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A Review of the Proposals for Taxation of Profits of Businesses in the Digitalized Economy

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ABSTRACT

The advent of information technology and digitalization has changed and continues to change everyday life, including the manner in which business operations are carried out. Years back, to run a taxi business, you would need to own vehicles and employ drivers. Today, some digitalized businesses are able to operate the same business by just owning a digital interface and related intellectual property rights. This change in the way things are done has significant impact on traditional legal systems. In the realm of tax law, digitalization has impacted on traditional international tax rules including the threshold for allocating taxing rights. In. this paper, the author presents a broad review of the main current issues regarding allocation of taxing rights, and the different solutions that have been proposed to accommodate digitalization in the international tax system. In terms of structure, this paper shall proceed as follows. Section 1 is the introduction. Section 2 will review the germane aspects of the current PE concept. Section 3 will examine the nature of digitalized business models which are the subjects of international discussions in this area. Section 4 will review the efforts that have been made at the international level at taxing digital businesses, and highlight the critical points of these efforts. The scope of this work will focus on the ongoing discussions regarding direct taxation of the digital economy. Indirect taxation of the digital economy may be referred to when necessary but will not be reviewed in any detail.

1 INTRODUCTION

Taxation is an overt character of sovereignty.[1] International law recognizes a sovereign's right to prescribe laws and exert its jurisdiction based on two main factors – nationality and territoriality.[2] However, taxing jurisdiction follows a somewhat special set of attributes. While territoriality is relevant for determining jurisdiction both under general international law and under international tax law, nationality is often irrelevant. Aside the United States, there is no other country that exercise taxing jurisdiction based on nationality.[3] Generally, under international tax jurisprudence, a sovereign has the jurisdiction to impose and enforce its tax laws mostly based on territoriality. First, a sovereign may impose tax on residents of its territory for activities performed within and outside its territory.[4] This is known as residence-based taxation.[5] A sovereign may also exercise taxing jurisdiction over activities of residents of other countries for activities within its territory. This is known as source-based taxation.

The two taxing jurisdictions referred to above would have posed no challenges if they were exercised in parallel. However, globalization triggered situations where a person is frequently subject to both residence and source-based taxation, thereby incurring double tax liability, a phenomenon that is general considered to be an obstacle to international trade and investment.[6] To avoid double taxation, governments entered into anti-double tax treaties, and in these treaties adopted the Permanent Establishment ("PE") concept as a means of allocating taxing rights based on the residence and source jurisdictions.[7] The PE concept which is largely characterized by its physical and tangible nature was adopted in

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[1] *United States of America v Harden*, 1963 C (available on http://canlii.ca/t/21vdg).
[2] Reuven S Avi-Yonah, "International Tax as International Law" PublicLaw Leg Theory Res Pap No41 1.
[3] Bernard Schneider, "The End of Taxation Without End: A New Tax Regime For U.S. Expatriates" (2012) 32:1 Va Tax Rev 1 at 3.
[4] Kevin J Holmes, *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application*, second revised edition ed (Amsterdam: IBFD, 2014) at 19.
[5] *Ibid*.
[6] Yasin Uslu, "An Analysis of 'Google Taxes' in the Context of Action 7 of the OECD/G20 Base Erosion and Profit Shifting Initiative" (2018) 72:No. 4a/Special Issue Bull Intl Taxn 1 at 1.
[7] *Ibid*.

the first model tax treaty released by the League of Nations in 1927[8], a period long before the advent of technology and digitalization.

The advent of technology and increase in cross border trade activities occasioned substantial tension on territorial jurisdiction in the sense that the practical line of distinction between territories is blurred. This tension also applied to tax sovereignty given its territorial scope. In particular, following the advent of information technology and digital revolution, the PE concept designed for allocation of taxing jurisdictions became inadequate. The intangible feature of digitalization makes it easier for technologically advanced businesses to remotely access a global market without having a physical presence in the market.[9] As noted by Cockfield: "digital goods and services can be transferred in near-costless fashion across a border and 'exist' for tax purposes within another country or subnational state".[10]

One would imagine that, given that digitalized businesses have existed for some time now, the international tax laws would have evolved accordingly. This is however not the case as the PE concept in tax treaties has largely maintained its essential physical character to date.[11] One explanation for the consistent application of the old PE rules to the digital economy could be the fact that law making is mostly slow while technological advancement occurs at a much faster pace.[12] Another explanation could be the political tussle that it raises, which is substantially a consequence of the fact that the current state of international rules is in favor of the jurisdictions that have the most technologically advanced corporations.

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[8] Arvid Aage Skaar, *Permanent establishment: erosion of a tax treaty principle*, Series on international taxation 13 (Deventer ; Boston: Kluwer Law and Taxation Publishers, 1991) at 82.
[9] Arthur J Cockfield et al, *Taxing global digital commerce* (Alphen aan den Rijn: Kluwer Law International, 2013) at 4.
[10] *Ibid*.
[11] Uslu, *supra* note 6 at 1; Marie Sapirie, "Permanent Establishment and the Digital Economy" (2018) 72:4 Bull Int Tax 1 at 1.
[12] Subhajit Basu, *Global perspectives on E-commerce taxation law*, Markets and the law (Burlington, VT: Ashgate, 2007) at 1.

Nevertheless, there have been some efforts by governments at the international level to address the challenges that have arisen from digitalization. The first global effort at taxing activities conducted over the internet was the meeting of the Organization for Economic Co-operation and Development ("OECD") member states in Turku, Finland in 1997.[13] This meeting which, merely set out an agenda for tackling the challenges of e-commerce, was followed by a more robust meeting in Ottawa, Ontario in 1998.[14] At the 1998 meeting in Ottawa, the OECD members states reached consensus on an agreement for the taxation of e-commerce. The agreement which was popularly tagged the Ottawa Taxation Framework primarily noted that e-commerce should be taxed within the scope of traditional international tax rules.[15] The Ottawa Taxation Framework set out the following principles for the taxation of e-commerce: (i) neutrality in taxing e-commerce and the traditional commerce, (ii) efficiency or low administrative cost, (iii) certainty and simplicity, (iv) fairness and by producing the right amount of tax at the right time and limiting tax avoidance opportunities, (v) flexibility of the regime to follow developments in technology.[16]

Premised on the aforementioned principles, the OECD updated its commentary to the PE concept to address its definition for the purpose of e-commerce.[17] However, as would be disclosed in more details in this work, the revision largely applied the same physical attributes of the traditional PE concept.[18] As a result, the challenges posed by the technology persisted, more so as technology advanced and became more dematerialized.

Digitalization and advancement in technology did not only render source taxation porous and ineffective, it also created an avenue for substantial tax planning and avoidance. As a result of this and similar challenges, stakeholders at the international level reached a near consensus that the current international tax system require some amendments to efficiently

[13] Cockfield et al, *supra* note 9 at 115.
[14] Rifat Azam, "Ruling the World: Generating International Tax Norms in the Era of Globalization and BEPS" (2017) L:4 Suffolk Univ Law Rev 519 at 546.
[15] Cockfield et al, *supra* note 9 at 115.
[16] Azam, *supra* note 14 at 546. Cockfield et al, *supra* note 9 at 115.
[17] Cockfield et al, *supra* note 9 at 117.
[18] *Ibid*; Azam, *supra* note 14 at 547.

tax highly digitalized corporations.[19] In response to this challenge, the OECD at the request of the G20 countries, produced a report titled "*Action Plan on Base Erosion and Profit Shifting*" (BEPS Action Plan) in 2013, which detailed fifteen (15) action plans to combat base erosion. Action 1 of the BEPS Action Plan was designated to "Address the tax challenges of the digital economy" by identifying "the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation".[20] Although the BEPS was originally intended to address base erosion by multinational corporations leveraging on technology, the project again reactivated the concern of the international community regarding the current international principles for allocation of taxing rights; particularly the PE concept.[21]

In September 2014, the OECD's Task Force on the Digital Economy (TFDE) presented its interim report and subsequently, a final report was presented in 2015. In the 2015 report, the TFDE reviewed the nature of highly digitalized business models and recognized the need to review the extant PE rules with a view to adapting it to the digitalized businesses. Subsequently, in a 2018 report, the OECD reemphasized the need to reevaluate the current nexus and attribution rules considering the impacts of digitalization on the economy and value creation.[22] In May 2019, the TFDE released a public consultation paper titled: "Addressing the Tax Challenges of the Digitalisation of the Economy"[23] and subsequently, "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from

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[19] Raffaele Pertuzzi & Vasiliki Koukoulioti, "The European Commission's Proposal on Corporate Taxation and Significant Digital Presence: A Preliminary Assessment" (2018) 58:9 Eur Tax 391 at 391.

[20] OECD, "Action Plan on Base Erosion and Profit Shifting", online: *OECD ILibrary* <https://read.oecd-ilibrary.org/taxation/action-plan-on-base-erosion-and-profit-shifting_9789264202719-en> at 14.

[21] Daniel Blum, "Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined?" (2015) 69:6/7 Bull Int Tax 314 at 316.

[22] OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD, 2018) at 172.

[23] OECD, "Public Consultation Document: Addressing the Tax Challenges of the Digitalization of the Economy", (2019), online: *OECD ILibrary* <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf>.

the Digitalization of the Economy".[24] Both documents provided further analysis on the proposals for taxing the digital economy, specifically a revision of the nexus and profit allocation rules for source taxation.

The OECD is not the only body that proposed rules for tackling challenges posed by digitalization to the traditional system of taxation. The European Commission (EC) also considered these issues and its implications for members of the European Union (EU). In 2018, the EC released two proposals that seek to address the challenges posed by the digital economy – the first being proposals for source corporate taxation based on a "significant digital presence" nexus, and the other a proposal for a common system of digital service tax.[25] The first proposal was designed to confront the digital economy within the confines of the tax treaties, while the second was designed as an interim unilateral domestic measure pending when global consensus is reached on the issues.[26] However, the EC's efforts failed because member states failed to reach unanimous agreement on the proposals.[27]

The objective of this paper is to review and assess the efforts that have been made so far by the OECD within the scope of the BEPS, the EC's efforts as well as unilateral measures adopted by some countries for the purpose of ensuring equitable taxation of the digital economy. The paper will set out in a big picture perspective the complexities of the digital economy, the issues that it raises for existing PE rules, how these issues have been considered in international debates, and possible postulations regarding what the future could hold for international tax law in this area.

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[24] OECD, "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy", (2019), online: *OECD ILibrary* <https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm>.

[25] Pertuzzi & Koukoulioti, *supra* note 19 at 391.

[26] Marie Lamensch, "Digital Services Tax: A Critical Analysis and Comparison with the VAT System" (2019) 59:6 Eur Tax at 1–2.

[27] Lomas Ullrika, "EU Drops Digital Tax Plans", (2019), online: *Tax-News* <https://www.tax-news.com/news/EU_Drops_Digital_Tax_Plans____97044.html>.

2 THE PE AS AN APPARATUS FOR ALLOCATION OF INTERNATIONAL TAXING RIGHTS

2.1 Evolution of the PE

A good starting point for this paper is to clearly set out the principle that underlies the current PE concept. As stated earlier, the PE concept is a recognized apparatus under international tax law for allocating taxing rights among residence and source jurisdictions. However, the PE concept did not emanate first in international law.[28] Historically, the concept was first used in the 19th century in the Industrial Code of Prussia, Germany to denote a place of business activity for German business law purposes.[29] The concept which was originally known as "*Bestriebsstatte*" evolved to become a tax principle for preventing double taxation among Prussia's municipalities in the middle of the 19th century.[30] For a "place of business" to give rise to source taxation by a municipality, it must be a fixed location in that municipality, and "it had to be possible to recognize the enterprise's intentions to go on performing the business activity at this place".[31]

In the late 19th century and early 20th century, international trade increased, and this gave rise to increased inter-state double taxation.[32] The intrastate and municipal anti double tax statutes proved insufficient to address this challenge, giving rise to the coming into force of inter-state double tax treaties. The first of this kind was the Convention between the Governments of Austria-Hungary and Prussia in 1899.[33] The Austria-Hungary and Prussia inter-state tax convention retained the twin elements applicable to the *Bestriebsstatte* to wit: fixed location and a visible intention to carry on business.[34]

The PE concept did not gain worldwide prominence until after the First World War when the League of Nations set up a committee of experts to undertake a study of the theoretical

[28] Skaar, *supra* note 8 at 72.
[29] *Ibid*.
[30] *Ibid* at 73.
[31] *Ibid*.
[32] *Ibid* at 75.
[33] *Ibid*.
[34] *Ibid*.

principles for allocating taxing rights.[35] This was necessitated by the need to reduce double taxation which had at the time increased as a result of the revenue needs of countries following the world war.[36] The committee of experts presented a report expressing the view that economic allegiance principle should be the basis for allocating taxing rights.[37] The committee identified four elements of the economic allegiance principle: (i) the origin of wealth, (ii) the location of wealth, (iii) the place of right to enforcement, and (iv) the residence or place of consumption.[38] The committee selected residence or place of consumption and origin or source of wealth as the most policy compelling bases for international taxation under the economic allegiance principle.[39] The committee however recommended that the country of residence should have exclusive jurisdiction because it was a more practical option. According to the committee "a state cannot successfully tax a foreigner, only shut him out".[40]

However, further review undertaken by the League of Nations revealed that source taxation was already supported in existing bilateral tax treaties, and "as far as income from commercial or industrial activities was concerned, source-state taxation was accepted if the enterprise had a branch, an agency, an establishment, a stable commercial or industrial organization, or a permanent representative".[41] This was the turning point for reliance on the PE concept in tax treaties as a basis for source taxation; a principle that have survived several amendments and have been retained in different revisions of double tax treaties[42], including the OECD Model Tax Convention ("OECD MTC") first developed in 1963.[43] This was effected without prejudice to the primary preference for residence-based taxation.

