establishment' should be developed either by the enterprise itself or by a dependent agent, as it is today. Users can (and do) create value, but we believe this value lies outside the scope of direct taxes. Moreover, if compared to more traditional business models, the users can be distantly associated to independent agents. Although they create value for the company, their activities cannot be deemed to be considered as activities *of the* enterprise.

Finally, the idea of 'generating revenue' holds an obvious connection to the nature of the tax in study.

Another important aspect that we believe should not be changed is the fact that the mere collection or 'self-storage' of data must not be included in the activities enabling the creation of a virtual PE. A difference that is rarely made in academic papers is the one between 'raw data' and 'processed and monetized data'[137].

---

[137] Petruzzi and Buriak highlight the necessity to consider the 'collection, elaboration and exploitation' of data for there to be an imposition of income tax connected to it. We believe that this idea lies closely to ours in terms of taxing data only by the time it generates revenue. With the considerations of the mentioned authors, data can also be taxed in a net base, considering the costs incurred in the process of collecting, elaborating and exploiting the given data. Raffaele Petruzzi and Svitlana Buriak, "Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules?", *Bulletin for International Taxation, 72, 4a, Special Edition* (2018).

Data should be seen as the basic raw material of the digital age, just like iron or wood are for the traditional industry. The mere possession of these materials should not be subject to tax. Contrarily is the case where these materials are brought or sold, for instance.

To deal with raw data differently than other core raw materials would be extremely ring-fencing and would, as already mentioned by us, shift the nature of the income tax.

As discussed in Part II of this study, we also believe that data and user participation are generally responsible for the increase in revenue making activities of the MCG in the locations where, respectively, they are gathered and where the users are located. Our new permanent establishment threshold will, therefore, be able to capture this value by the time they generate revenue in these other states, regardless of a physical presence.

Finally, we consider that no human function (or no substantial, nor major human function), *in loco*, should be needed for the activity to be verified in a certain jurisdiction. In this case, the 'significant people function' does not need to be undertaken by people in the PE jurisdiction, but by someone in the MGC outsourced to do so, by distance and even not formally working at the PE in question[138]. Moreover, the number of employees would not necessarily determine the extension of the profits attributable to the PE, as more and more AI can be applied in generating revenue, together with very limited (and specialized) human labor force.

This would, for instance, enable cloud computing activities to be captured by the new PE threshold, as well as software installation facilities. Of course, technical studies must be carried out for tax authorities and taxpayers to have more certainty as to the where some cloud activities, for instance, are taking place, especially when dealing with multi-sided business activities. This point should be strengthened for the taxation of cloud computing to be more effective.

The problem of determining the place where activities, such as the former, are taking place, is called 'source conundrum'. In the words of Carlo Garbarino:

[138] Lisa Spinosa and Vikram Chand, "A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should the Focus Be on a Shared Taxing Rights Mechanism?", *Intertax, 46, 6/7* (2018), 476.

> ‘The source conundrum is precisely locating the place of the income-generating activity and identifying the link between taxation and where economic activity takes place.’[139]

Therefore, considering all the statements made in this topic, we are confident that the new virtual permanent establishment threshold would be able to capture revenues obtained digitally by online social media; search engines; online marketplaces and cloud computing, as well as intermediary activities, mainly developed in a B2B scenario[140]. The scope of our proposal, therefore, seems to be broader than the current main OECD and EU proposals, although, ours would still need sided strategies to tackle the source conundrum issue, as the others under analysis.

As is it is going to be debated in Topic 6.2, the aspects of functions developed, assets used and risks undertaken are also very important to determine the existence and wider of the new virtual permanent establishment, as they should continue to be responsible for the determination of the amount of revenue created in connection to the new PE.

After determining the question of the ‘economic presence’, which is basically a matter of the ‘nature’ of the enterprise (or activity), it is also important to evaluate whether this activity is significant enough as to trigger the new PE threshold. This discussion is developed at the following topic.

6.2: Determination of profits attributable to the ‘to be verified’ virtual permanent establishment (Transfer Pricing)

After the analysis of the methods proposed by several of the players in the international taxation scenario for the attribution of profits to the ‘to be verified’ (or ‘possible’) source state permanent establishment, namely the methods of the ‘residual profit split’, ‘formulary apportionment’, ‘fixed allocation key’, ‘transfer pricing’ (‘arm’s

---

[139] Carlo Garbarino, “Permanent Establishments and BEPS Action 7: Perspectives in Evolution.” *Intertax, 47, 4*. (2019), 367.

[140] Even Hongler and Pistone admit that the application of an ‘user threshold’, as defended by some of the proposals analyzed at this study, would have a less significant impact in B2B operations than in B2C. We do believe that it would be another issue connected to this threshold. Peter Hongler and Pasquale Pistone, “Blueprints for a New PE Nexus to Tax Business Income in the Era of Digital Economy.” *IBDF Whitepapers* (2015), 3.

length principle') and even gross income taxation, we have elaborated the considerations that follow.

Firstly, to identify how much of value is being created at the source state level, we should consider the functions performed, assets used and risks assumed, as mentioned in the previous topic. In this regard, we believe on the maintenance of the use of transfer pricing rules, from which we would still need to make some adjustments, although not under the scope of this study.[141]

More specifically, in order to be more accurate in the determination of this profit, we believe on the application of the 'profit split method', as defined at the OECD Transfer Pricing Guidelines[142].

On the other hand, some relevant arguments are presented against the use of transfer pricing rules. The first lies on the fact that they would be unable to measure some value creating activities, namely the user participation. We agree with that impossibility (or, at least, this great difficulty), but, on the other hand, we believe that taxing these activities would have several negative consequences, as extensively addressed.

Moreover, we are not denning that value can be created by several activities outside the thresholds set at Topic 6.1 above, but we advocate that not every value created should be taxed in terms of business income taxation or, broadly speaking, in terms of direct taxation.

User participation usually translates into the increasing of business being conducted in the jurisdiction where those users are located, which also attracts more revenues in terms of indirect taxation.

On the other hand, in the less common cases where this user engagement is not translated into the increase of local business, so we believe no income taxation should be levied, by the simple fact that no (or very few) income is been generated from that

---

[141] *Similarly*: Petruzzi and Svitlana Buriak, "Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules?", *Bulletin for International Taxation, 72, 4a, Special Edition* (2018).

[142] Organization for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris, France, 2017), 133-145.

valuable asset. We cannot, at least not in the scope of income taxation, tax a profit not yet incurred.[143]

Some other critics, usually made by those against the application of TP rules, is that some value creating activities cannot be compared as if they were performed by independent companies. Ana Paula Dourado, for example, points out the difficulty in aligning transfer pricing rules with financing activities typically connected to intra-group arrangements, such as cash pooling[144]. We have mentioned this position at Chapter 1.

Despite this argument, we believe that, in such cases, transfer pricing rules can still be applied, especially if considering the transactional profit split method, which relies not at the existence of a very similar transaction, but more on the profit margins obtained by companies performing activities of a more or less comparable activities. In this case, a cash pooling agreement, as used in our example, could be 'broken' into several loan schemes, for instance, and, thus, the profit split method could still be reliable.

Surely, the international community, notedly the OECD, has been working on improvements to the rules on transfer pricing, to better adapt them to the new schemes. We agree that improvements are, indeed, welcome.

The comments on our defense to the maintenance of the application of transfer pricing rules relates, therefore, to the question on 'how much' to attribute to this new virtual PE. Although is our goal to provide for a solution as more comprehensive as possible, we recognize that the analysis of this topic, inside the current study, is far too incipient and requires further efforts.