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[35] *Ibid* at 79.
[36] Michael Kobetsky, *International taxation of permanent establishments: principles and policy*, Cambridge tax law series (Cambridge, UK ; New York: Cambridge University Press, 2011) at 111.
[37] Benjamin Hoffart, "Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through an Access to Markets Proxy Approach" (2007) 6:1 Northwest J Technol Intellect Prop 18.
[38] Kobetsky, *supra* note 36 at 112.
[39] *Ibid*.
[40] Skaar, *supra* note 8 at 80.
[41] *Ibid* at 82.
[42] *Ibid* at 82–95.
[43] Kobetsky, *supra* note 36 at 150.

According to Reimer, Schmid and Orell, the PE concept was introduced in tax treaties to achieve three main objectives.[44] First, to ensure tax fairness and justice to the source states in recognition of its efforts to create and maintain good economic condition and environment for the foreign enterprise's business.[45] Second, the PE concept is also intended to place the business of the foreign enterprise on the same standard and thereby maintain neutrality between them.[46] The PE concept together with the exemption method in Article 23A(I) OECD MTC ensures capital import neutrality.[47] Third, is the practical justification that the PE concept restrains unconditional source based taxation which would have had the negative effect of impeding international exchange and trade.[48]

2.2 **The basic PE definition**

Currently, the PE concept as found in the OECD MTC 2017 plays the same role and is substantially of the same character as that originally designed by the League of Nations.[49] Under the current OECD MTC, the basic rule is that an enterprise is liable to pay income tax in the country where it is resident.[50] An enterprise would not be liable to pay tax on profits made from a source country unless it has a PE; a "real and significant or substantial economic nexus with the country in which the profits arise".[51] Even when this is the case, the profit of the foreign enterprise that would be subject to tax is the profit that is attributable to a PE in the source state.[52] This principle which can be found in Article 7(1) OECD MTC, represents a codification of the historical preference for residence-based

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[44] Ekkehart Reimer et al, eds, *Permanent establishments: a domestic taxation, bilateral tax treaty and OECD perspective*, third edition ed (Alphen aan den Rijn, The Netherlands: Kluwer Law International, 2014) at 11.
[45] *Ibid*.
[46] *Ibid* at 12.
[47] *Ibid*.
[48] *Ibid* at 12–13.
[49] Kobetsky, *supra* note 36 at 150. "Model Tax Convention on Income and on Capital: Condensed Version 2017 | READ online", online: *OECD ILibrary* <https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en>.
[50] Holmes, *supra* note 4 at 151–152.
[51] *Ibid* at 152.
[52] Reimer et al, *supra* note 44 at 137.

taxation. The PE definition is important to allocation of business profit[53], for capital gains from moveable assets attributed to a PE[54] and for source taxation of dividends, interest, royalties and other income[55] which guarantees taxation in the PE state if the underlying value of the mentioned types of income can be allocated to the PE.[56]

Article 5 OECD MTC laid down the principle for determining what qualifies as PE. The Article defines a PE as "a fixed place of business through which the business of an enterprise is wholly or partly carried on". The PE definition has the following elements: (i) a Place, (ii) fixation or permanence, (iii) business activity, and (iv) integration.

The place of business element requires that a PE must be a physical tangible place.[57] This element has been referred to in literature as the cornerstone of the PE concept.[58] The requirement for a fixed place serves not only as the basis for the distributive rules in Article 7, but also for other distributive rules in the OECD MTC.[59] The place of business need not be a building; it can be any substantial physical object that can sustain a business activity in a commercial manner.[60] Fixation requires that the place of business is linked to a specific geographic point in the source state.[61] However, in the case of business activities located in different places in the source jurisdiction that by their nature require movement from location to location, the requirement for fixation is satisfied if the business has geographical and commercial coherence.[62] Intangible properties cannot qualify as a PE under the extant laws; they can only form a part of a constituted PE.[63]

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[53] Article 7, OECD MTC
[54] Article 13, OECD MTC
[55] Article 10(4), 11(4), 12(13) and 21(2) OECD MTC
[56] Andreas Waltrich, *Cross-border taxation of permanent establishments: an international comparison*, Series on International taxation volume 59 (Alphen aan den Rijn: Kluwer Law International, 2016) at 13.
[57] Ekkehart Reimer, Alexander Rust & Klaus Vogel, eds, *Klaus Vogel on double taxation conventions*, fourth edition ed (Alphen aan den Rijn, The Netherlands: Kluwer Law International, 2015) at 337.
[58] *Ibid* at 336.
[59] Jean Schaffner, *How fixed is a permanent establishment?*, Series on international taxation v. 42 (Alphen aan den Rijn, The Netherlands : Frederick, MD: Kluwer Law International ; Sold and distributed in North, Central and South American by Aspen Publishers, 2013) at 123.
[60] Reimer, Rust, & Vogel, *supra* note 57 at 337.
[61] Waltrich, *supra* note 56 at 15.
[62] *Ibid*.
[63] Reimer, Rust, & Vogel, *supra* note 57 at 337.

Although the basic definition of a PE requires meeting the conditions of geographical fixation, there are some provisions in the OECD MTC that deem a PE to exist even in the absence of a fixed place of business. These exceptions are found in Article 5(3) of the OECD MTC which provides for construction sites PE, and Article 5(5) of the OECD MTC which provides for the dependent agent PE. The reason behind both exceptions is to prevent businesses from avoiding tax by artificially carrying out business in a source state without having a fixed place of business.[64] With respect to Article 5(5), a PE is created where a person who is not an independent agent acts on behalf of the foreign enterprise and has the enterprise's authority to conclude contracts in its name, and exercises this authority habitually. Article 5(3) MTC provides that a building or construction or installation project would constitute a PE if and only if it lasts longer than twelve months.

In addition to being fixed and tangible, a PE must have some degree of permanence.[65] According to Commentary No.5 of the OECD Commentary on Article 5, the requirement for fixation signifies a link to a specific and distinct geographical point.[66] The requirement for fixation does not mean forever; rather it is best understood as "not temporary".[67] This accord with the third policy objective of a PE as identified by Reimer, Schmid and Orell. In essence, permanence ensures that source taxation is not unconditional or unlimited.

Another important element is that the foreign enterprise must carry on business through the PE before it would trigger source taxation. The element serves to distinguish between passive income that are taxed at source and active income.[68] Consequently, a business is defined as every active income generating activity.[69] Notwithstanding, passive activities may qualify as business if they are a component of active business activity.[70]

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[64] Holmes, *supra* note 4 at 61.
[65] *Ibid* at 153.
[66] Reimer, Rust, & Vogel, *supra* note 57 at 345.
[67] Holmes, *supra* note 4 at 153.
[68] Reimer et al, *supra* note 44 at 37–38.
[69] Reimer, Rust, & Vogel, *supra* note 57 at 340.
[70] Schaffner, *supra* note 59 at 137.

The last basic requirement is that the PE must be at the disposal of the foreign enterprise or its staff.[71] Disposal refers to the ability of the foreign enterprise to control and use the place of business at will for the purpose of carrying on the business.[72] Control required could be legal or factual control.[73]

Article 5(2) of the OECD MTC sets out a non-exhaustive list of what would suffice as a PE and they are: (a) a place of management, (b) a branch, (c) an office, (d) a factory, (e) a workshop, and (f) a mine, an oil or gas well. However, to qualify as a PE, these examples necessarily have to meet the conditions expressed above.

Article 5(4) of the OECD definition of PE contains a negative list of what would not qualify as a PE. These include facilities used for storage, display, maintenance of goods belonging to a resident, *etc*. The items in the list are commonly denominated by their preparatory or auxiliary nature.[74] The policy objective behind this is to ensure that source jurisdiction is activated only when the foreign enterprise has a sufficient economic presence in the source state.[75]

2.2.1 The Server PE

The OECD introduced the Server PE in its commentary to Article 5 OECD MTC, following the principles adopted in the Ottawa Taxation Framework.[76] The commentary largely maintained the physical nature of the PE concept and requires the existence of most of the elements described above. This is consistent with the objective of the OECD at the time to ensure that e-commerce is taxed within the traditional framework. In OECD's view, a website in itself does not constitute a PE.[77] However, a server on which the website is

[71] Reimer, Rust, & Vogel, *supra* note 57 at 352.
[72] Waltrich, *supra* note 56 at 16.
[73] *Ibid*.
[74] Holmes, *supra* note 4 at 158.
[75] *Ibid* at 159.
[76] Cockfield et al, *supra* note 9 at 117.
[77] *Ibid*.

hosted would constitute a PE if (i) it is a tangible property and (ii) if it has a geographical location, (iii) and some degree of permanence.[78]

Assuming that a server constitutes a PE, the next determination is whether the server is at the disposal of the foreign enterprise.[79] The test is same with the traditional establishments only that in this case, the presence of personnel is not relevant. [80] Finally, to fully trigger source tax jurisdiction, the foreign enterprise must carry on its business through the server.[81]

It is important to note that even when a server apparently constitutes a PE, it would have to be determined whether the activities for which the PE is used is auxiliary or preparatory in line with Article 5(4) OECD MTC.[82] If this is the case, then a PE would be deemed not to exist.

2.3 **Allocation of profit to the PE**

Under current source tax principles, after the PE threshold issues are determined, and a foreign enterprise is found to have a PE in the source state, the next consideration is to determine the quantum of profit that could be attributable to the PE. This is the case because, as noted above, Article 7(1) of the OECD MTC preserves the historical supremacy of residence-based taxation, and source taxing jurisdiction is limited to the profits attributable to the PE.[83]

Article 7(2) OECD MTC provides the details for determining a PE's profit for the purpose of complying with the principle in Article 7(1) OECD MTC. Article 7(2) relies on the fiction that the PE is separate and independent from the foreign enterprise that carries on business through the PE, and applies the arms-length principle to determine the PE's profit

[78] *Ibid*; Holmes, *supra* note 4 at 168.
[79] Holmes, *supra* note 4 at 168.
[80] *Ibid* at 169; Cockfield et al, *supra* note 9 at 119.
[81] Cockfield et al, *supra* note 9 at 117.
[82] *Ibid* at 118.
[83] Reimer, Rust, & Vogel, *supra* note 57 at 479–480.

in transactions between the PE and the foreign parent enterprise, associated enterprises and third parties.[84] The Article provides that the PE's profit is the profit which it would have been expected to make if it was a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed.[85]

The current provision of the old Article 7(2) OECD MTC is based on the Authorized OECD Approach (AOA). The AOA is a creation of a 2008 report by the OECD which pescribes the method for applying the arms-length principle in Article 7(2) OECD MTC.[86] The AOA retained the already existing arms-length principle, but proceeded further to treat the PE as a "functional" separate entity capable of owning assets and assuming risks, in line with the transfer pricing principles in the OECD's Transfer Pricing Guideline.[87] The functional separate entity approach introduced by the AOA involves a two-step analysis – a factual and functional analysis, and arms-length valuation of internal dealings.[88]

First, under a factual and functional analysis, profit is allocated to the PE based on the risks it bears which is a product of the functions performed by the PE and assets attributed to those functions.[89] This first stage reinforces the basic requirement that the PE must indeed engage in an active business involving significant people's function. The second stage of analysis requires that internal dealings between the PE and the foreign enterprise, including associated enterprises are priced at an arms-length applying the OECD Transfer Pricing Guideline.[90]

In determining the PE's profit under Article 7(2), whether in respect of dealings with the foreign enterprise, with other permanent establishments or with associated enterprises,

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[84] Kobetsky, *supra* note 36 at 361.
[85] Reimer, Rust, & Vogel, *supra* note 57 at 480.
[86] Uslu, *supra* note 6 at 4.
[87] Waltrich, *supra* note 56 at 37.
[88] *Ibid* at 36–37.
[89] *Ibid*.
[90] *Ibid* at 37.

arm's-length deductions are allowed to the PE for the purpose of determining its profits.[91] The quantum of deductions is a matter of domestic law. However, the OECD commentary to Article 24 requires amongst other things that expenses be allowed deductions in the same manner as the source jurisdiction allows its residents.[92]

3 DISRUPTION OF THE TRADITIONAL PE RULE BY DIGITALIZATION

3.1 Introductory comments

The previous section of this paper clearly indicates that the PE concept is largely a concept that is designed for a physical and tangible economy.[93] The PE threshold requires a physical or tangible place, and in addition, the place must be used by the enterprise to "*carry on business*". There is also no gainsaying that the service PE aimed at bringing e-commerce within source jurisdiction was not particularly successful because of its physical character requirement. Similarly, the profit allocation principles in Article 7(2) OECD MTC, especially as expressed in the AOA complements the physical nature of the PE by hypothesizing the PE as a separate entity and requiring a factual and functional analysis before profit could be attributed to the PE. As would be seen in the next section of this paper, the obvious feature of digitalization is its reliance on intangible assets and minimization of human input. The immediate implication of this is that digitalized businesses can circumvent the PE threshold to minimize or completely remove their taxable presence and consequently diminish the tax base of source jurisdictions.[94] As noted by Sarfo: "the business world is now dominated by digital companies earning revenue in jurisdictions where they do not have a physical presence, at times making it unclear where the revenue-generating activity is taking place".[95]

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[91] Reimer, Rust, & Vogel, *supra* note 57 at 484–485.
[92] *Ibid* at 485.
[93] Nana Sarfo, "Finding Middle Ground over Unilateral Digital Taxation" (2018) 72:4a Bull Int Tax 1 at 1.
[94] Uslu, *supra* note 6 at 4.
[95] Sarfo, *supra* note 93 at 1.