6.2.1: Monetary thresholds for the attribution of the virtual permanent establishment status

After determining the nature of the activities that should be taken into account for matters of virtual cross-border income taxation and deciding for the maintenance of transfer pricing rules to determine the amount of profit generated at the 'to be verified'

---

[143] This would also represent a tax upon the inefficiency of companies, provided that a gross income tax would culminate in the same fiscal burden to be undertaken by companies deriving much less profit than others or, in a worst case scenario, even upon loss making companies, with high turnovers, for instance.
[144] Ana Paula Dourado, "Editorial: The OECD Financial Transactions Discussion Draft and BEPS Actions 8-10." *Intertax, 46, 10* (2018), 740.

permanent establishment level, it is needed to determine a threshold for the actual attribution of the idea of '**significant**' and, consequently, of the new PE status.

At this second step, we believe on the need to set two orders of threshold: the first one would be an absolute minimum revenue obtained at the source country, simply for matters of lowering the demands for tax audits to be performed by tax authorities and to lower compliance costs for taxpayers that, ultimately, could create international market expansion barriers to small enterprises and start-ups.

We also believe that this 'absolute' (or fixed) number for the first threshold should be set bilaterally by the treaty partners and that the MLI should only cover the implementation of the general formula (we will come back to role of the MLI in the procedure for implementation of our proposal in Topic 7.1).

The reason behind this bilateral flexibility is because countries have different economic backgrounds and different levels of sophistication of their tax authorities. To set a common and standard number for this absolute threshold would be disproportional and would also culminate in the disregard of national and regional economic and administrative differences.

Lastly, consensus would be extremely hard to archive in this proposal if a fixed number was selected.

The second threshold to be analyzed would be related to the proportion of the global revenue of the MGC and the revenue generated at the source country (external benchmark approach). This would be a cumulative requirement for enabling source taxation, together with the previous threshold.

Therefore, an enterprise in the source country would only trigger the virtual permanent establishment status if the activity developed in the source country represents a minimum percentual (importance) to the MGC global revenue.

This proportionate approach is interesting because it would help to measure the effective participation of the source country in the construction of value for that given MGC and the importance of the bound (or link) established between the MGC and that particular jurisdiction where it acts without having a physical presence (economic allegiance).

Well, although some business can establish a huge digital (or virtual) presence in a given jurisdiction, sometimes, in 'less highly digitalized business models', for instance, this presence may as well be not as much significative. Our proposal seems capable of measuring this level of participation and translating it into a new rule of progressive (re)attributing (or distributing) taxing rights (Topic 6.3).

This *percentual approach* can also be able to better align taxation in situations where a given activity is now not seen any more as preparatory or auxiliary but, at the same time, does not constitute something of a great proportion to the company's revenues.

This second threshold, therefore, would be set by the treaty partners, but, here, as we are dealing with percentage, we believe that it can be set around the mark of the 10% for companies with a global revenue up to 7.000.000, of 5% in regard to revenues from 7.000.000 to 750.000.000 Euros[145] and of 0,5% in cases the revenues exceed the previous threshold, creating, therefore, **3 categories**, according to the illustrative table below:

Table 1. Example of categories for minimum monetary proportional income

Revenue	Percentual of global income obtained at source jurisdiction to enable source taxation	Category
Up to 7.000.000 Euros	10%	1
From 7.000.000 to 750.000.000 Euros	5%	2
More than 750.000.000 Euros	0,5%[146]	3

[145] The election of these number lies in reference to some documents discussed at the present study. The first 'minimum' number of 7.000.000 Euros is a reference to the European Commission, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM (2018) 147 final; 2018/0072 (CNS) (Brussels, Belgium, 2018), Art.4(3). It could well be established at a lower level, if used the thresholds presented at the EU DST, from which it is highlighted the number of 5.000.000 Euros. Surely, the use of the latter would increase the efforts of audit and compliance. Finally, the value of 750.000.000 Euros is a 'political agreement' for determining the 'giant digital multinationals'. European Commission, Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM/2018/0148 final - 2018/073 (CNS) (Brussels, Belgium, 2018), Art. 4. This number also appears at the BEPS Action 13, in relation to the obligations of the preparation of a country-by-country report. Organization for Economic Co-operation and Development, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report* (Paris, France, 2015).

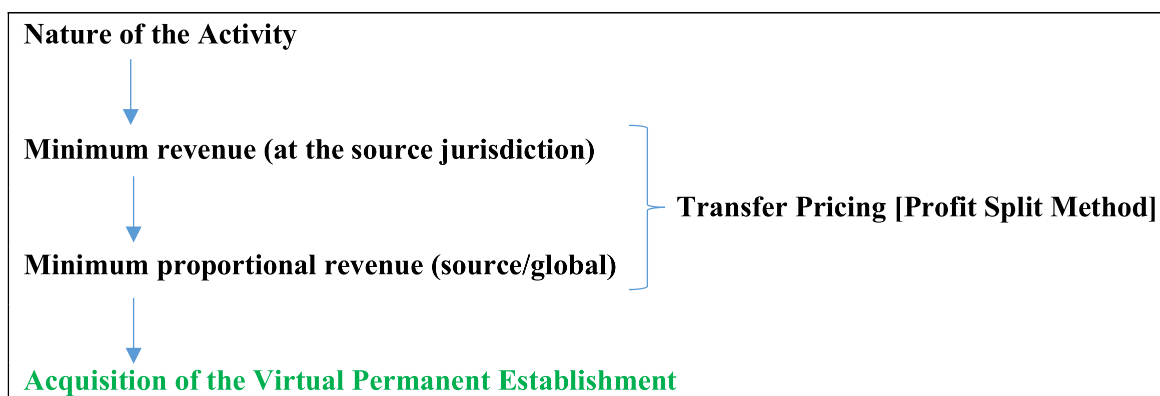
[146] In cases of treaties including small jurisdictions (specially in terms of size of population) the thresholds could be bilaterally set into a lower level, as to harmonize with the idea that a given activity, especially

Especially regarding 'category 2', we understand that, perhaps, the international community could choose to split it into several other categories. These would increase tax fairness but also administrative complexity, representing another dilemma in terms of the necessary trade-off that the international community would have to go through when dealing with some points of our (or any other) proposal.[147]

Surely, as there will be the need to establish a 'global tax base' of the given MGC, the rules on determining this base will have to be harmonize. We understand the difficulty in developing this point and we should present our ideas in this regard on Topic 7.1 below.

So far, we can summarize the steps towards the verification of the existence of a virtual permanent establishment, according to our proposal, as follows:

Figure 1. Acquisition of the virtual permanent establishment status



6.3: Allocation of taxing rights upon the profits attributed to the virtual permanent establishment (Simplified Formulary Apportionment Method)

After determining the amount of income attributable to the non-resident enterprise in the source country and, thus, establishing the formation of a virtual permanent establishment therein (in case the analysis lead to the process exemplified in **Figure 1**) we need to discuss where to allocate the taxing rights upon the given income.

---

when developed by giants of the digital economy, may have insignificant impact in their global revenues, but a fairly large impact in the local economy of the small source state. Lowering these thresholds would bring more balance to such cases.

[147] Alessandro Turina, "Which 'Source Taxation' for the Digital Economy?" *Intertax, 46, 6/7 (2018)*, 495.

Before we proceed with the technicalities of our proposal, in terms of allocation of taxing rights, we must recognize that this new way of attributing taxing rights should not be extended to physical (or classic) permanent establishments, as already mentioned at the beginning of this Chapter. Besides the arguments already exposed, it is worth mentioning that, as a virtual presence can significantly vary of intensity, the physical one usually entails an always strong connection with the source state, with its society (in line with the 'benefit principle').