To properly appreciate the inadequacies of the current PE concept to the digitalized economy, it is relevant to review in some details the nature of digitalized business models. This paper will achieve this in the succeeding paragraphs by reviewing in details the key features of highly digitalized businesses, and the types of digitalized business models identified in Action 1 of the OECD's BEPS project.

3.2 **Key features of digitalized businesses**

Action 1 of the OECD BEPS report 2015 identified the predominant features of digitalized business models that pose challenges to the existing international source rules, which in turn increases BEPS risks.[96] The non-exhaustive list of key features include: (a) mobility, (b) reliance on data, (c) network effects (which is understood with reference to user participation), (d) use of multi-sided business models, (e) tendency toward monopoly or oligopoly, and (f) volatility due to low barriers to entry and rapidly evolving technology.[97] In the subsequent report of 2018, the OECD collapsed the features of these businesses further into three, namely: (a) cross-jurisdictional scale without mass, (b) reliance upon intangible assets and (c) data and user participation. The OECD's views of these features as expressed in the later report are summarised in the succeeding paragraphs.

Cross-jurisdictional scale without mass refers to the ability of digitalized business models to leverage on technology to permeate jurisdictions without an actual physical presence.[98] The OECD noted that whilst this is not a function of globalization, the trend has become much more prevalent due to digitalization.[99] This implies that although traditional businesses can effectively operate in a jurisdiction without a substantial physical presence, the highly digitalized businesses are better equipped and have more tendency to operate without mass.

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[96] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD, 2015) at 64.
[97] *Ibid* at 65.
[98] OECD, *supra* note 22 at 51.
[99] *Ibid* at 2018.

With respect to the second feature, the OECD's empirical research showed that intangible assets often feature in the business models of digitalized businesses and constitute an important value driver for these business models. The challenge posed by intangibles to the existing international tax rules was clearly articulated in the OECD BEPS report 2015. As noted in that report, the challenge posed by intangibles to existing nexus for source taxation is that under extant rules, ownership of intangibles can be transferred and assigned among associated enterprises in a manner that an enterprise can legally own an intangible to the exclusion of the enterprise that actually developed the intangible asset.[100]

The third feature identified in the OECD 2018 report – data and user participation is the most controversial and debated of all features.[101] The OECD is of the view that data has allowed digitalized businesses to improve their products and services, leading to productivity and growth.[102] In particular, "data analysis has often allowed firms to extract more of the consumers' surplus through pricing and, therefore, increase their potential profitability".[103] The OECD also identified three prevalent methods by which data is monetized by highly digitalized businesses. First method is by leveraging on customer preferences identified through data collection and analysis to sell targeted online advertisement to customers. The second is using consumer data to improve on consumer products and marketing activities. Finally, "data collection and the subsequent accumulation of big datasets has also supported significant increases in firm value on the basis of the expected gains from data exploitation".[104] The important point of this feature in comparison to other traditional business models is that whilst traditional business models utilize data in improving their products, the digitalized businesses are able to gain increased economies of scale. Put differently, the digitalized businesses are able to collect and

[100] OECD, *supra* note 96 at 65.
[101] Aleksandra Bal, "(Mis)guided by the Value Creation Principle – Can New Concepts Solve Old Problems?" (2018) 72:11 Bull Int Tax; Barry Larking, "A Review of Comments on the Tax Challenges of the Digital Economy" (2018) 72:4 Bull Int Tax; Yariv Brauner & Pasquale Pistone, "Some Comments on the Attribution of Profits to the Digital Permanent Establishment" 72:4 Bull Int Tax; Pertuzzi & Koukoulioti, *supra* note 19.
[102] OECD, *supra* note 22 at 53.
[103] *Ibid*.
[104] *Ibid*.

analyze a larger and more varied set of data than the traditional businesses at a faster pace.[105]

The OECD highlighted the stages that data go through in the value creation process of digitalized businesses as follows: (i) data origination which involves generation of digital data from online activities, (ii) data collection which involves collection and storage of data, (iii) data analytics which involves the processing and interpretation of data collected in order to generate economic value, (iv) knowledge base which involves accumulation of information from data processed, which then becomes the basis for economic value generated in the process, and (v) business decision making based on the knowledge obtained from the processed data.[106]

The OECD's view on the relevance of data is also shared by many academic writers and stakeholders. Bal noted that: "data has become a key economic driver around the globe. It is frequently said that data is the new gold or the lifeblood of the digital economy. As companies face unprecedented demands from consumers and constant needs for product innovation, they are looking to their data to power strategic decision-making that can solve challenges".[107] However, there is no consensus on which of the processes identified in OECD's value chain creates significant value for a corporation which would give rise to source taxation. Larking noted that "a commonly expressed view is that raw data has no value – it is its analysis and processing that generates value".[108] Similarly, Bal argued that user data ought to be considered simply as raw materials which has no value unless processed with technology or algorithms developed by digitalized businesses. The author submitted that "without skilled people, data is of no value".[109] Brauner and Pistone had a different opinion when they argued that "the processing activity per se does not generate much value, because it only gathers and reclassifies data using apposite servers and statistical software, the final output being information that was already present, although

[105] *Ibid*.
[106] *Ibid* at 54.
[107] Bal, *supra* note 101 at 3.
[108] Larking, *supra* note 101 at 4.
[109] Bal, *supra* note 101 at 3.

not clearly identifiable, in the data forwarded".[110] Petruzzi and Koukoulioti supported the view that user data play a significant role as a value driver in digitalized business models, but observed that the role of user data and extent of their contribution to value creation is not clear or easily quantifiable.[111] According to the scholars:

> "The indisputable role of user data and participation, as value drives for digital businesses, as well as the manner and degree of their contribution to creation of value, do not appear to be clear or easily quantifiable. This difficulty derives from both the diversity of highly digitalized business models, which consequently permit the involvement of users in the value creation process by various means, as well as from the interaction each user opts to have with a particular digital product".[112]

In the same manner as data, the OECD identified user participation as a dominant feature of highly digitalized businesses.[113] The OECD noted that obtaining and analyzing internal data is not new as it had been the practice in the traditional economy. However, this practiced has changed following digitalization, because "users now play an increasingly significant role; their data being analysed by businesses to gain insights about markets and demand trends".[114] The distinction made by the OECD between data analysis in the traditional economy and what is applicable in the digitalized economy is that while the former relies on internally generated data, the latter relies on external user data with the user supplying the data either actively or passively.[115] Bal however disagrees with this analysis. In his view, user data had always contributed to traditional businesses models. For Bal, the only difference is that in the traditional business models, user data is limited

[110] Brauner & Pistone, *supra* note 101 at 2.
[111] Pertuzzi & Koukoulioti, *supra* note 19 at 392.
[112] *Ibid*.
[113] OECD, *supra* note 22 at 54.
[114] *Ibid*.
[115] *Ibid* at 55.

and captured in the jurisdiction where the users reside, while the latter is global in scale relying on user participation from multiple countries.[116]

Whilst users contribute data actively by voluntarily submitting data through activities like bookmarking pages and posting contents, user data may also be collected without any direct involvement of the user for example through cookies or location trackers.[117] Broadly speaking, user data is valuable to digitalized businesses as it enables them to create customize and improve their products and services to ensure personalized experience for its users.[118] In addition, the OECD noted that user-generated content creates value for businesses through traffic, product trust building (through reviews and ratings), advertisement, and in some instances, they represent the core business of the digitalized corporation.[119]

There is agreement amongst scholars that user data is crucial in the value creation process of digitalized businesses.[120] The OECD and some commentators hold the view that the role of user data in the value creation process would vary depending on the nature of the business model.[121] The area of divergence among most scholars is to what degree user data is relevant in the value creation process, whether the value so contributed should be taxable as business profit and if so, how the data can be captured for the purpose of effecting source taxation. Bal noted that not all users contribute to value creation and that the number of users should not be measured to the number of accounts. According to Bal, the extent of user participation in the platform created by digitalized businesses should be accounted for in the value creation process.[122] Bal also raised the challenges that touch on how to determine a user's location for income tax purposes, and how relief can be granted to digitalized corporations for losses caused by negative user contents.[123] Pertuzzi &

[116] Bal, *supra* note 101 at 3.
[117] OECD, *supra* note 22 at 55–56.
[118] *Ibid* at 53.
[119] *Ibid* at 56.
[120] Pertuzzi & Koukoulioti, *supra* note 19 at 391–392; Bal, *supra* note 101 at 3.
[121] Pertuzzi & Koukoulioti, *supra* note 19 at 392; OECD, *supra* note 22 at 57.
[122] Bal, *supra* note 101 at 4.
[123] *Ibid*.

Koukoulioti commented on the difficulty in measuring the value of user data that contributes to creating value for digitalized businesses and noted that each business model would have to be evaluated independently.[124] The OECD's 2018 interim report recognized that there is no consensus among countries on the precise role of user data and participation in the value cycle of digitalized businesses.[125] According to the OECD, there are two broad views in this regard. The first view is that user data and participation is a key driver of value creation for digitalized businesses because it enables the businesses to sell targeted advertising, increases the value of businesses' platform, and builds brand trust, reputation and growth.[126] The second does not agree that the "value" created by users should be activity which gives rise to taxable profit for digitalized corporations. This view holds that since users mostly use the platforms of digitalized businesses without charge, the transaction between the users and the businesses is in the nature of trade by barter, a type of transaction that is rarely captured by most income tax systems.[127] As at date there is no general consensus on the actual role of user data in the business model of highly digitalized businesses.

3.3 **Types of digitalized businesses**

In the OECD report 2015, the OECD identified four different kinds of digitalized business models all characterized by their ability to scale, rely on intangibles and commercialize user data. These business models are considered briefly below.

3.3.1 Multi-sided social networks

Multi-sided social networks are digital platforms such as Facebook, Twitter and LinkedIn that provide an avenue for some interaction amongst users. As noted by the OECD, multi-sided social network platforms have two objectives - first to provide a digital space for

[124] Pertuzzi & Koukoulioti, *supra* note 19 at 393.
[125] OECD, *supra* note 22 at 59.
[126] *Ibid* at 58.
[127] *Ibid* at 59.

users to interact, connect and share information usually without charge.[128] Secondly, multi-sided social networks enable customers to use their platform in advertising their products, sometimes taking advantage of data contributed by other users. Although different, the two objectives highlighted by the OECD are complementary in the sense that data of users of the platform provide market research resources for advertising customers.[129]

The equivalent of multi-sided social networks in the traditional economy are advertising media such as the television or radio commercials.[130] Just like the social networks, traditional advertising media "aim to foster a community of users".[131] However there are a number of differences, the most relevant for the purpose of this paper being the ability of digitalized businesses to scale without barriers and operate in multiple jurisdictions without a physical presence.[132]

3.3.2 Reseller of goods

This category of businesses engage in the traditional sale of goods to final consumer, but in this case, sale is facilitated through a digital platform. In this model, the digital platform which could be in the form of a website or an app is used to either circumvent having a physical location, or in addition to having a physical location.[133] Amazon is a good example of this business model.

The difference between a digital reseller and the traditional reseller lies mainly in the impact of technology in the business models of digitalized corporations. For instance, resellers have the ability to collect consumer data when they interact with their digital platform either actively or passively. The data collected is subsequently utilized in improving products, directing marketing activities to specific customers and engaging in

[128] *Ibid* at 44.
[129] *Ibid* at 45.
[130] *Ibid.*
[131] *Ibid* at 48.
[132] *Ibid* at 50.
[133] *Ibid* at 61.

product pricing and differential pricing.[134] This can be distinguished from the blanket marketing strategy employed by traditional resellers which are usually targeted at a more general consumer base.[135] This difference calls into question the role of user data in the value chain of digitalized businesses and its consequence for allocating taxing right.

Similarly, whereas a traditional reseller is constrained by geographical location to a limited market at a time, the digitalized reseller using technological platforms can directly reach and cater for the needs of a global supplier and customer base.[136] This is consistent with the "scale without mass" feature of digitalized businesses, a feature that has rendered the physical PE threshold inefficient.

3.3.3 Ride-for-hire

A ride-for-hire business model is a type of digitalized business that "creates value by matching drivers and passengers so that they can complete a ride on a pay-as-you-go basis".[137] This is achieved through digital platforms (usually an app) through which passengers can book a ride with drivers registered with the ride-for-hire company.[138] The ride-for-hire companies do not own vehicles (drivers own their own vehicles) but earn commission from revenue earned by drivers from rides.[139]

The closet comparable business with the ride-for-hire is the traditional taxi business. Whilst there are some similarities in the two business models, the OECD pointed out some very significant differences. First, the presence of a digital platform in the business model of digitalized businesses (in this case, an app) provides an opportunity for these businesses to gather profiles of both drivers and passengers. The profiles of drivers are subjected to rating by passengers (and vice versa) after each ride.[140] The ratings provide quality

[134] *Ibid* at 62.
[135] *Ibid* at 65.
[136] *Ibid* at 63.
[137] *Ibid* at 66.
[138] *Ibid* at 67.
[139] *Ibid.*
[140] *Ibid* at 70.

assurance that adds significant value to ride-for-hire company's in the sense that while traditional taxi riders can pick up passengers based on demand and supply, in addition to demand and supply, only drivers with positive rating can operate in the platform provided by the ride or share company.[141]

Second, technology provides ride-for-hire businesses with far greater scale than their traditional taxi contemporaries.[142] This is so because the ride-or-hire corporation only need its app and limited management operations or employee workforce to operate. The OECD put this feature succinctly as follows: "Ride-for-hire companies are able to build consumer bases through the transmission of data without the presence of employees or management in non-headquarter jurisdictions".[143] In contrast, traditional taxi riders need full managerial and logistic operation within each jurisdiction which reduces their ability to scale.