This last argument may help us to defend that the proposal is not unproportionable ring-fencing and, as we are going to demonstrate, where a virtual presence is indeed large, the final tax result (in terms of taxing rights) would be exact the same as in regard to the physical PE.

Our proposal, here, is also in line with the mentioned schedular structure of the international tax regime, based on the tax treaties.[148]

Back to the core issue of this topic, we would like to introduce a 'simplified apportionment formula', to progressively (re)attribute the taxing rights, as follows:

Figure 2. Simplified apportionment formula.

Y x % of the MGC income attributable to the source state = % of the source income to be taxed by the source state

*(Where '**Y'** would be a variable determined bilaterally by the treaty partners, in order to facilitate consensus and to enable sovereignty and flexibility)*

In the formula above, '**Y'** would be the responsible for translating the progressivity we are talking about.

Although we believe in setting the determination of the precise value for '**Y'** to the treaty partners, some limits are recommended in order to avoid an *unfair*

[148] Klaus Vogel, "The Schedular Structure of Tax Treaties." *Bulletin for International Taxation*, 56, 6 (2002).

('unbalanced', 'low') share of taxing rights to the source state and an incentive to the development of artificial highly fragmented business enterprises (low **'Y'** values).

On the other hand, in cases of high values for **'Y'**, the idea of 'significant' would be mitigated and, probably, residence countries would not work towards a consensus implementation of the proposal.

We must reinforce, therefore, that our rule on the attribution of taxing rights for the new figure of the 'virtual permanent establishment' is not only a new threshold for the attribution of source taxing rights but, together with the efforts connected to the BEPS implementation and the fight against artificial schemes, with the expected recovery of before 'stateless income' derived from the possibilities of avoidance of the PE status, our proposed rules would also be able to enlarge the taxable base of MGC in their countries of residence.

The table below demonstrates the percentage of taxing rights, upon the income derived from a virtual PE in the source state that would fall into the competence of the latter. To better illustrate, assume that a given MGC derives **20%** of its global revenue from that particular source state.

Table 2. Example of percentual distribution of taxing rights.

Value of 'Y'	Formula (Y x 20% = STR[149])	% of the income derived from the source state to be taxed therein (STR)
0	0 x 20% = 0%	0%
1	1 x 20% = 20%	20%
2	2 x 20% = 40%	40%
3	3 x 20% = 60%	60%
4	4 x 20% = 80%	80%
5	5 x 20% = 100%	100%
6 (+)	6 x 20% = 120%	100%

As the table demonstrates, of course, the maximum amount of taxing rights to be attributed to the source state where the virtual PE threshold was met is 100%.

[149] STR = source income to be taxed by the source State (Source Taxing Rights).

In accordance to the reasons explained above, we believe that the establishment of values for **'Y'** could be linked to the 'income thresholds' set at the 3 categories (or more, if decided by the treaty partners) shown in **Table. 1**. This will ensure a meaningful taxation at the source level even in cases of giant multinationals with very spread and fragmentated business activities.

As an illustrative example, we believe that the following values could be set as parameters for the bilateral negotiations.

Table 3. Example of values for 'Y'

Value of 'Y'	Category
From **3** to **6**	1
From **6** to **12**	2
From **50** to **100**	3

The use of external benchmarking elements to determine the proportion of income to be taxed at the source level may create problems, as observed by Daniel Blum. According to that author, the adoption of such a method may lead to different tax treatment in a given source state to companies with the same amount of income obtained therein, but with very different proportions of this income in relation to their worldwide revenues[150].

We, to a certain extent, agree with this consideration. Nevertheless, we believe that the difference in the tax treatment is justified by the fact that, as defended by us, the MGC should be seen as a single unit and, therefore, the consideration of its global distribution of activities would be a reliable element to establish the connection, the economic allegiance and the benefit obtained by that MGC as an unit from the particular state.

Otherwise, if an external benchmarking was not to be used, the author mentioned suggests the possibility to determine the source taxing rights by analyzing the internal

[150] Daniel W. Blum, "Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined?" *Bulletin for International Taxation, 69, 6/7* (2015), 319.

market share of the taxpayer[151]. We are against the use of this element, provided that it would walk in the opposite direction of the idea of tax certainty. Moreover, and similar to our argument that the creation of value by users should not be accounted because it does not depend on the actions directly developed by the MGC, the same applies to the market share, where the tax burden of a MGC would rely on the business strategies of its competitors. It creates a much bigger discrimination problem than our proposal.

Besides, as we have already mentioned, we advocate in favor of the possibility of, in face of a single enterprise of a MGC in a source state, of the constitution of more than one type of PE, when verified the respective conditions for the attribution of the different PE status. The rules on attribution of profits and taxing rights upon this profit, for both of types of PEs, should follow the respective rules of each type (physical types and the virtual one).[152]

Our idea, therefore, would also be in line with the current 'schedular' structure of the double tax treaties and, thus, of the international business income taxation scenario. According to this idea, developed by Vogel[153], there could be verified the existence of different categories of income that would be treated differently in terms of the distribution of the rights to tax the given incomes (exclusively or cumulatively) to the treaty partners[154].

The maintenance of such a structure, nevertheless, is criticized by some academics, some of which also advocates in favor of the extinction of direct taxes at all. We have already discussed our thoughts on that subject before during our study.

The adoption of the possibility of the configuration of more than one type of PE should complement the efforts made in connection with BEPS Action 7[155].

[151] Daniel W. Blum, "Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined?" *Bulletin for International Taxation, 69, 6/7* (2015), 319.
[152] The IBFD Task Force on the Digital Economy refers to that possibility as a 'mixed PE'. *See*: Pasquale Pistone; João Félix Pinto Nogueira and Betty Andrade. "Comments submitted by The International Bureau of Fiscal Documentation (IBFD) Task Force on the Digital Economy," (OECD, Paris, 2019).
[153] Klaus Vogel, "The Schedular Structure of Tax Treaties." *Bulletin for International Taxation*, 56, 6 (2002).
[154] João Francisco Bianco and João Tomazella Santos. "A Change of Paradigm in International Tax Law: Article 7 of Tax Treaties and the Need to Resolve the Source versus Residence Dichotomy." *Bulletin for International Taxation, 70, 3* (2016).
[155] Organization for Economic Co-operation and Development, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report* (Paris, France, 2015).

As we have recognized, this Action was actually able to minimize the actual avoidance of a physical PE status, but was unable to align the source taxation in accordance to the value created in the source state, provided that companies are still able to constitute a simple low risk distributor permanent establishment (LRD PE), which would trigger low or no taxation in the source jurisdiction, because 'non-physical' activities would not be considered as they should.[156]

With our proposal, the physical LRD PE constituted would still be taxed in accordance with the actual rules, but the profit related to the virtual PE associated to the physical LRD PE would be taxed by the new rules, increasing the source tax burden of that enterprise and helping to align taxation with value creation.

This approach would also help to avoid further uncertainties and the consequent problems relating to the application of distributive rules. The elements already captured today, under the 'physical' rules would remain unaltered, while some of the elements not captured today would fall into the scope of the new rules.

Finally, we understand that the fairly large discretionary power among the selection of values for **'Y'** and for the percentual threshold of global profit obtained at source jurisdiction to enable source taxation will allow the existence of tax competition among nations. On the other hand, this would be a more 'level playing field' competition[157], provided that at least a margin (minimum and maximum) could be provided at the MLI (what we have called a 'general formula').

We are not against tax competition and we do believe that this is even an intrinsic element of the tax sovereignty of jurisdictions. The problem is the current **harmful** tax competition and the 'race to the bottom'. Our solution does not promote these problems.

[156] Torvik raises the question as whether the low-risk distributor characterization of the local permanent establishment would give enough taxing rights to the source state. Oddleif Trovik, "Chapter 25: The Allocation of Residual Profits from Unique and Valuable IP to Permanent Establishments" in *Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chain*s (IBFD Doctoral Series, 45, 2019), 9-10.

[157] The European Union appears to be in line with our differentiation, as it does not seem to be against a 'fair tax competition' between Member States, provided they observe, of course, the fundamental freedoms and the idea of real economic activity. This discussion is well structured in: Martijn Nouwen and Peter Wattel, "Tax Competition and the Code of Conduct for Business Taxation" in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen (Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018), 500-501.

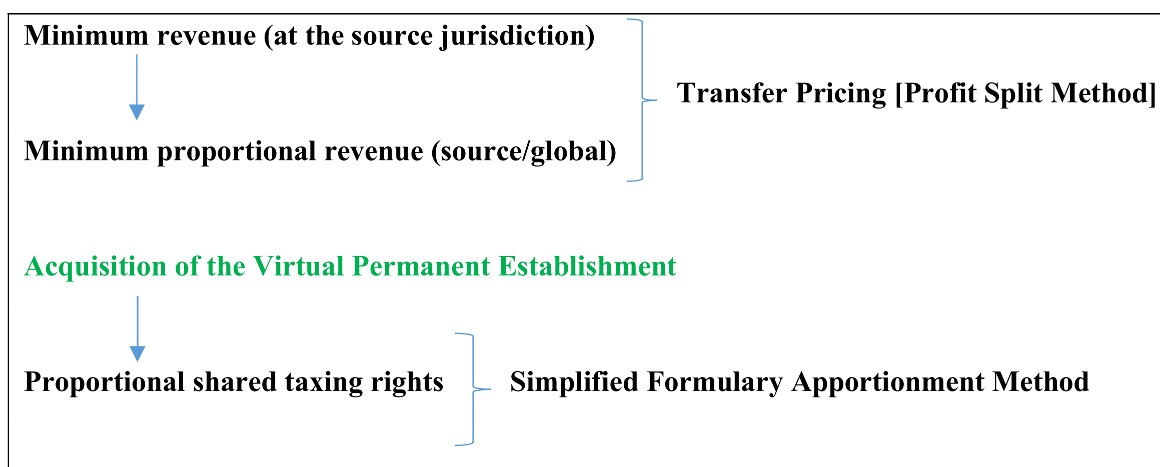
Moreover, as we like to remind, flexibility and 'space' for a certain domestic and bilateral control over business income tax policy is fundamental for reaching a feasible solution in the short to mid-term.

Of course, the Inclusive Framework should discuss whether to adopt a more standardize or a more flexible version of our proposals, depending on the level of 'rows' (or categories) countries are willing to create both for **Table 1**. and for **Table 2**.

Another question to be answered would be the broadness of the margins for attributing a number to **'Y'**, both in cases of a low or high number of categories as discussed in the previous paragraph.

In a nutshell, we can conclude our 'rationale' scheme as follows:

Figure 3. Acquisition of the virtual permanent establishment status and attribution of taxing rights.



6.3.1: The need to establish a common base for the 'minimum proportional revenue'

For there to be an agreement as to what portion of the global income is being generated at the source level, the countries involved (source and residence) must essentially agree on how to calculate this mentioned global income. Otherwise, the application of the transfer pricing as suggested in this study would lead to severe inconsistencies.

Therefore, this is as issue of establishing a common tax base between the treaty partners in every concrete case. We see three interesting options that could, at a macro

perspective (looking to the entire web of DTT), be applied, depending on the case, without creating any new problem in terms of artificial tax schemes and harmful tax competition.

Beforehand, we do not believe on the feasibility of a global common corporate tax base, as pursued by the European Union both at the CCTB and the CCCTB proposals[158]. Even inside the context of the EU, this proposal has struggled to be adopted and, in a global scenario, agreement in terms like this one, for now, appears to be utopic. On the other direction, the IBFD Task Force on the Digital Economy suggests the creation of this global common tax base.

With that consideration, we believe that the best feasible solution (or the idea of the 'second best') is to leave for the treaty partners to bilaterally agree on a common base to be applied between them whenever the treaty is applicable in terms of the analysis of a possible virtual permanent establishment.

Of course, we understand that this solution may require a long time to be efficiently implemented, provided that bilateral (re)negotiations could take a lot of time, even in best-case scenarios.

Thus, the OECD Model Tax Convention could provide for a 'model' for determining the tax base to be applied and this 'model' could be included in the MLI (the question of whether or not to include it as a minimum standard could be raised) and countries would just adopt it while the bilateral negotiations are not yet undertaken.

The same Model Convention could yet provide for an alternative option, both in case the countries do not agree with the 'model' established or in case technicalities make its application excessively burdensome. Therefore, the OECD Model could establish the possibility, for the determination of the global income of the MGC, of the adoption of the same criteria for determination of profits of a resident in the source country where the virtual permanent establishment is being analyzed.

Please notice that, although the MGC may derive profit from more than one hundred jurisdictions, the methods to determine the proportion of the global profits attributable to one of the virtual permanent establishments would always be bilateral, as

---

[158] European Commission, "Proposal for a Council Directive on a Common Corporate Tax Base, Strasbourg, 25.10.2016 COM (2016) 685 final, 2016/0337 (CNS) (Strasbourg, France, 2016). European Commission, "Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), Strasbourg, 25.10.2016 COM (2016) 683 final 2016/0336 (CNS) (Strasbourg, France, 2016).

described in all the three options provided above. This is the only way possible in the absence of a global common standard for calculation of the tax base.

One important difficulty in applying our suggested methods is the need for the treaty partners to have access to data regarding the global profits of the MGC. This can be mitigated by the rapid evolution of the coverage of measures relating to automatic change of information between tax authorities and tax transparency in general.

Surely, we recognize that any of the solutions proposed by us could lead to distortions at the taxation at the residence level, with either a final tax result of double-taxation or double non-taxation. This point, we understand, should be revisited by all stakeholders for there to be alternatives to mitigate this issue.

Chapter 7: Practicalities

7.1: Implementation

Among the analysis of the rationale of our proposal, at Chapter 6, we have highlighted that both in terms of some solutions, as in terms of the adoption of 'numbers' and 'categories', the international community will, in practice, have to choose between **more standardization** or **more flexibility**.

Depending on the choices made, which we believe should be taken inside the OECD Inclusive Framework, the issues on implementation would significantly vary. Nevertheless, we should begin with the common aspects, in terms of implementation, between both the more standardized and the more flexible forms.

In our opinion, the introduction of the new virtual permanent establishment threshold should be made through the existing Multilateral Instrument[159], thought by the BEPS Action 15[160]. This instrument is already in force[161] and can, in the best feasible way, be effective in the introduction of new rules to the international business income taxation scenario.

The main positive aspect of the MLI is that it is responsible for saving a significant amount of time in bilateral negotiations. Therefore, if the international community, namely via the work of the OECD, decides to go for a more flexible solution, this would still need to be negotiated between the parties and, therefore, the shape of the MLI, as it looks today, would need to be adapted.

On the other hand, if a more standardized solution is to be chosen, the implementation through the MLI could be more effective.

We conclude that, although we prefer the flexible solution (as defended in the topics ahead) we understand that, in terms of implementation, this solution requires more effort and time.