3.3.4 Cloud computing

The OECD recognized that unlike most digitalized businesses cloud computing has no equivalent or comparable business in the traditional economy.[144] Cloud computing businesses provide value to only digitalized businesses and this it does by enabling these businesses host their operations on its cloud-based servers.[145] As noted by Rossi: "cloud services are virtual, flexible, accessible from anywhere by one or multiple users and chargeable or rendered for free".[146] Cloud computing companies provide services such as provision of virtual servers, storage services, data warehousing and management, *etc*. As noted earlier, cloud computing business is the only novel digitalized business model considered by the OECD.

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[141] *Ibid*.
[142] *Ibid*.
[143] *Ibid*.
[144] *Ibid* at 76.
[145] *Ibid* at 73.
[146] Maria Cecilia Rossi, "Is Cloud Computing a Challenge to the Traditional Concept of a Permanent Establishment?" (2013) SSRN Electron J, online: <http://www.ssrn.com/abstract=2685649> at 7.

3.4 Concluding comments

It has been demonstrated so far that the digitalized businesses are substantially different from the traditional businesses and thus much more advanced. While the current PE rule possesses a predominantly physical character, the above features and examples of digitalized businesses evinces the intangible and multi-jurisdictional nature of digitalized businesses. The key feature and examples of digitalized businesses discussed above also highlights the new role of user data in the value cycle of digitalized businesses, and the relative ease with which business profits in the market jurisdiction can be reduced or completely extinguished for lack of sufficient physical nexus. In the next section, this paper reviews the options proposed for bringing digitalized businesses within the tax net of market jurisdiction and debates surrounding those proposals.

4 CURRENT PROPOSALS TO THE DEAL WITH THE CHALLENGES OF THE DIGITALIZED ECONOMY

4.1 Introductory comments

Broadly speaking, there are two category of options that have been explored for taxing the digitalized economy. The first category consists of efforts made to adapt existing treaty principles in order to substantially cover the peculiar features of the digitalized economy. These consist of Action 1 of the OECD BEPS project and the EU's proposal for a digital PE. The second category is the EU's proposal for digital service tax and unilateral digital taxes imposed by some EU and non-EU states to tax the digital economy outside the treaty. These proposals are discussed in detail in this section.

4.1.1 Proposals in Action 1 of the OECD BEPS project

The OECD's BEPS project is the most robust work currently being undertaken for the purpose of finding solutions to the challenges of the digital economy. It is necessary to state at this point that the initial objective of Action 1 of OECD's BEPS project was not to redefine the rules for allocation of taxing rights. However, this project took a somewhat

broader direction because of the clamour for review of taxing rights predominantly from countries where a large number of customers to digitalized businesses are resident.[147]

While considering options for redefining the basis for allocation of taxing rights, the OECD holds the position that it would not introduce rules to "ring fence" the digitalized business models from the rest of the economy[148] as digital transformation has not changed the fundamental nature of core activities that businesses carry out to generate profits.[149] This is the indication that the OECD's aims to introduce proposals that would be consistent with existing principles. Accordingly, the proposals currently being developed by the OECD are intended to apply broadly, which naturally would be achieved through tax treaties. Whether this would be achieved and if so, to what extent, would become apparent from an analysis of the issues that have been raised so far regarding the options proposed by the OECD. However, before delving deeply into these options it is useful to review the OECD's overall objective of allocating taxing right based on value creation.

4.1.1.1 The concept of value creation

Actions 1 and 7 of the OECD BEPS projects embody the OECD's analysis of the significant issues regarding the inadequacy of the PE concept. Specifically, Action 1 focuses on addressing the tax challenges raised by the digital economy, while Action 7 focuses on preventing artificial avoidance of PE status through such tactics as using a dependent agent. Given that the focus of this work is on the impact of digitalization on the PE threshold, this paper will focus its analysis on Action1. In all of the BEPS Action plans, including Action 1, the OECD's overreaching objective is to align place where profit is to be taxed with place where value is created.[150] Whilst some commentators have argued that value creation have always been a dominant consideration in international tax policy[151], the concept only gained popularity following OECD's BEPS project.

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[147] João Bianco & Ramon Santos, "A Change of Paradigm in International Tax Law: Article 7 of Tax Treaties and the Need To Resolve the Source versus Residence Dichotomy" (2016) 70:3 Bull Int Tax at 3.
[148] OECD, *supra* note 96 at 54.
[149] OECD, *supra* note 22 at 167.
[150] Pertuzzi & Koukoulioti, *supra* note 19 at 392.
[151] Sapirie, *supra* note 11 at 1.

Although value creation features very dominantly in the current debate on taxation of the digital economy, the term was not defined by the OECD, and its precise meaning is another source of debate for many commentators.[152] According to Bal, "the ambiguity of this term is the reason for its enormous popularity: everyone agrees that taxation should be in line with value creation and everyone has their own view of what it means. In other words, we agree to disagree".[153] It is also uncertain if the concept of value creation is a new rule for allocating taxing rights or a derivate of the existing principles of international taxation. Interestingly, the OECD does not refer to the historical primacy of residence taxation and its relationship with taxation based on value creation. The OECD only noted that "the concept of value creation is currently not captured by existing tax framework".[154] However, the OECD's position is still very much debated. According to Sapirie: "nexus for direct taxation has historically been based primarily on where value is created", suggesting that the value creation principle is consistent with source and residence basis of taxation.[155] In a somewhat contrary view, Petruzzi and Koukoulioti noted that: "the concept of value creation seems to act as a *new* benchmark for allocation of taxing rights".[156] Christians held a similar view arguing strongly that allocation of taxing rights have never been based on value creation but a question of political agreement. According to Christians:

> "Of course, the international tax system has occupied itself for approximately a century in ascertaining which country ought to have a primary right to tax a given income item or stream. However, the goal of identifying this primary right has never really been about ascertaining where value is created. It has instead always been about creating a set of rules by which competing taxing authorities – each

[152] Marcel Olbert & Christoph Spengel, "International Taxation in the Digital Economy: Challenge Accepted?" (2017) 9:1 World Tax J 3 at 22.
[153] Bal, *supra* note 101 at 3.
[154] OECD, *supra* note 22 at 171.
[155] Sapirie, *supra* note 11.
[156] Pertuzzi & Koukoulioti, *supra* note 19 at 392.

> understood by all to be equally justified in imposing a tax on a given income item – would agree to give way to the other so as to prevent double taxation".[157]

One other problem that arises from taxation based on value creation is the imprecise scope of the term. The scope of value creation seems unlimited, as almost any location can be regarded as having contributed value in some way. According to Bal: "almost any location can be considered as having contributed to value creation in some way. For a country with strong customer base, value creation will take place in the market jurisdiction (destination principle) and such a country will advocate for principles that will allocate income based on the location of customers. A developing country with low-cost production factors will support value creation in line with production not consumption (origin principle)".[158] This view was also expressed by Morse who noted that:

> "The idea of "local market feature" illustrates the tension in the concept of value creation. This could include customer location (a feature of market countries, often developed countries) but could also mean location savings (often a feature of developing export countries). As another example, value creation allocates risk to parties who "exercise control" over the risk. It refuses to allocate risk based on financial capacity but does not fully specify what factors are relevant".[159]

Consequently, as it stands, there is no universal conclusion on whether or not value creation is a concept based on the origin principle (which is the extant principle in international tax jurisprudence for source taxation), or the destination principle. This raises significant

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[157] Allison Christians, "Taxing According to Value Creation" (2018) Tax Notes Int, online: <https://ssrn.com/abstract=3230370> at 3.
[158] Bal, *supra* note 101 at 3.
[159] Susan Morse, "Value Creation: A Standard in Search of a Process" (2018) 72:4/5 Bull Int Tax 196 at 196.

problem regarding how value creation can be conceptually harmonized with existing international tax rules in order not to ring-fence the digital economy.

Another view that has been expressed about the OECD's value creation objective is that value creation is a myth. This view was articulated in Christian's work. According to the scholar, allocation of taxing right is strictly a distributive exercise anchored on political will, and not based on any economic value. The scholar argued that taxation based on value creation proceeds from a false assumption that income is capable of fragmentation. According to Christians: "it is incontrovertibly wrong to think that a dollar of income that depends on a seamlessly symbiotic global economic order can somehow be re-fragmented and correctly assigned to one or another jurisdiction as a technical or economic matter".[160] The scholar also argued that the impossibility of fragmentation of income is manifest from the historical work of the economists who birthed the current principles for allocation of taxing rights. Christians argued that:

> "The economists posited that the tax base, as a product of economic activity ought to be divided not on the basis of taxpayer's political or social connections to a country, but by their economic interaction with and within it, which were to be identified by, inter alia, locating the origin (source) of various income streams. Yet in the very process of articulating this idea, the economists readily admitted in many cases – perhaps a majority of cases – the idea of origin would simply confound economic analysis. To the economists, it was all too clear that assigning origin would be scientifically impossible: many types of income would have several origins, and the whole would be fundamentally indivisible into parts. There are too many variables, and too much interdependence among them, to extract a precise

[160] Christians, *supra* note 157 at 3.

> origin for each portion of a dollar of income earned in a global economy. The economist therefore concluded that the division of the global income tax bases would be a question of political feasibility, and not science".[161]

There seem to be some merit in the Christian's argument. Indeed, the argument that income of a corporation is a whole and fragmentation is scientifically impossible is evident in the current debate about the true scope of value creation. It would be recalled that the Bal had argued that "almost any location can be considered as having contributed value in some way". Accordingly, allocation based on value creation would give rise to tracing income to multiple jurisdictions. Further, the debate regarding the role of data in the value cycle of digitalized corporations indicates the nature of issues that arise with "fragmentation of value". The question remains: how can value derived from a particular user in a particular jurisdiction be captured and delineated for tax purposes? It could be argued that the inability to determine the precise role of data and user participation in value creation may be a consequence of a false assumption that economic value of a corporation is capable of fragmentation. As would be disclosed in the course of this paper, the nexus and attribution rules proposed by the OECD attempted to address this uncertainty, but even this effort is not free from its own criticism.

Although the OECD has dedicated significant resources to defining how value is created in the value chain of digitalized businesses, there is a more fundamental question of what value creation actually means and how it could be viewed holistically alongside other concepts in international tax. The fact that the concept is susceptible to various interpretations makes it less reliable and it also would tend to generate disputes among countries. Morse suggested that the meaning of value creation would be shaped by interest based on the interested parties' incentive to favour their jurisdiction through either (i) participation and contributions to OECD work, (ii) unilateral definition of the term in domestic law, and (iii) treaty-based dispute resolutions.[162] This would inevitably generate

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[161] *Ibid* at 4.

[162] Morse, *supra* note 159 at 199–201.

conflicts not just on the definition of value creation but also on other distributive provisions in treaties. More so, it presents a potential risk for double taxation because countries can interpret the concept to impose corporate tax on non-resident digitalized corporations by holding on to the value creation mantra. Hey put this concern succinctly as follows:

> "Countries, which, given their contribution to value creation, adopt the position that they [do] not have the appropriate taxing rights invent new taxes. This has already happened in India and been discussed at an EU level. The main drivers of this are the discovery of the significance of the market as well as of consumer data as a new form of natural resource that can be exploited by data mining by way of monopolistic networks. In addition, if value creation results in investment shifting rather than profit shifting, this could motivate countries suffering from the effects of investment shifting to introduce new taxes. The resulting defensive measures of countries affected by such new taxes are a likely consequence, which also give rise to the risk of new double taxation".[163]

This concern is amplified by the fact that almost anything can pass as contributing to value creation. There is therefore no gainsaying that the concept of value creation needs to be reexamined as it would most likely undermine the OECD's efforts towards setting out treaty-consistent rules for taxing the digital economy.

Having reviewed the controversy surrounding taxation based on the concept of value creation, this paper will now review the options proposed by the OECD for taxation of the digitalized economy.

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[163] Johanna Hey, "Taxation Where Value is Created and the OECD/G20 Base Erosion and Profit Shifting Initiative" (2018) 72:4/5 Bull Int Tax at 3.

4.1.1.2 The OECD's digital nexus and profit allocation proposals

The OECD identified three main policy challenges posed by the peculiar features of digitalized businesses to direct taxation.[164] These challenges are: (i) nexus, (ii) data, and (iii) characterization.