---

[159] Organization for Economic Co-operation and Development, *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (Paris, France, 2015).
[160] Organization for Economic Co-operation and Development, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report* (Paris, France, 2015).
[161]

Of course, the choice, here, would rely on the political will of the international community build in the near future, specially inside the discussions (and public consultations) at the scope of the Inclusive Framework. An interesting idea maybe to begin with the adoption of a more standardized approach and make it temporary, as the MLI itself is supposed to be and, in a second moment, to proceed with gradual bilateral 'adaptation'. Of course, we should take special care when implementing measures aimed at been temporary.

In any case, regardless of the chosen 'configuration' for implementation of the options above, the changes would conceptually fit in the scope of Art. 2 of the Model Convention, as already explained, which would facilitate the procedure.

In the context of the European Union, our proposed solution could be implemented via Directive, in a scenario where the OECD and the global community strive to implement the measures via MLI. Of course, as we have discussed mainly in Chapter 5, the issues of the competence of the EU, in matters of legislating about direct taxation and the high requirements for political alliance in adopting new measures could also impose barriers in the putting forward of our proposal inside the Union.

7.2: Enforcement and collection

The issue of an effective enforcement of the taxes to be paid to the source jurisdiction, where the virtual permanent establishment is located, is probably one of the biggest challenge to be faced by the adoption of any proposal in terms of taxing an activity generating revenue without any physical presence. As we have discussed in the first chapter, it is also a matter of tax fairness.

Therefore, the first instrument that comes to mind is, of course, the application of withholding taxes on the payments attributable to the virtual permanent establishments. Although this idea is strongly defended by the work of Hongler and Pistone[162], we believe that the main problem with the 'normal' application of withholding taxes is that it is applied upon the gross income.

[162] Hongler, Peter and Pistone, Pasquale, "Blueprints for a New PE Nexus to Tax Business Income in the Era of Digital Economy". *IBDF Whitepapers* (2015).

Apart from that conceptual problem in the broad application of withholding taxes, the challenge is even bigger when this application is simply not possible.

Imagine, for instance, that a company A, located in Country A, has a virtual permanent establishment in Country B, without any other form of permanent establish therein (namely, a *physical* PE). Assume that, in the development of a particular business, company C, resident in Country C, pays for company A to a digital service provided through the virtual permanent establishment in Country B.

In the described scenario, we have an activity falling under the scope of the new PE threshold and, for matters of exemplification, it is generating revenues above the minimum thresholds for the attribution of source taxing rights (to Country B), but no cash flow is actually passing through that jurisdiction and, therefore, a direct withholding tax is not possibly applicable.

For these cases, there should be a subsidiary form of tax collection, to substitute the common withholding tax application.

The subsidiary method could be built based on an idea of a collection made by the country of the payer (in our example, Country C), probably via a withholding tax, and the subsequent transfer of the collected value to the country of the virtual PE (Country B) upon the retention of a kind of 'administrative fee' for the collecting Country – 'indirect withholding tax'.

Alternatively, a form of netting scheme could be developed in order to minimize the amount of transaction flows of collected taxes among several jurisdictions. This last solution, nevertheless, would require a very strong global level of cooperation, which we do not believe to be feasible any time soon.

Another idea to be further developed would be to create a form of registration for companies operating in a virtual form in a given country. It is not our aim to develop this idea, as it would require an effort outside the scope of our study. Nevertheless, a measure with this rationale could be able to facilitate enforcement and, if accompanied with compliance incentives to the taxpayers (such as the possibility of net basis taxation and filling tax returns) this idea could effectively work in the future.

As for the specific case of the European Union, an idea as above would have a real chance of success, provided the current level of integration of the Member States.

Comparable to this scheme is the 'one stop shop' system, applicable to the collection and distribution of VAT, considered to be an efficacious mechanism.

In any case, considering our comments above, we still believe that withholding taxes, in comparison to equalization levy or small turnover taxes should be preferred.[163]

7.3: Recognition of losses

The possibility of the recognition of losses, in our point of view, lies closely related to the exercise of a net taxation upon the virtual activities under the scope of our proposal. Therefore, it appears to be a hard task to conciliate a 'normal' gross base taxation via withholding taxes and the recognition of losses.

Perhaps, if the virtual permanent establishment is connected to a physical one, the losses of the first could be offset with the income of the latter, even with an application of gross withholding taxes in the virtual PE and the regular net income tax of the physical PE. This still would not completely work if the losses of the first are considerably higher than the income of the latter.

Moreover, in the case where no physical PE relates to the virtual PE in analysis, this offset would simply not be possible.

The way in which losses of virtual permanent establishments would be recognized is if our 'registration proposal' is put forward. Surely, the technicalities of this procedure would have to be debated. This discussion will not be included in the present study.

Again, this would be reasonably easier to achieve inside the European Union, as the level of integration of the Member States could facilitate the implementation of a cross-border system for the recognition of losses in virtual permanent establishments, as it is fundamental for the development of a free internal market.

---

[163] Yariv Brauner, "Editorial: Taxing the Digital Economy Post-BEPS, Seriously". *Intertax, 46, 6/7* (2018), 462. *Also,* Roland Ismer and Christoph Jescheck, "Debate: Taxes on Digital Services and the Substantive Scope of Application of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model?" *Intertax, 46, 6/7* (2018), 573.

Furthermore, it is important to highlight that Member States have several restrictions regarding the application of gross withholding taxes, such as in cases covered by the Interest and Royalties Directive.[164]

[164] European Parliament and the European Council, "Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States".

Chapter 8: Implications

Several should be the implications of the adoption of our proposal and we should discuss, in more specific terms, these implications upon the principles of the Ottawa Framework (Topic 8.1); upon the tax administrations (Topic 8.2) and upon the taxpayers (Topic 8.3). Most likely, this Chapter will not be able to discuss all the possible implications, as it would take another full dissertation. Nevertheless, we hope to achieve a comprehensive analysis.

Therefore, we start with some general commentaries.

The first one is that we believe that, as a consequence of the implementation of our proposal, together with the successful implementation of the Actions of the BEPS Action Plan, there should be no need to the parallel adoption of any of the proposals under the OECD 'Pillar Two', as well as any similar measures, like the DST EU proposal. We have already discussed these proposals at the second part of this study.

Another important implication relates to the 'incentive vs. disincentive' of the development of the digital economy and, with it, with the development of new (and more efficient) technologies and business models.

Politically, the international community (and, strongly, the European Union as well) demonstrates a will to enhance the development of the digital economy, nevertheless, in parallel, both this international community and the countries, domestically, are discussing several proposals to impose a higher tax burden upon the development of such activities. Our proposal does not create a barrier to the development of the digital economy.

Besides the analysis of these two main implications, we are aware, as already mentioned during the study, that certain trade-offs will have to be made and the international community will have to weigh the consequences of the choices made, specially inside the scope of our proposal.

We should now take a deeper look at the implications in relation to the principles of the Ottawa Framework, which are also good examples of the just mentioned trade-offs.

8.1: *Upon* principles of the Ottawa Framework

As mentioned in Topic 6.2 above, the use of transfer pricing methods, namely the 'profit split method' prevents the incidence of taxes upon activities that cannot be measure (or seen) between independent parties, such as the user participation or contribution.

To actually impose a tax upon an attributable value in the scope of this category of activities would represent an 'extra-fiscal' character of the income tax in question, as it would act as an element in favor of the discouragement of the performance of business in more digitalized ways.

Ultimately, and contradictious enough, this would go in a totally opposite direction in regard to what countries are current engaged in terms of shaping social and economic behavior by changes in taxes. The imposition of higher tax burdens on unhealthy food or beverage products and in non-sustainable environment activities are examples of what we defend.

The application of transfer pricing methods (and the arm's length principle) at the moment of analyzing the amount of profits (or value) to attribute to the virtual permanent establishment ensures, at the best way viable, a level playing field between different business models (more or less digitalized). Therefore, less economic distortions would be likely to emerge and, consequently, less deadweight loss would be perceived.

Translating these considerations into the 'language' of the Ottawa Framework, it seems clear to us that the use, at this stage, of the TP rules would ensure the 'neutrality' searched by the OECD and the global community.

Moreover, as founded on feasible choices, related to the expressed political will of most countries and on compromising shares of taxing rights, based on our proportional attribution formula, we believe that the new 'virtual permanent establishment' could work efficiently.

Combined with relatively simple formulas, still able to accommodate the differences exiting inside the spectrum of taxpayers, our solution could bring more certainty to both tax authorities and taxpayers, also contributing to the mentioned effectiveness of the system.

Finally, we have also developed a flexible enough solution. At first, because although it is supposed to be a global solution, it would still adapt to the economic and political regional and national differences, once again, also enabling consensus. Secondly,

because it is not designed to tackle very particular business models. It is rather a comprehensive solution that we believe could adapt to the development of the digital economy and to new business models to come.

8.2: *Upon* tax administrations and taxpayers

As a natural consequence of the impacts of our proposed solution in the framework of the Ottawa principles, we believe that the implications for both taxpayers and tax administrations would be positive. Of course, as mentioned during our studies, trade-offs will inevitably happen.

With the global implementation of our solution, both tax administrations and taxpayers would benefit from more certainty, simplicity and efficient, which would contribute both for the safeguard of the collection of income taxes, from the State perspective, as for the possibility to better plan the international tax burden, for MGC, which lower the costs of doing business abroad and acts as an incentive to the development of the digital economy.

Moreover, we also believe that our proposal could help decreasing the number of tax claims (disputes), which ultimately benefits all stakeholders.

Surely, on the other side, both tax administrations and taxpayers would have initial extra costs of compliance and audit, provided that the global implementation of our solution (*or of most of the others*) should require a stronger international cooperation and the sharing of documents, as accountings documents, for instance.

Finally, we believe that the trade-offs in evidence still work in favor of all stakeholders, as debated in this topic.

Conclusions

Throughout this study, we could properly identify the nature of the tax challenges of the digital economy. Interestingly, we were also able to perceive that tax scholars are living in exiting times, provided the intense (and rapidly) changes occurring in the system for international business income taxation.

In this context, several proposals to tackle the tax challenges of the digitalization of the economy, namely the need to prevent BEPS and to (re)think the global distribution (or attribution) of taxing rights, were debated. We dedicated a special part of this work to specifically discuss the proposals developed by the OECD and the EU, with the critical confrontation of these proposals with the input from several scholars.

The relatively wide range of different proposals and the lack of an adopted strategy revel space for creativity and innovation in presenting new ideas. Nevertheless, as debated, these new ideas must be politically accepted and technically feasible.

With that in mind, there was proposed a new virtual permanent establishment threshold, able to capture the non-physical activities of multinational group of companies and to realign the distribution of the tax revenue among residence and source States.

Importantly, we also believe that our proposed solution was able to accommodate the changes needed without been disproportionately ring-fencing[165], differently, as discussed, from the user participation proposal (OECD) or the DST proposal, from the EU. Although we do not advocate in favor of the extension of the new rules to the existing physical PE, we were able to demonstrate that, whenever the digital presence represents a large enough participation of the MGC at the source State, the final tax result (fiscal burden and competent country) would be the same as of the 'regular' PE.

Moreover, the proposed solution was included in the current framework for international business income taxation, which we believe to be of fundamental importance, provided the political discourse both at the OECD and the EU and the facilitation in matters of implementation, given its compatibility with the current Art.2 od the OECD Model Convention.

[165] Michael P. Devereux and John Vella, "Debate: Implications of Digitalization for International Corporate Tax Reform." *Intertax, 46, 6/7* (2018), 550.

Therefore, we opted for the maintenance of the application of income taxes and for a nexus-based solution, as most of the ongoing proposals. In a more detailed way, we also advocated in favor of the maintenance of the *current* nexus: 'residence'; 'source' and 'permanent establishment'. Most of the discussed proposals, nevertheless, either confused the meanings of 'source' and 'market' jurisdiction or deliberately shifted the nexus from the first to the latter. Some other stakeholders, for instance, are against the use of the idea of permanent establishment.

Our proposal also defended the maintenance of the use of transfer pricing and the arm's length principle for the attribution (or definition) of the profits generated at the new virtual permanent establishment level. In this regard, different opinions were debated and we have recognized the need to there to be some changes and adaptations at the OECD Transfer Pricing Guidelines, especially in terms of intra-group financial transactions, as highlighted by Ana Paula Dourado.

Besides, we have detailed the technicalities of a system to proportionately attribute taxing rights for both the source and the residence country, after the determination of the profits attributable to the new PE. In this sense, two minimum monetary thresholds were created in order to comply with the principle of simplicity and to lower the need (and expenses related) of tax audits and compliance, from the taxpayer side. The first was an absolute minimum revenue threshold, while the second measured the proportion of profits attributable to the 'to be verified' PE and the global profits of the MGC.

In the scope of the mentioned thresholds, we have set different categories in order to accommodate possible bilateral or regional variations, to accommodate the difference in the economic background of countries and to facilitate flexibility and consensus. Nevertheless, we pointed for the possibility of, especially in the future, for there to be a more standardized adoption of our proposal.

We also concluded that it would enable a global application of the proposal and that, with the possible variations, tax competition would keep existing. On the other hand, aligned with the development in the implementation of the outcomes of the BEPS project, our solution would lead to a fair tax competition[166], based on real economic activity and

[166] Maarten de Wilde, "Tax Competition within the European Union – Is the CCCTB Directive a Solution?" *Erasmus Law Review, 24, 1* (2014), 26.

leading space for tax sovereignty[167] and for the possibilities of countries to exercise some control over their income tax policy.

The studies also analyzed the practicalities of the adoption of such a solution, in terms of implementation, enforcement and collection and the recognition of losses attributable to the virtual permanent establishment.

Moreover, the proposed solution showed a comprehensive approach to the challenges faced and provided both the theoretical and practical grounds for its successful implementation (*globally*, via the MLI). We, on the other hand, recognize the need to advance in technical studies to complement our efforts in matters, for instance, of solving the 'source conundrum' issue.

Finally, these studies debated all the main questions raised, for instance, at the special issues of *Intertax*[168], from 2018 and 2019, as well as from the special issue of the *Bulletin for International Taxation*, from 2018, all in relation to the subject of 'taxing the digital economy'. We have also benefited from the analysis of the most updated documents from both the OECD and the EU and from the participation in several conferences relating to the subject, all around Europe.

With these final considerations, we hope our solution could be able to add to the discussions on the international community, especially in the scope of the OECD and the EU and that it can, somehow, contribute to the achievement of a 'consensus based' global solution, by the first, until the end of 2020, when the Organization should release a final document on the subject.

[167] Peter Hongler and Pasquale Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of Digital Economy." *IBDF Whitepapers* (2015), 2.
[168] *See*: Ana Paula Dourado, "Editorial: Is There a Light at the End of the Tunnel of the International Tax System?" Intertax, 46, 8/9 (2018), 607-609.