Nexus refers to two main issues; the reduced or extinguished relevance of a physical connection as well as the increased impact of user participation in the business of digitalized corporations.[165]

As noted previously, the OECD recognizes that digitalization has increased "the flexibility of businesses to choose where substantial business activities take place, or to move existing functions to a new location, even if those locations may be removed both from the ultimate market jurisdiction and from the jurisdictions in which other related business functions may take place".[166] The issues of nexus raises specific concern about the PE threshold in Article 5 and the attribution rules in Article 7. In addition, the OECD recognized that the user data and participation adds value to digitalized businesses in a manner which differs significantly from the traditional economy, and noted the need to consider policy changes to reflect the role of user data and participation.[167] Data raises the question of whether normatively, user data should create a taxable presence in the jurisdiction where it was gathered and if so, how such data should be characterized and valued for tax purposes.[168] The OECD noted that "it may be challenging for the purpose of an analysis of functions, assets and risks, to assign an objective value to the raw data itself, as distinct from the processes used to collect, analyze and use that data".[169] The crux of this challenges lies on determining the economic value of data and the appropriate place where value is created for the purpose of imposing tax on income associated with that value.[170] Characterization refers to the difficult question of determining how to characterize payments made for

[164] OECD, *supra* note 96 at 99.
[165] *Ibid*.
[166] *Ibid* at 100.
[167] *Ibid* at 101–102.
[168] *Ibid* at 102.
[169] *Ibid* at 103.
[170] *Ibid* at 104.

certain digitalized corporations for tax purposes.[171] For example, the OECD highlighted the difficulty in determining if payments made to a cloud computing service is royalty, fees for technical services or business profits.[172]

With respect to nexus, the OECD held the view that the best solution is to create a new threshold for digitalized businesses.[173] Accordingly, the OECD identified three options that could be adopted to address the challenges of the digitalized economy. These options are: (a) a significant economic presence, (b) withholding tax, and (c) equalization levy.[174] These options will be addressed *seriatim*. As noted earlier, the OECD intends that these options would align taxation with value creation relying on user, data and technology as the underpinning economic value indicators.

4.1.1.2.1 Significant economic presence

The proposed significant economic presence nexus seeks to allocate taxing right to the user or market jurisdiction when a foreign enterprise has a significant economic presence on the basis of factors that indicate a sustained economic interaction with the jurisdiction through digital media.[175] The OECD proposed three factors, a combination[176] of which would be relevant in determining if a corporation has met the level of digital economic presence that justifies tax liability in the country where it maintains such presence to wit – (i) revenue factors, (ii) digital factors, and (iii) user-based factors.[177] A combination of these factors serve to demonstrate a nexus between the income generating activities of the non-resident business and its digital presence in the users' country.

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[171] *Ibid* at 105.
[172] *Ibid*.
[173] *Ibid* at 107.Peter Hongler & Pasquale Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy", (20 January 2015), online: <https://www.ibfd.org/sites/ibfd.org/files/content/pdf/Redefining_the_PE_concept-whitepaper.pdf> at 22–23.
[174] OECD, *supra* note 96 at 106–117.
[175] Blum, *supra* note 21 at 105.
[176] OECD, *supra* note 96 at 111.
[177] *Ibid* at 107–110.

The revenue-based factor refers to the level of revenue received by a digitalized business from the jurisdiction of its users at a given time. This factor is premised on the assumption that the value of users and user data is reflected in the revenue of the foreign digitalized corporation.[178] According to the OECD: "because user data serves to enhance the value of the services an enterprise offer, a strong user network (and the attendant user data) is likely to result in enterprises either selling more or enterprises charging more for its core products/services, or both".[179] The OECD considered that the scope of this factor should be broadly defined to cover revenue generated from transactions concluded by non-resident enterprise remotely with customers resident in the relevant jurisdiction.[180] In order to reduce administrative and compliance burden, the OECD recommended a fixed and significantly high revenue threshold. For the same purpose, the OECD also recommended that countries implement a mandatory registration system for highly digitalized businesses to avoid administrative cost of monitoring remote sale activities of this corporations.[181] However, the OECD did not recommend any mechanism for ensuring registration by digitalized corporations given that they are outside the territorial jurisdiction of the tax authorities of the market country.

The digital-based factor seeks to define the significant economic presence nexus by using automation as a test for digital presence. Thus, where a non-resident digitalized business engages with users in a jurisdiction through digital means, the digital means would give rise to sufficient digital presence.[182] The OECD's example of sufficient digital factors are: the existence of a local or specialized domain name on which the local site targeted at the in-country customers would be hosted, the existence of a digital platform such as websites or other digital platforms through which goods, services or an interactive platform are offered to in-country customers, or the existence of local payment options for receiving payments from in-country customers.[183]

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[178] *Ibid* at 107.
[179] *Ibid.*
[180] *Ibid* at 108.
[181] *Ibid.*
[182] *Ibid* at 109.
[183] *Ibid.*

The final factor that could be relevant in determining a significant economic presence is the degree of relevance of users and user data in the business of the non-resident.[184] The OECD recommended regular conclusion of contracts and volume of data collected by the non-resident business as digital factors that would be relevant in determining whether a significant economic presence exists or not.[185] In addition, the OECD proposed the option that the monthly active users on the digital platform that are "*habitually resident in a given country in a taxable year*" should be considered as reflecting the level of penetration in the economy of the jurisdiction. The phrase "*habitually resident*" was not explained further by the OECD. In the author's view, the phrase is ambiguous and can be interpreted absurdly in some cases. For instance, does it mean that a person who regularly enters and leaves a jurisdiction and during each stay qualifies as a part time resident can be included in computing monthly active users in a jurisdiction even when they are not at the relevant time resident in the jurisdiction? This is not very clear from the OECD's report. There is a need to further clarify the phrase in other to ensure that it is not misunderstood.

Dhuldhoya noted that there are some similarities between the significant economic presence threshold and the traditional PE. According to the commentator, the requirement for certain local elements including "local domain names, a local website, and user-based factors that take into account contracts with local customers" all indicate a significant connection with the market jurisdiction.[186] This makes this option the most consistent with the underlying principle that taxes should be based on sufficient interaction with the economy of a country.

Notwithstanding, the significant economic presence test has been criticized by commentators on different grounds. The first criticism worthy of note is the OECD's reliance on user data in the significant economic presence. It has been argued that reliance on raw data to establish a digital threshold does not align with value creation. This

[184] *Ibid* at 110.
[185] *Ibid*.
[186] Vishesh Dhuldhoya, "The Future of the Permanent Establishment Concept" (2018) 72:4a Bull Int Tax at 15.

argument is premised on the view that raw data has no value and that it is rather the algorithms and remote people functions that give rise to analysis and processing of the data that create value.[187] In this regard, Bal submitted that:

> "data is another input in business processes. It should be treated no differently than raw materials and inventories. Companies receive data sets, process them and feed them into these algorithms to generate insights about customer or competitor behavior. Without skilled people, data is of no value. To the author's best knowledge, there have not been any proposals focusing on taxing businesses inputs. It is generally recognized that inputs need to be converted into outputs, these outputs need to be marketed, sold and if these operations result in any profits, these profits should be subject to tax. The aim of corporate tax systems is to tax these profits. If the existing tax law has loopholes and prevents an effective taxation of company profits (for example, because the company is not resident in any jurisdiction or takes advantage of hybrid instruments), these loopholes should be addressed rather than shifting taxation to the input side"[188]

Another criticism of the digital threshold pertains to its enforceability. One challenge with the option is that the factors proposed by the OECD for determining the significant economic presence nexus, especially the revenue-based factor, did not consider the prevalent difficulty in determining the level of a corporations' digital presence. Bianco and Santos noted this very clearly when they argued that: "the procedure to measure the digital presence of a non-resident company, which could involve the number of customers, the market share or sales volume, raises important questions, not only because of the need to

[187] Larking, *supra* note 101 at 4.
[188] Bal, *supra* note 101 at 3.

establish an objective, reasonable and non-arbitrary criterion, but also due to the difficulty in monitoring and quantifying the degree of virtual presence".[189] Another critical point for the significant economic presence nexus relates to the possibility that some market jurisdictions may not have the ability to enforce necessary registration and reporting requirements which would enable these jurisdictions determine that sufficient digital nexus has been created. Hellerstein noted that although the OECD's digital PE has been presented to have a legal means of enforcement, there isn't much said about the practicability of these enforcement procedures. According to Hellerstein:

> "the problem with this suggestion, of course, is the enforceability of this standard from a practical standpoint, even though jurisdiction exists as a matter of law under a virtual PE standard. Indeed, these practical enforcement issues are ultimate arbiters of our ability to align substantive and enforcement jurisdiction when substantive jurisdiction is defined to include value associated with a digital presence.".[190]

Hellerstein concluded his analysis by arguing that the success or otherwise of the virtual PE would more likely depend on the political will to enforce the penalties for non-compliance.[191]

Another point of criticism that has been raised in literature is the OECD's approach of isolating the digital PE from other distributive rules in its review. According to Bianco & Santos, "the characterization of a PE in the source state may produce consequences in the application [of] article 6 (Immovable property), 10 (Dividends), 11 (Interest), 12 (Royalties), 13 (Capital gains), 15(Income from employment), 21 (Other income), 22(Capital) and 24 (Non-discrimination). In this context, Action 1 of the OECD BEPS

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[189] Bianco & Santos, *supra* note 147 at 9.
[190] Walter Hellerstein, "Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments" (2014) 68:6/7 Bull Int Tax at 348.
[191] *Ibid*.

initiative does not address how a merely virtual PE would interact with the other distributive rules in the OECD Model".[192] Given the absence of a clear understanding of how these rules interact at this stage, it is very likely that the digital PE concept would give rise to significant conflicts and inconsistencies in its application, which would eventually increase the chances of double taxation occurring.

Finally, in view of all that have been noted so far regarding the OECD's reliance on user data as value drivers, there is a tendency that digitalized corporations will meet the significant economic threshold in many jurisdictions leading to high cost of compliance, which cost may indirectly be passed on to customers of these businesses.

Just like the traditional nexus rules, in addition to a threshold for taxation of digitalized businesses, there needs to be in place an appropriate mechanism for allocating profit to the digital PE. This requirement poses a significant challenge regarding the OECD's proposal for a significant digital threshold. As noted by Bianco & Santos: "the greatest difficulty appears, however, to lie in the attribution of profits to a virtual PE, which would involve simultaneous application of two fictions. These are: (i) the fictitious characterization of a virtual PE; and (ii) the fictitious independence of a PE for the purposes of profit allocation".[193] The OECD made a similar point in the following words: "a significant economic presence associated with little or no physical presence in terms of tangible assets and/or personnel in the other country is not likely to involve the carrying on of any functions of the enterprise in the traditional sense. Unless significant adjustments are made to the existing rules, therefore, it would not be possible to allocate any meaningful income to the new nexus".[194]

The OECD report indicated some proposals that have been considered for mitigating this problem. One of these proposals is fractional apportionment based on the following steps – (i) definition of the tax base to be divided, (2) determination of allocation keys to divide

[192] Bianco & Santos, *supra* note 147 at 9.
[193] *Ibid* at 11.
[194] OECD, *supra* note 96 at 111–112.

the tax base, and (3) the weighting of these allocation keys.[195] The OECD was reluctant to adopt this proposal. The OECD held the view that reliance on fractional apportionment would constitute a departure from the international tax standard of allocating profit based on the arm's length principle, and this approach would be contrary to tax neutrality since it would give rise to different tax results between the traditional PE and the digital PE.[196] Despite the OECD's evident lack of favour for the formulary apportionment option, as would be seen in the course of this work, the method still stands as one of the options being considered for profit allocation to the digital PE.

Another option proposed by the OECD is the modified deemed profit method. This option requires that a digitalized business with a significant economic presence should be regarded as a physical business undertaken in the consumer's jurisdiction, and then the profit of the digitalized business would be deemed by presuming a certain ratio of expenses as being incurred in the course of the business. The presumed expenses would be determined having regard to the profit margins of domestic businesses operating the same type of business.[197] The difficulty with this approach is the optimistic assumption that domestic non-digitalized businesses would be comparable to digitalized transnational businesses. One clear example is that traditional businesses do not invest in data and technology in the same manner as digitalized businesses. The OECD clearly noted this difficulty but proffered no cogent recommendation for mitigating it.[198]

4.1.1.2.2 Withholding tax on digital transactions

The second option proposed by the OECD is imposition of a withholding tax on gross payments made by domestic taxpayers to the digitalized corporations.[199] The OECD noted that this option could be designed either as a standalone tax, or an enforcement mechanism for collecting taxes on a net basis where a significant economic presence exists.[200] The

[195] *Ibid* at 112.
[196] *Ibid*.
[197] *Ibid*.
[198] *Ibid* at 113.
[199] *Ibid*.
[200] *Ibid*.

OECD highlighted three major challenges with this process and they are: the difficulty in determining appropriate methods for defining transactions to be taxed (i.e. transactions covered), difficulty in determining appropriate methods for collecting the taxes, and most importantly, the likelihood that gross withholding tax would occasion violations of international trade and related obligations. [201] In addition, the OECD's withholding tax has been widely criticized for the "negative impact of gross revenue".[202] Larking noted the "inability of businesses with low margins to absorb a tax on gross revenue".[203] Larking also highlighted the commonly shared view that withholding tax obligation would have very negative consequences on young businesses that are in a loss position.[204] This problem calls for real concern because it would create a disincentive for investment in the sense that emerging business will avoid investing in jurisdictions with a withholding tax.[205] There is also the legitimate concern that the withholding tax may be passed on to final consumers. The OECD itself recognized these challenges and proposed that withholding tax be used as a collection mechanism to enforce net-basis taxation.[206] This may be an imperfect solution given the difficulties in collection highlighted by the OECD, but it is a "better evil" compared to gross taxation.

4.1.1.2.3 Equalization levy

The OECD introduced the equalization levy as a means of addressing the disparity between domestic traditional businesses and non-resident digitalized businesses.[207] The OECD recommended that the equalization levy would be combined with the significant economic presence so as to reduce administrative cost and capture only real economic non-physical presence.[208] The equalization levy would be imposed on all sales conducted in a jurisdiction by the non-resident digitalized corporation, or on all contracts concluded

[201] *Ibid* at 113–115.
[202] Larking, *supra* note 101 at 4.
[203] *Ibid*.
[204] *Ibid*.
[205] *Ibid*.
[206] OECD, *supra* note 96 at 115.
[207] *Ibid*.
[208] *Ibid* at 116.

through a digital platform.[209] The equalization levy is already being implemented by India and this will be reviewed in a later part of this work.