References

Bibliographic References

A

Avi-Yonah, Reuven S. “International Tax as International Law”. *Tax Law Review*, 57*, 4* (2004): 483-501.

B

Bal, Aleksandra. “(Mis)guided by the Value Creation Principle – Can New Concepts Solve Old Problems”. *Bulletin for International Taxation, 72, 11* (2018): 6 p.

Bianco, João Francisco & Tomazella Santos, João. “A Change of Paradigm in International Tax Law: Article 7 of Tax Treaties and the Need to Resolve the Source versus Residence Dichotomy”. *Bulletin for International Taxation, 70, 3* (2016): 12 p.

Blum, Daniel W. “Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined?”. *Bulletin for International Taxation, 69, 6/7* (2015): 314-325.

Boulogne, Frederik. “Chapter 7 (Updated): The Tax Merger Directive” in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen. Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018.

Brauner, Yariv. “Editorial: Taxing the Digital Economy Post-BEPS, Seriously”. *Intertax, 46, 6/7* (2018): 462-465.

C

Chand, Vikram and Danon, Robert. *The Interaction of Domestic Anti-Avoidance Rules with Tax Treaties (with special references to the BEPS project)*. Lausanne, Switzerland: Université de Lausanne; Schulthess, 2018.

Cordewener, Axel. “Chapter 10 (Updated): The Intertest and Royalty Directive” in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J.

Wattel, Otto Marres and Hein Vermeulen. Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018.

Courinha, Gustavo Lopes. *A Residência no Direito Internacional Fiscal: do Abuso Subjectivo de Convenções*. Lisbon, Portugal: Almedina, 2015.

D

Devereux, Michael P. and Vella, John. "Debate: Implications of Digitalization for International Corporate Tax Reform". *Intertax, 46, 6/7* (2018): 550-559.

De Wilde, Maarten. *Sharing the Pie: Taxing Multinationals in a Global Market*. Amsterdam, the Netherlands: IBFD, 2017.

De Wilde, Maarten. "Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy". *Intertax, 38, 5* (2010): 281-305.

De Wilde, Maarten. "Tax Competition within the European Union – Is the CCCTB Directive a Solution?". *Erasmus Law Review, 24, 1* (2014): 24-38.

Dhuldhoya, Vishesh. "The Future of the Permanent Establishment Concept". *Bulletin for International Taxation*, 72, 4*a*, Special Issue (2018): 18 p.

Dourado, Ana Paula. "Debate: Digital Taxation Opens the Pandora Box: The OECD Interim Report and the European Commission Proposals". *Intertax, 46, 6/7* (2018): 565-572.

Dourado, Ana Paula. "Editorial: In Search of an International Tax System in a Post-BEPS Tax Competition Setting". *Intertax, 47, 1* (2019): 2-6.

Dourado, Ana Paula. "Editorial: Is There a Light at the End of the Tunnel of the International Tax System?". *Intertax, 46, 8/9* (2018), 607.

Dourado, Ana Paula. "Editorial: The OECD Financial Transactions Discussion Draft and BEPS Actions 8-10." *Intertax, 46, 10* (2018), 740-743.

Dourado, Ana Paula. *Governação Fiscal Global*. Lisbon, Portugal: Almedina, 2017.

Dourado, Ana Paula. "Justiça e Redistribuição Financeira" in *Ética e o Futuro da Democracia* (Lisboa, Portugal: Edições Colibri, 1998).

E

Engelen, Frank. *Interpretation of Tax Treaties under International Law*. Amsterdam, the Netherlands: IBFD Doctoral Series, 7, 2004.

G

Gadžo, Stjepan. *Nexus Requirements for Taxation of Non-Residents' Business Income – A Normative Evaluation in the Context of the Global Economy*. Amsterdam, the Netherlands: IBFD Doctoral Series, 41, 2018.

Gadžo, Stjepan. "The Principles of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law: A Reappraisal". *Intertax, 46, 3* (2018): 194-209.

Garbarino, Carlo. "Permanent Establishments and BEPS Action 7: Perspectives in Evolution". *Intertax, 47, 4*. (2019): 365-381.

H

Hemmelrath, A. and Wilcox, E. "Chapter 8: AOA, BEPS, E-Commerce" in "*Permanent Establishment" in Flux in Practical Problems in European and International Tax Law*. Jochum, Heike, Essers, Peter, Lang, Michael, Winkeljohann, Norbert & Wiman, Bertil. Amsterdam, the Netherlands, IBFD, 2016.

Hohenwarter, Daniela, Kofler, Georg, Mayr, Gunter & Sinnig, Julia. "Guest editorial: Qualification of the Digital Services Tax Under Tax Treaties." *Intertax, 47, 2* (2019): 140-147.

Hongler, Peter and Pistone, Pasquale. "Blueprints for a New PE Nexus to Tax Business Income in the Era of Digital Economy". *IBDF Whitepapers* (2015).

I

Ismer, Roland & Jescheck, Christoph. "Debate: Taxes on Digital Services and the Substantive Scope of Application of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model?". *Intertax, 46, 6/7* (2018): 573-578.

Ismer, Roland & Reimer, Katharina. "Chapter 2, Article 4" in *Klaus Vogel on Double Taxation Conventions*, Klaus Vogel. The Netherlands: Ekkehart Reimer and Alexander Rust, Vol 1. 4th Ed., 2015.

J

Jiménez, Adolfo Mantín. “BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties”. *Intertax, 46, 8/9* (2018): 620-638.

M

Marres, Otto. “Chapter 6 (Update): The Parent-Subsidiary Directive.” in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen. Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018.

N

Nouwen, Martijn & Wattel, Peter. “Tax Competition and the Code of Conduct for Business Taxation” in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen. Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018.

O

Olbert, Marcel and Pengel, Christoph. “International Taxation in the Digital Economy: Challenge Accepted?”. *World Tax Journal*, *No.1* (2017): 3-46.

P

Petruzzi, Raffaele & Buriak, Svitlana. “Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules?”. *Bulletin for International Taxation, 72, 4a, Special Edition* (2018): 19 p.

Pistone, Pasquale. “Chapter 8: EU Cross-Border Tax Disputes Settlement” in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen (Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018).

Pistone, Pasquale. *Diritto Tributario Internazionale*. Italy, Giappichelli, 2017.

Pistone, Pasquale, Pinto Nogueira, João Félix & Andrade, Betty. *Comments submitted by The International Bureau of Fiscal Documentation (IBFD) Task Force on the Digital Economy*. Paris, France: OECD Publisher, 2019.

R

Reimer, Ekkehart, Schmid, Stefan & Orell, Marianne. *Permanent Establishment: Domestic Taxation, Bilateral Tax Treaty and OECD Perspective*. The Netherlands: Wolters Kluwer, 5th Edition, 2016.

S

Sanghavi, Dhruv. *Structural Issues in the Income Tax Treaty Network: Towards a Coherent Framework*. Enschede, the Netherlands: Ipskamp Printing BV, 2018.

Sapirie, Marie. "Permanent Establishment and the Digital Economy". *Bulletin for International Taxation*, 72, 4a, Special Issue (2018): 3 p.

Schmitz F., Ricardo Sergio. "The challenges of sovereignty, justice and representation related to the movement towards multilateralism in international taxation". Paper presented at the 29th IVR World Congress, Lucerne, Switzerland, July 2019.

Schön, Wolfgang. "Ten Questions about Why and How to Tax the Digitalized Economy". *Bulletin for International Taxation, 73, 4/5* (2018): 278-292.

Smit, Daniël. "Chapter 12: The Anti-Tax Avoidance Directive (ATAD)" in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*, Peter J. Wattel, Otto Marres and Hein Vermeulen. Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018.

Spinosa, Lisa, Chand, Vikram. "A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should the Focus Be on a Shared Taxing Rights Mechanism?". *Intertax, 46, 6/7* (2018): 476-494.

Szudoczky, Rita & Weber, Dennis. "Chapter 2: Constitutional Foundations: EU Tax Competences; Legal Basis for Tax Integration; Sources and Enactment of EU Tax Law" in *Terra/Wattel European Tax Law: Volume 1 General Topics and Direct Taxation*. Peter J. Wattel, Otto Marres and Hein Vermeulen. Deventer, the Netherlands: 7th Ed., Wolters Kluwer, 2018.

T

Trovik, Oddleif. "Chapter 25: The Allocation of Residual Profits from Unique and Valuable IP to Permanent Establishments" in *Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains*. Amsterdam, the Netherlands: IBFD Doctoral Series, 45, 2019.

Turina, Alessandro. "Which 'Source Taxation' for the Digital Economy?". *Intertax, 46, 6/7* (2018): 495-519.

V

Vogel, Klaus. "The Schedular Structure of Tax Treaties". *Bulletin for International Taxation, 56, 6* (2002): 260-261.

W

Williams, Robert. *Fundamentals of Permanent Establishments*. The Netherlands: Wolters Kluwer, 2nd Ed., 2014.

Documents and Legal Acts

Brazil

Brazil. "Law No. 9.430/1996", Art. 18, 18-A, 19, and 19-A. (1996).

Brazil, Receita Federal, "Interpretative Declaratory Act RFB 5/2014". (2014).

European Commission

European Commission. Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM (2018) 147 final; 2018/0072 (CNS). Brussels, Belgium, 2018.

European Commission, "Proposal for a Council Directive on a Common Corporate Tax Base, Strasbourg, 25.10.2016 COM (2016) 685 final, 2016/0337 (CNS). Strasbourg, France, 2016.

European Commission, “Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), Strasbourg, 25.10.2016 COM (2016) 683 final 2016/0336 (CNS). Strasbourg, France, 2016.

European Commission. Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM/2018/0148 final ; 2018/073 (CNS). Brussels, Belgium, 2018.

European Parliament and the European Council

European Parliament and the European Council, “Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States”.

European Parliament and the European Council, “Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States”.

European Parliament and the European Council, “Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States”.

European Parliament and the European Council, “Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market”.

League of Nations

League of Nations. *Draft Model Treaty on Double Taxation and Tax Evasion*. Geneva, Switzerland, 1928.

League of Nations. *Economic and Financial Commission Report on Double Taxation Submitted to the Financial Committee*. Geneva, Switzerland, 1923.

Mexico

Mexico. “Mexican Income Tax Law”, Art.180.

Organization for Economic Co-operation and Development

Organization for Economic Co-operation and Development. *Action 1, 2015 Final Report: Addressing the Tax Challenges of the Digital Economy*. Paris, France, 2015.

Organization for Economic Co-operation and Development. *Action Plan on Base Erosion and Profit Shifting*. Paris, France, 2013.

Organization for Economic Co-operation and Development. *Aligning Transfer Pricing Outcomes with Value Creation: Actions 8-10: 2015 Final Reports*. Paris, France, 2015.

Organization for Economic Co-operation and Development. "Commentary on Article 4 Concerning the Definition of Resident" in *Model Tax Convention on Income and Capital: Condensed Version 2017*. Paris, France, 2017.

Organization for Economic Co-operation and Development. *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report.* Paris, France, 2015.

Organization for Economic Co-operation and Development. *Electronic Commerce: Taxation Framework* Conditions. Paris, France, 1998.

Organization for Economic Co-operation and Development. *Implementation of the Ottawa Taxation Framework Conditions: the 2003 report*. Paris, France, 2003.

Organization for Economic Co-operation and Development. *Model Tax Convention on Income and Capital: condensate version*. Paris, France, 2017.

Organization for Economic Co-operation and Development. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*. Paris, France, 2016.

Organization for Economic Co-operation and Development. *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*. Paris, France, 2015.

Organization for Economic Co-operation and Development. *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*. Paris, France, 2015.

Organization for Economic Co-operation and Development. *Public Consultation Document. Addressing the Tax Challenges of the Digitalisation of the Economy*. Paris, France, 2019.

Organization for Economic Co-operation and Development. *Tax Challenges Arrising from Digitalisation. Interim Report, Inclusive Framework on BEPS*. Paris, France, 2018.

Organization for Economic Co-operation and Development. *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report*. Paris, France, 2015.

Organization for Economic Co-operation and Development. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris, France, 2017.

Russian Federation

Russian Federation. “Tax Code of the Russian Federation.”, Art.105.7-105.13.

United Nations

United Nations. *United Nations Model Double Taxation Convention Between Developed and Developing Countries*. New York, USA, 2017.

United States of America

The Government of the United States of America. *United States Model Income Tax Convention*. Washington D.C, USA, 2016.

Jurisprudence

European Commission

Amazon (EU Commission Case No. SA.38944).

Apple (EU Commission Case No. SA.38373).

FIAT (EU Commission Case No. SA38375).

Starbucks (EU Commission Case No. SA.38374).

European Court of Justice

Case C-446/03, *Marks & Spencer*, EU:C:2005:763.

Case C-279/93, *Schumacker*, EU:C:1995:31.

Websites and Press Release

Deloitte

"Taxation and Investment in Malta 2014: Reach, Relevance and Reliability". Deloitte. Accessed 2019 July 16. https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-maltaguide-2014.pdf.

European Commission

"Fair Taxation of the Digital Economy". European Commission. Accessed 2019 July 14. https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en.

Organization for Economic Co-operation and Development

"BEPS Actions." Organization for Economic Co-operation and Development. Accessed 2019 April 20, http://www.oecd.org/ctp/beps-actions.htm.

"BEPS MLI Signatories and Parties." Organization for Economic Co-operation and Development. Accessed 2019 April 20, http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf .

"Members of the Inclusive Framework on BEPS." Organization for Economic Co-operation and Development. Accessed 2019 April 27, https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf.

"Public Consultation on the Tax Challenges of Digitalisation". Organization for Economic Co-operation and Development. Accessed in 2019 July 16, https://oecdtv.webtv-solution.com/5524/or/Public-Consultation-Tax-Challenges-of-Digitalisation.html.

"Tax treaties: update to OECD Model Tax Convention released". Organization for Economic Co-operation and Development. Accessed 2019 April 27, https://www.oecd.org/tax/treaties/tax-treaties-2017-update-to-oecd-model-tax-convention-released.htm.

GENERAL PLAN

INTRODUCTION

PART I - BACKGROUND

CHAPTER 1: THE TAX CHALLENGES OF THE DIGITAL ECONOMY

CHAPTER 2: OTTAWA FRAMEWORK FOR TAXATION IN THE DIGITAL ECONOMY

CHAPTER 3: THE CONCEPTS OF 'SOURCE'; 'RESIDENCE'; 'PERMANENT ESTABLISHMENT' AND COMPLEMENTARY NOTES

PART II – CURRENT PROPOSALS

CHAPTER 4: OECD PROPOSALS FOR TAXING THE DIGITAL ECONOMY

CHAPTER 5: EU PROPOSALS FOR TAXING THE DIGITAL ECONOMY

PART III – OUR PROPOSAL

CHAPTER 6: RATIONALE

CHAPTER 7: PRACTICALITIES

CHAPTER 8: IMPLICATIONS

CONCLUSIONS