The criticism of the equalization levy is very similar to that raised against withholding taxes, which is the negative consequences that arise from taxation at gross, and inconsistency with trade obligations including the EU's non-discrimination obligation. Secondly, as pointed out by Larking, the equalization levy is most likely not a direct tax within the meaning of Article 2 of the OECD Model Tax Convention and would therefore not be covered under tax treaties. This would inevitably give rise to double taxation since there would be no means of giving relief in the same manners as a tax covered by treaty would have.[210] The OECD noted this challenge but suggested that "to address these potential concerns, it would be necessary to structure the levy to apply only to situations in which the income would otherwise be untaxed or subject only to a very low rate of tax".[211]

The OECD's suggestion in this regard is curious, particularly when one examines the suggestion with the mindset of discovering its real purpose. Aside, its "ring-fencing nature", the recommendation raises the following question: is the OECD's consideration at this point to set up appropriate rules to ensure equitable allocation of taxing rights or is it to create measures against BEPS. It would seem that the proposal aligns more to the former because, the OECD's suggestion seems to be that in cases where income is earned in a zero or low tax jurisdiction, then the user jurisdiction would be justified in asserting its taxing right (by imposing an equalization levy), but where the income is earned in a low tax jurisdiction, then user jurisdiction would not be justified in imposing tax on the income. This is at best a misalignment of two related but different objectives. In the author's view, the equalization levy itself suffers the same defect in that its only policy justification is its ability to achieve tax neutrality.

[209] Dhuldhoya, *supra* note 186 at 16.
[210] Larking, *supra* note 101 at 5.
[211] OECD, *supra* note 96 at 117.

Finally, some commentators oppose the equalization levy because it relies on the controversial assumption that user data create value.[212] As earlier noted, many of these commentators hold the view that raw data does not have any value, and only processed data is valuable.

4.1.1.3 The OECD's new nexus and profit allocation rules proposals

Following the OECD report in 2015 and interim report on Action 1 in 2018, it continued work to achieve its mandate of reaching global consensus on the appropriate rules and principles for taxing the digitalized economy by 2020. In furtherance of this continued effort, in January and May 2019, the OECD released a further public consultation document and the program of work respectively. The public consultation document sought comments on some newly proposed nexus and profit allocation rules, while the program of work, which was released by the OECD after it received comments on the public consultation document, highlighted the trajectory of its further work on setting out rules for taxing the digitalized economy. Both documents also elaborated on some issues which the OECD referred to as the "remaining BEPS concern".[213] This issue which relates in the main to treatment of income subject to low or zero tax is outside the scope of this paper and would not be considered.

An interesting point to note in the OECD's program of work is the fact that the OECD seems to be much more motivated by the unilateral approaches that some countries have adopted to tax highly digitalized businesses without a physical presence, than by a need to ensure adequate and fair allocation of taxing rights. This is evident from the introductory part of the program of work where the OECD noted that the incentive for the program of work is to reach a global consensus on how to reallocate income to user jurisdiction, in view of the "proliferation of uncoordinated and unilateral actions" by some countries that have enacted statutes outside the treaties to tax digitalized corporations.[214] Accordingly, it

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[212] Larking, *supra* note 101 at 5.
[213] OECD, *supra* note 24 at 25.OECD, *supra* note 23 at 24.
[214] OECD, *supra* note 24 at 7.

is safe to say that at this stage, the OECD is no longer asking "if" market jurisdictions should be granted right to tax but "how" market jurisdictions should tax. Additionally, not much was said about the initial objective of not "ring-fencing" the digitalized economy.

As hinted above, the OECD presented further options for taxing the digitalized economy. In addition to significant economic presence reviewed in the preceding section, the OECD proposed "user participation" and "marketing intangible" as further options for the taxing the digitalized economy.[215] These proposals are considered in the succeeding paragraphs.

4.1.1.3.1 The User participation proposal

This proposal underscores the OECD's view that user data is the lifeblood of digitalized business models. The proposal proceeds from the premise that highly digitalized businesses create value "through developing an active and engaged user base, and soliciting data and content contributions from them.[216] Consequently, the main policy justification for this proposal as highlighted by the OECD is that the value of user data in the aforementioned businesses is not currently captured in the international tax rules.[217]

The OECD narrowed the businesses which it specifically intends to capture to three – social media platforms, search engines and online marketplaces.[218] Given the massive scale of business these digitalized corporations operate, which effectively means that taxing rights would be triggered in quite a number of jurisdictions with a user base, the OECD proposed that "additional restrictions based on size of the businesses" should be included in the mechanics of this formula to minimize controversy and double taxation.[219] It is unclear whether the size of the businesses is merely a means of ensuring administrative convenience or it is a benchmark for creating a nexus under the user participation proposal. However, given the reliance on revenue and user data in the significant economic presence

[215] *Ibid* at 11.
[216] OECD, *supra* note 23 at 9.
[217] *Ibid* at 10.
[218] *Ibid* at 9–10.
[219] *Ibid* at 11.

proposal, it is reasonable to conclude that the OECD may have intended to adopt the size of the business as benchmark for establishing nexus.

The mechanics of this approach are such that it requires a part of the profit of the businesses covered to be allocated to the user jurisdiction, irrespective of whether or not those businesses have a physical presence.[220] The profit allocation rules for this proposal are designed in such a manner that routine profit of the business is first calculated based on the traditional arm's length principle. This amount is deducted from the total profit of the corporation to determine the corporation's residual profit. Thereafter, a portion of the residual profit is attributed to user jurisdictions using qualitative or quantitative information or a simplified percentage. This process ends with splitting the portion of residual profit attributable to user jurisdictions among those jurisdictions based on agreed allocation metrics.[221]

The OECD's user participation proposal received significant criticism from stakeholders.[222] Larking noted that the comments reflected "little expectation" of consensus being reached on the proposal.[223] Some of the criticisms condemned this option as being inconsistent with tax neutrality, in the sense that it would create a disincentive to engage in the businesses to which it specifically targeted.[224] There was also a similar concern that the OECD would be unduly ringfencing these digitalized businesses from the broad international tax framework. EBIT and BlaBlaCar's submission raised the point that there is no real difference between the use of consumer data in the digitalized businesses and use of same in traditional businesses. BlaBlaCar noted that "value creation of a supermarket customer whose consumption habits are known thanks to loyalty cards follow

[220] *Ibid* at 10.
[221] *Ibid* at 10–11.
[222] Barry Larking, "OECD Weighing Extensive Input on Digital Economy Tax Proposals", *Tax Notes Int* (2019), online: <https://www.taxnotes.com/tax-notes-international/base-erosion-and-profit-shifting-beps/oecd-weighing-extensive-input-digital-economy-tax-proposals/2019/05/06/29drw?highlight=Taxing%20According%20to%20Value%20Creation> at 513.
[223] *Ibid*.
[224] *Ibid*.

the same process".[225] Taxand noted that given the everchanging nature of the digitalized economy, targeting specific businesses is not a sufficient long-term solution.[226] In the same manner, the Chartered Professional Accountants of Canada advised that the proposal must be refined to deal holistically with all businesses that have digital elements.[227]

Another recurrent critical point raised by commentators is the practicality of the attribution principle proposed for the user participation threshold. For instance, EBIT noted that digitalized businesses don't typically keep track of user locations and given this fact compliance burden on digitalized businesses would be heavy.[228] On the other side, the World Bank Group noted in their own comments that "the approach to identifying the residual income attributable to marketing intangibles in paragraphs 45 and 46 looks very challenging for administrations already struggling with the complexity of BEPS measures". The World Bank Group proceeded to suggest a more mechanical approach.[229]

Other commentators also criticized the proposal for being vague and arbitrary. According to KPMG: "with respect to the user participation proposal, we see substantial risk that it would lead to arbitrary and distortive results".[230] The arbitrariness of this proposal is illustrated by the OECD's "quantitative/qualitative information" or a "simple pre-agreed percentage" recommendations for determining a corporation's residual profit.[231] The OECD acknowledged this challenge in its public consultation document, but suggested the remedy that formulary methods that relies on value of users should be adopted to determine residual profit, together with a strong dispute resolution component to address conflicts

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[225] *Ibid*.
[226] LED Taxand, "OECD public consultation on the taxation of the digital economy", (2019), online: *Led-Taxandit* <https://www.led-taxand.it/2019/03/12/oecd-public-consultation-on-the-taxation-of-the-digital-economy/> at 1.
[227] Chartered Professional Accountants Canada, *Public Consultation Document "Addressing the Tax Challenges of the Digitalisation of the Economy"* (2019) at 2.
[228] Larking, *supra* note 222 at 516.
[229] World Bank Group, *Comments on the OECD Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy, February 2019* (2019) at 3.
[230] KPMG, "Comments on OECD Public Consultation Document on Addressing the Tax Challenges of the Digitalized Economy", (2019), online: <https://tax.kpmg.us/content/dam/tax/en/pdfs/2019/3-6-19-kpmgi-comment-letter-oecd-consultation-document-digital-economy.pdf> at 3.
[231] Larking, *supra* note 222 at 516.

and double taxation.[232] However, as noted earlier, the extent to which user factor can be relied on in allocating taxing rights is still subject to huge controversy. BIAC for instance argued that the value of a user's contribution is not necessarily same as another user because 10 users may contribute more valuable data than 100 users put together.[233] The United States Council for International Business (USCIB) argued firmly that "the proposal based on user-created value are unsupported by economic analysis and do not appropriately reflect the contributions to value of research and development (R&D) and investment in capital assets".[234] In the author's opinion, the fact that arguments on the value of user data stills persists at this stage raises doubt about the chances of a global consensus.

4.1.1.3.2 The "Marketing intangibles" proposal

Marketing intangibles is a transfer pricing concept that refers to intangibles such as customer list, customer data, brand name or trade name, utilized in promoting and selling goods and services in a particular jurisdiction.[235] As clarified by the OECD in paragraph 29 of the public consultation document, the term "marketing intangibles' as used in the proposal also has the same meaning as in the transfer pricing context highlighted above.[236]

The marketing intangibles concept seeks to allocate profit to market jurisdictions just like the user participation proposal.[237] However, unlike the user participation proposal that applies generally to highly digitalized businesses, and specifically to the digitalized business models listed therein, the marketing intangibles proposal seeks to have a wider scope to apply to even non-digitalized businesses operating remotely or through a limited risk distributor structure.[238] The OECD noted that the marketing intangibles proposal is premised on a functional link between marketing intangibles and the market jurisdiction,

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[232] OECD, *supra* note 23 at 11.
[233] Larking, *supra* note 222 at 516.
[234] USCIB, *USCIB Comments on the OECD Public Consultation Document on Addressing the Tax Challenges of the Digitalisation of the Economy* (2019) at 2.
[235] Publishing OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* - (Paris: OECD Publishing, 2017) at 27.
[236] OECD, *supra* note 23 at 11.
[237] *Ibid.*
[238] *Ibid.*

and further illustrated this functional link in two different ways – the fact that the value of marketing intangibles such as brand name and trade name are created in the market jurisdiction, and "reflected in the favorable attitudes in the minds of customers. Secondly, that customer data, customer list, relationships are "derived from activities targeted at customers and users in market jurisdiction".[239]

Just like the user participation approach, the proposal seeks to modify existing profit allocation and nexus rules by requiring the residual income of the multinational group attributable to the marketing intangibles to be allocated to the market jurisdiction.[240] The residual income is determined after all other income including income generated from technology-based intangibles, routine functions, routine marketing activities, and routine distributions are deducted from the overall income of the multinational group.[241] This approach is group-based in the sense that the residual profits mechanism from marketing intangibles would apply regardless of which entity in the multinational group owns the legal title to the marketing intangible[242] Further, the mechanism applies regardless of which entity perform or control the DEMPE (development, enhancement, maintenance, protection and exploitation) functions related to the intangibles, regardless of how risk related to the marketing intangibles is allocated or how profit would be allocated under extant transfer pricing rules.[243] After the residual profit is determined, the profit is then allocated between market jurisdictions "based on agreed metric, such as sales or revenues".[244] As rightly noted by Larking, this proposal made no reference to the requisite nexus for its application.[245]

The marketing intangible approach was generally commended by many commentators because it does not target specific businesses like the user participation proposal.[246]

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[239] *Ibid* at 12.
[240] *Ibid* at 14.
[241] *Ibid*.
[242] *Ibid* at 15.
[243] *Ibid*.
[244] *Ibid*.
[245] Larking, *supra* note 222 at 517.
[246] *Ibid*.

According to the World Bank Group, the marketing intangibles proposals avoids some of the present and future challenges that are associated with distinguishing between digitalized and non-digitalized business lines and models.[247] However, there were still concerns that the proposal is capable of creating economic distortions.[248] Aside this broad policy concern, the proposal also received significant conceptual criticisms. One commentator argued that the OECD's reference to an "intrinsic factual link" as validation for attributing taxing right to a market jurisdiction over marketing intangibles would require psychological, behavioral and sociological studies, analysis and proof.[249] NERA Economic Consulting argued that the assumption in the "intrinsic factual link" that brand name is created by users in the market jurisdiction is erroneous. The commentators submitted that brand value is a product of "centralized development and management" and associated risks owned and assumed by the business.[250]

The proposal was also criticized on grounds of practicability. KPMG asked a fundamental definitional question to which multinationals are covered by the proposal?[251] Is there a specific size or industry limit? Unless, this is determined at this stage, there may be dispute as to whether the marketing proposal should apply to a specific multinational corporation or not. Another challenge is drawing a distinction between intangibles generated from research and development to which the traditional transfer pricing rules apply and marketing intangibles that potentially derive value from users. IBFD noted that "singling out marketing intangibles and their value may be tough to execute in the practice of developing countries, which often lack capacity and suitable information".[252] IBFD also noted that valuing marketing intangibles would require corresponding changes in the

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[247] World Bank Group, *Comments on the OECD Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy, February 2019* (2019) at 3.
[248] Larking, *supra* note 222 at 517.
[249] *Ibid*.
[250] *Ibid* at 518. NERA Economic Consulting, *Public Consultation Document – Addressing the Tax Challenges of the Digitalisation of the Economy* (2019) at 3.3.
[251] KPMG, *supra* note 230 at 4.
[252] IBFD, "OECD Public Consultation Document: IBFD Task Force on Digital Economy issues comments", (2019), online: *IBFD Tax Portal* <https://www.ibfd.org/IBFD-Tax-Portal/News/OECD-Public-Consultation-Document-IBFD-Task-Force-Digital-Economy-issues> at 33.

OECD Transfer Pricing Guidelines.[253] Another important point raised by IBFD is the challenge in determining how the marketing intangibles proposal would apply together with existing principles for allocation of taxing rights. Specifically, IBFD asked the very difficult question of whether the taxing powers of market jurisdictions over marketing intangibles would prevent entirely the primary taxing right of residence jurisdictions.[254] USCIB observed the absence of a loss allocating mechanism in the residual profit method and submitted that having a mechanism that factors in pre-existing and future losses should be a mandatory element in the residual profit split attribution mechanics for the marketing intangibles proposal.[255]

Finally, this proposal has been criticized for failing to examine the relationship between the residual profit split mechanics and the existing arm's length principle.[256] For instance, failing to consider the business that performs the DEMPE function related to the marketing intangibles would be inconsistent with the OECD transfer pricing rules. NERA Economic Consulting noted that the marketing intangibles proposal (and the user participation proposal) pose a serious challenge to the arm's length principle by attributing value not to any activity of the enterprise but to users who are not part of the enterprise, and who do not have any economic interest in the enterprise.[257]

4.1.1.3.3 The Significant Economic Presence proposal

As noted by Larking, the significant economic presence is the only nexus proposal in the OECD's Action 1 report that was presented for comments in the public consultation documents.[258] The features and analysis of this proposal is exactly the same as addressed in Action 1 of the BEPS report 2015.

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[253] *Ibid.*
[254] *Ibid.*
[255] USCIB, *supra* note 234 at 4.
[256] KPMG, *supra* note 230 at 4.
[257] NERA Economic Consulting, *supra* note 250 at 3.2.
[258] Larking, *supra* note 222 at 518.

Although this concept and issues arising have been considered in this paper, two criticisms that arose from the public consultation document deserve to be mentioned here. First is the view held by BIAC that the cumulative factors of revenue, digital factors and users, have no practical relevance as the significant economic presence de facto relies solely on revenue.[259] BIAC went further to criticize the equity of this approach. Commenting also on the equity of the approach, USCIB stated that the revenue factor is not fair to developing countries who have a smaller market and would thus be unable to compete with developed countries.[260] The second criticism is the concern raised by many commentators about the formulary apportionment mechanics recommended by the OECD for attributing profit to the significant economic presence. It would be recalled that the OECD expressed its reluctance to adopt formulary apportionment as a profit allocation rule. In Action 1 of the 2015 BEPS report, the OECD stated as follows:

> "It is important to note that domestic laws of most countries use profit attribution methods based on the separate accounts of the PE, rather than fractional apportionment. In addition, fractional apportionment methods would be a departure from current international standards. Furthermore, pursuing such an approach in the case of application of the new nexus would produce very different tax results depending on whether business was conducted through a "traditional" permanent establishment, a separate subsidiary or the new nexus. Given those constraints, fractional apportionment methods were not pursued further".[261]

It is therefore interesting that the OECD has continued to look into fractional apportionment despite the reluctance it expressed in 2015. One reason why this option may appear to continue attracting the OECD's attention could be its simplicity in application,

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[259] *Ibid* at 519.
[260] *Ibid*.
[261] OECD, *supra* note 96 at 112.

especially given the complicated options that have been reviewed so far. As expected, this option has been criticized by many of the commentators to the public consultation document. Larking noted that vast majority of criticisms of this factor is the inability of this factor to consider the differences between businesses and business models.[262] Other commentators criticized formulary apportionment for failing the test of tax neutrality. EBIT expressed the concern that formulary apportionment would create "an incentive to outsource manufacturing in high-tax jurisdictions and insource in low-tax jurisdictions".[263] Finally, some commentators have held the view that consensus may never be reached on the formulary apportionment option. KPMG noted that reaching a global consensus on formulary apportionment would be difficult because the proposal "would effectively pick winners and losers among jurisdictions, making it unlikely that single uniform set of factors could be agreed upon".[264]

4.1.1.4 The future of OECD's work on taxation of the digitalized economy

As noted earlier, the OECD released its roadmap for addressing the tax challenges of the digitalized economy in its program of work after it received comments on the options raised in its public consultation document. In the program of work, the OECD presented its plan for developing a new nexus based on the concept of remote taxable presence, and also proposed additional profit allocation options that would be analyzed further.[265] In all cases, the OECD stated that its policy objective is to design a nexus for taxing digitalized businesses in the absence of physical presence, consider using the total profit of the business as benchmark to determining the taxing right of source jurisdiction and consider simplified allocation rules different from the existing separate entity principle.[266]

On the issue, the OECD did not comment further on some of the nexus options it had already proposed, but noted that in developing a remote taxable presence it would evaluate

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[262] Larking, *supra* note 222 at 519.
[263] *Ibid*.
[264] KPMG, *supra* note 230 at 8.
[265] OECD, *supra* note 24 at 11–23.
[266] *Ibid* at 11.

two alternative options: amend the definition of a PE in Article 5 and 7 of the OECD MTC, or develop a standalone rule establishing an independent nexus, "either through a new taxable presence or a concept of source".[267] With respect to the profit allocation principles, the OECD introduced yet another option – the Distribution-based approaches.[268] In this option, a fixed baseline profit of a business would be allocated to the market jurisdictions for marketing, distribution and user-related activities carried out in the jurisdictions.[269] This OECD anticipates that this proposal will resolve some of the issues raised against the modified residual profit split method. In particular, the option is perceived to have the potential to address the arguments associated with the proper pricing of marketing and distribution activities.[270]

4.1.1.5 Concluding comments

From the foregoing, it is clear that the OECD's original intention of not ring-fencing the digitalized economy has given way to a new objective: reallocating taxing rights to allow market jurisdiction exercise some right over corporations with remote presence. The reason for this shift is predominantly a consequence of the unilateral steps taken by some countries (most of which are members of the EU), to tax the digitalized businesses which has put the OECD under immense pressure to control "proliferation of uncoordinated and unilateral actions".[271] Thus, the OECD's objective is to gain global acceptance by balancing some taxing rights among the competing interests of the countries with huge markets, countries that depend largely on an extractive economy, and countries that are home to most of the digitalized businesses. Clearly, this is not an easy task because the proposals don't represent a common interest. It is not an "all win" situation. As noted by VanderWolk: "allocation is the most difficult issue, because re-allocation will create winners and losers from a pure revenue perspective".[272] Accordingly, no matter which proposal the OECD

[267] *Ibid* at 18.
[268] *Ibid* at 15.
[269] *Ibid*.
[270] *Ibid*.
[271] *Ibid* at 7.
[272] Jefferson VanderWolk, "The OECD/Inclusive Framework's Program of Work on Revised Nexus and Profit Allocation Rules (Pillar One): Where Will It Lead?", (2019), online: *Kluwer Int Tax Blog*

comes up with, its effectiveness would depend to a very large extent to how much support it has globally. Whether this would happen remains uncertain at this stage.

4.1.2 EC's proposals for taxation of the digitalized economy and the multiplicity of unilateral measures

The EC's approach to taxing the digital economy is in two-fold. On the one hand, the EC proposed that that digitalized businesses be taxed based on a taxable nexus described as a "significant digital presence". This proposal which was expatiated on in the EC's "proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence"[273] (the digital PE proposal) was designed to apply within the framework of existing tax treaties. The EC recommended that upon approval of the proposal, member states would include the significant digital presence in their tax treaties with other countries.[274] The second approach was a recommendation for a digital service tax imposed on digitalized businesses that have a certain user threshold in the EU.[275] The EC indicated in the "Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services"[276] (the digital service tax or "DST" proposal) that the digital tax is an interim measure which EU countries can adopt in their corporate tax rules pending the development of a comprehensive solution by the OECD.[277] The EC claims that a unified interim unilateral digital service tax is useful because it served to harmonize some of the unilateral measures that were already being considered by some member states. The EC's objective was to avoid uncoordinated taxes that could fragment its single market and distort competition in the union.[278]

<http://kluwertaxblog.com/2019/06/25/the-oecdinclusive-frameworks-program-of-work-on-revised-nexus-and-profit-allocation-rules-pillar-one-where-will-it-lead/>.

[273] European Commission, *Proposal for Council Directives laying down rules relating to the corporate taxation of a significant digital presence* (2018).

[274] Alessandro Simone Samari, "Digital Economy and Profit Allocation: The Application of the Profit Split Method to the Value Created by a 'Significant Digital Presence'" (2018) 26:1 1 at 1.

[275] *Ibid*.

[276] 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* (2018) at 2.

[277] *Ibid* at 2–3.

[278] *Ibid* at 3.

Similar to the OECD's approach, the EC proposed to enforce taxation against digital corporations that have sufficient digital presence in EU countries, based on the understanding that users are value drivers in the business models of digitalized corporations.[279] The EC also indicated that its proposals are based on a need to ensure that digitalized businesses pay their "fair" share of tax.[280] According to the EC, "ensuring fair taxation of the digital economy is also part of the European Commission's agenda on a fair and efficient tax system in the European Union".[281]

It is relevant to state at this point that the EC's digital PE and DST proposal was short-lived as the proposal failed to gain a consensus among the 28 EC member states.[282] The EC's proposal for an EU-wide DST failed despite modified proposals from some countries such as the Austria, Germany and France to limit the scope of the DST to online advertising. Nevertheless, the EC's digital PE will be considered briefly in this work for completeness while the DST would be considered in some details because it forms the basis for most of the domestic digital tax statutes which will be reviewed in the course of this work.

4.1.2.1 The EC's digital PE and profit allocation rules

The EC's proposed digital PE is very similar in structure and content to the OECD's significant economic presence nexus. Article 4(1) of the EC's digital PE proposal provides that a PE would exist if a foreign enterprise has a "significant digital presence" through which it wholly or partly carries on business.[283] Just like the OECD's significant economic presence, the EC's digital PE reflects the revenue, digital and user factors proposed by the OECD. This is evident from Article 4(3) which deemed a significant digital presence to exist if the foreign enterprise carries on the business of digital services through a digital

[279] Pertuzzi & Koukoulioti, *supra* note 19 at 391.European Commission, *supra* note 276 at 2.European Commission, *supra* note 273 at 2–3.
[280] European Commission, *supra* note 273 at 1.
[281] European Commission, *supra* note 276 at 1.
[282] Ullrika, *supra* note 27.
[283] European Commission, *supra* note 273 at 16.

interface and the entity together with its associated entities meet one or more of the following thresholds:

(a) the proportion of total revenue obtained in that tax period and resulting from the supply of digital services to users in a member state exceeds EUR 7,000,000;

(b) the number of users of one or more of those digital services in each member state in that tax period exceeds 100,000;

(c) the number of business contracts for supply of any such digital service concluded in each member state exceeds 3000.

To attribute profit of a digitalized business to the digital PE, the EC's proposal opted for a modified version of the OECD's AOA in Article 7(2) OECD MTC. Article 5(2) of the digital PE proposal provides that the profits that are attributable to the significant digital presence would be those that the digital PE would have earned on an arm's length basis as a separate and independent enterprise performing the same or similar activities, in the same or similar conditions taking into accounts functions performed, assets used and risks assumed through the digital interface.[284] Article 5(3) of the proposal provides some explanation on how the functional analysis would be performed. The provision states that in the functional analysis, economically significant activities performed by the PE through a digital interface would be taken into consideration, and "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".[285] Article 5(4) of the proposal requires that the profit attribution rules should take into account the economically significant activities performed by the significant digital presence that are relevant to DEMPE of the enterprise's intangibles.[286] Finally, the EC proposed that after,

[284] *Ibid* at 17.
[285] *Ibid.*
[286] *Ibid.*

the functional analysis is concluded, the profit split method would be adopted to split profit between the foreign digitalized business and the significant digital presence.[287]

Given the close similarity between the OECD's significant economic presence and the EC's digital PE, it is not surprising that the later was criticized for the same or similar reasons as the former. For instance, Petruzzi & Koukoulioti raised the popular concern that equating the number of users to the quantum of value created in a given location is problematic because "not all users contribute equally to a digital enterprise and that different business models allow for a different degree of engagement and involvement of users".[288] In addition, these commentators raised some very interesting points that could potentially have some relevance to other options proposed by the OECD. They noted that the location of users is very difficult to determine especially for users that often travel to different locations in a tax year. The commentators raised the possible circumstance where users could be counted more than once in different jurisdiction for the purpose of establishing a nexus, and thereby leading to double and multiple taxation of the non-resident digital business.[289]

Aside the challenges raised about the EC's digital presence threshold, the EC's choice of the AOA as the profit allocation method for the digitalized businesses is another source of controversy. Blum as well as Petruzzi & Koukoulioti noted that the lack of a physical presence makes it very challenging to perform a functional analysis on a digital PE.[290] The EC seems to understand this challenge, which explains why it came up with its concept of "economically significant activities" related data and user based on which risks and economic ownership of assets are attributed to the SDP.[291] Article 5(5) highlighted some examples of economically significant activities to wit – "(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,

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[287] *Ibid* at 18.
[288] Pertuzzi & Koukoulioti, *supra* note 19 at 395.
[289] *Ibid* at 396.
[290] *Ibid* at 397.Blum, *supra* note 21 at 323.
[291] Pertuzzi & Koukoulioti, *supra* note 19 at 397.

(d) the making available of third-party created on a digital marketplace, and (e) the supply of any digital services not listed in (a)-(d) above".[292] However, this only complicates the EC's approach even further because it failed to clarify how these activities which are characterized by the presence of user and data factors can assume risks and own assets. Samari pointed out the same flaw in the EU's functional analysis using the "economically significant activities" concept as follows: 'the EU legislator should make an extra effort by providing the taxpayers with some clear and practical examples of "economically significant functions performed through a digital interface" in addition to those listed in Article 5.5 of the proposed EU Directive. Additionally, some further key points remain unclear: (i) should data be considered an asset in a significant digital presence functional analysis? (ii) How should the traditional risk analysis framework provided by the OECD Guidelines be used in relation to data?".[293]

Interestingly, Petruzzi & Buriak argued that a functional analysis can be modified to accommodate a digital PE because users of goods and services provided by digitalized businesses are unconscious contributors to the value of the digitalized businesses and can be likened to unconscious employees of the businesses.[294] The scholars also argued that for functional analysis purposes, user data should be considered assets that could be attributed to the user base.[295] Finally, while recognizing that users can't bear risks, the scholars argued that risk should no longer be considered relevant in a functional analysis for a digital PE. It is the present author's view that the views of Petruzzi and Buriak raise more questions than answers. First, the analogy between employees and customers is missing the "control" element that is viewed as the functional integration between a PE and the foreign enterprise.[296] In the absence of this link, it is contradictory to argue that a user-based PE is part of the digitalized foreign enterprise, in the same manner as employees of the enterprise in the traditional context. Second, the argument that data is an asset raises

[292] European Commission, *supra* note 273 at 15–17.
[293] Samari, *supra* note 274 at 8.
[294] Raffaele Petruzzi & Svitlana Buriak, "Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules?" (2018) 72:No. 4a/Special Issue Bull Intl Taxn 19 at 14.
[295] *Ibid.*
[296] Reimer, Rust, & Vogel, *supra* note 57 at 355–356.

a number of questions: (i) is it processed or unprocessed data that should be considered an asset, (ii) whose asset is data; that of the digitalized foreign enterprise or the customers, (iii) is data an intangible asset and if yes, what is the implication of the OECD transfer pricing guidelines for intangibles in the transfer pricing analysis for data? These questions are indicative of the complexity that arise when data is viewed as an asset that can be attributed in a functional analysis.

Although the EC's proposal for a digital PE has failed to reach the necessary consensus, it presents an insight into the difficulty in applying the arms-length principle to a digital PE, especially in the manner set out in the AOA. Luckily, this option is already off the table in the OECD's work.

4.1.2.2 The EC's digital service tax

As noted earlier, whilst the EC proposed for inclusion of a digital PE in the tax treaties of member states, the EC resorted to a proposal for a unified digital service tax as an interim measure to protect the EU's tax base pending when a global solution is agreed upon. According to Pierre Moscovici, the EU Tax Commissioner, "Member states are becoming increasingly frustrated at their inability to tax the high volumes of digital activity within their borders. Some have taken, or plan to take soon, unilateral measures in an attempt to solve the problem. A combination of fragmented uncoordinated national 'patches' and solutions would negatively affect the single market, raise compliance costs, and ultimately undermine competitiveness: That is the disorderly outcome we would very much like to avoid".[297]

The legal basis for the DST as indicated in the EC proposal is Article 113 of the Treaty on Functioning of the European Union (TFEU), which enables the EC to adopt provisions for the "harmonization of Member States' legislation concerning other forms of indirect taxation".[298] This effectively means that the DST is an indirect tax. Van & Van questioned

[297] Sarfo, *supra* note 93 at 2.
[298] European Commission, *supra* note 273 at 5.

the EC reliance on Article 113 TFEU. The commentators argued that the purpose of a statute enacted pursuant to Article 113 TFEU is to harmonize existing indirect taxation of member states. The commentators argued further that the EC's DST does not harmonize existing tax because "solely 10 out of 28 EU Member States have implemented or planned unilateral measures in this field and these unilateral measures are not similar either".[299]

By virtue of Article 3 and 8 of the DST proposal, the DST is a 3% tax on "revenue" (not income) specifically targeted at revenues accruing from: (a) "placing on a digital interface advertising targeted at users of that interface" (online advertisements on a digital platform), (b) "the making available to users a multi-sided digital interface which allows 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" (example social media networks), and (c) "the transmission of data collected about users and generated from users' activities on digital interfaces" (selling user data to product sellers and advertising agencies).[300]

Online advertising refers to businesses that publish advertisement and promotional materials through a digital interface for the attention of users. In this regard, Article 3(3) states that it is immaterial who owns the digital interface, as the entity liable to the tax is the entity that actually places the advertisement.[301] It therefore appears that cloud computing services that merely own a digital interface without more are exempted from this definition. It is not clear why this exemption was done especially given that cloud computing is one of the examples of digitalized businesses which the OECD reviewed in its 2018 interim report. The second services targeted by the EC's DST proposal are multi-sided business networks such as Facebook, Twitter, Instagram, etc., that own and operate digital interfaces which allows users to interact with one another while also facilitating sale of goods and services. The third service captured by the EC's DST proposal is sale of data generated from users of the digital interface. For instance, this would be triggered and

[299] Horzen Van & Esdonk Van, "Proposed 3% Digital Services Tax" (2018) 25:4 Int Transf Pricing J 267 at 271.
[300] European Commission, *supra* note 276 at 24.
[301] *Ibid* at 25.

payable by a corporation like Facebook or Google when it sells data obtained from users to advertisement and marketing corporations. Revenues from these services were technically referred to in the proposal as taxable revenues, while the service itself were referred to as taxable services.

Article 4(1) of the EC DST proposal defines the person taxable as any entity that (a) reports a worldwide revenue of EUR 750,000,000 of out which a total of EUR 50,000,000 must qualify as taxable revenue obtained from the EU.[302] According to Article 4(6), an entity does not necessarily mean a single corporation; a consolidated group to which the corporation in issue belongs would qualify as an entity.[303] On this point, Lamensch noted that the approach undertaken by the EC is inconsistent with tax neutrality because its specifically targeted not just specific corporations, but also specific services rendered by these corporations. Lamensch described this approach as "double ring-fencing".[304]

Article 5 (1) of the DST proposal sets out what it means for taxable revenue to be derived from an EU member state. According to this provision, taxable revenue is obtained from a EU member state if the relevant service was rendered to users in the member state during the tax period.[305] A user is deemed to be located in a member state:

(a) for online advertisement platform, if the advertisement appears in the user's device when it is being used in a member state;

(b) for services involving a multisided business network that facilitate underlying supplies of goods and services directly between users, if the user uses a device in the member state to access the digital interface and concludes a transaction on the interface, and for others types of multi-sided networks, if the user has an account opened with a device in a member state which allows the user to access the digital interface at any time during a tax year;

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[302] *Ibid*.
[303] *Ibid* at 26.
[304] Lamensch, *supra* note 26 at 7.
[305] European Commission, *supra* note 276 at 27.

(c) for sale or transmission of user data, if the data so transmitted in a tax period was generated from a user having used a device in a member state to access a digital interface.

This provision signifies the EC's shift from a requirement for a physical presence and reflects the popular view that users contribute to value creation in highly digitalized business models. As noted by Van & Van, "the users are there to create a connection or nexus between the taxpayer and the European Union".[306] Accordingly, it is irrelevant whether or not the providers of the taxable services are resident or carries on business in any EU member state. Another problem identified with the EC's proposal is the concern that the 3% tax on revenue does not take into consideration, the significantly diverse profit margins of the three taxable services.[307] This effectively means that the EC's intention to target specific businesses to ensure fair taxation was not really achieved.

Article 5(3) sets out the manner for determining how taxable revenues would be allocated to EU and members states. The provision requires that revenue would be attributed in proportion of the number of users in the EU, and subsequently in each member state based on the number of users living in the state.[308] How the location of users would be identified and implications for users that may be located in different places at different times in a tax year was not considered.

Given the lack of physical presence of the taxable persons in the EU, Article 9 of the DST proposal imposed the compliance obligation on the taxable persons. Thus, a taxable person is required by Article 10 to "notify member state of identification that the taxable person is liable to DST in one or more Member States".[309] Commenting on the effectiveness of the administrative approach taken by the EC, Lamensch noted that that although there would be some level of compliance by the targeted digitalized corporations, given their size and reputation. However, there would be no means to know if indeed compliance was

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[306] Van & Van, *supra* note 299 at 269.

[307] Anna Burchner, "United Kingdom/European Union/OECD - Extracting the Digit: Recent UK Reforms and New Proposals for Taxing the Digital Economy" (2019) 73:6/7 Bull Int Tax 316 at 350.

[308] Van & Van, *supra* note 299 at 269. European Commission, *supra* note 276 at 27–28.

[309] European Commission, *supra* note 276 at 29.

complete without incurring administrative costs that would outweigh the revenue which would ordinarily accrue to the EU member states from the tax collected.[310]

In addition to such arguments about the limiting effect of the EC's DST on sovereignty of EU member states[311], enforceability of the DST[312], its ring-fencing attributes[313] and recurring criticism of a user-based nexus[314], another notable criticism of the DST is the EC's attempt to avoid the digital taxes being mitigated or distorted by tax treaties. In this regard, it is relevant to recall the implication of Article 2 OECD MTC. Article 2 OECD MTC defines the scope of tax treaties by providing that treaties would apply to all taxes on *income and capital*, and substantially similar taxes. The EC attempted to shelter the DST from tax treaties by designating the DST as an indirect tax, and imposing tax on revenue as opposed to income or capital. This attempt raised significant criticism from commentators. Van & Van argued, and rightly so, that the "reason that the Commission refers to the DST as an indirect tax is, in the author's view, is because in this way the Commission wants to steer clear of any negative effect that double tax treaties concluded with non-EU countries may have on the EU Member States' power to tax".[315] The authors argue that indirect tax is better understood as a "cost-increasing tax", and that the digital service tax is not a cost-increasing because the tax was never intended to increase the financial burden of users, or any other person other than the digitalized businesses specifically targeted. Accordingly, the tax is the digitalized corporations' tax and not that of the users', or any other person.[316] The authors further stated that it makes no difference that the tax was imposed on revenue (as opposed to income) because "attributable deductible costs have been taken into account given the relatively low rate of 3%".[317]

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[310] Lamensch, *supra* note 26 at 7.
[311] Van & Van, *supra* note 299 at 269.
[312] Lamensch, *supra* note 26 at 7.
[313] *Ibid*.
[314] Van & Van, *supra* note 299 at 269.
[315] *Ibid*.
[316] *Ibid* at 270.
[317] *Ibid*.

Similarly, Lamensch argued that indirect taxation can only occur where the tax burden is transferred by the person paying it to another person.[318] In this case, no person other than the targeted digitalized corporations are responsible either in the interim or ultimately to pay or bear the burden of the DST. Accordingly, Lamensch submitted that DST is a direct tax because it is the taxable persons and not the users that suffer corresponding reduction in income. Lamensch also noted that the DST is chargeable on annual basis, a key attribute of direct taxes.[319] Finally, Lamensch argued that the fact that taxable persons can deduct DST paid from income taxable under the corporate income tax of member states is a tacit recognition that both taxes are same or substantially similar and deserving of relief in other to avoid double taxation.[320] In the author's opinion, the arguments raised regarding the EU's categorization of its DST as an indirect tax are valid. The DST has no real features that would qualify it as an indirect tax. Indeed, under close scrutiny, one can validly argue that that the tax is at the very least substantially similar with the taxes covered by tax treaties in line with Article 2(2) of the OECD MTC.[321]

4.1.2.3 Unilateral measures

As noted earlier, some countries have enacted their own domestic digital tax statutes. The common theme amongst the rationale behinds these unilateral measures is the perceived need to protect the national tax base from further exploitation. Some of these countries applied a somewhat different approach to the challenges of the digital economy (e.g. the United Kingdom's Diverted Profit Tax, Israel significant economic presence law, and India's equalization levy), other are modelled significantly after the EU DST (these countries include Spain, United Kingdom, Austria, France). These unilateral decisions are reviewed below.

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[318] Lamensch, *supra* note 26 at 7.
[319] *Ibid*.
[320] *Ibid*.
[321] *Ibid* at 8.

4.1.2.3.1 Israel's significant economic presence test

In 2016, the Israeli Tax Authority released an official circular to clarify in what circumstances a non-resident corporation engaged in online activities would be liable to corporate income tax in Israel under Section 4A of the Israel Income Tax Ordinance.[322] According to the circular, a non-resident person would be taxable in Israel for domestic law purposes if the activities of the person constitutes a significant economic presence.[323] The circular indicated that the Israeli significant economic presence would apply without the need for a physical presence to a foreign business that is resident in a country with which Israel has not concluded a tax treaty. A foreign resident in a tax treaty country may also be subjected to the significant economic presence nexus if they have a physical presence in Israel.[324]

The activities that would constitute a significant economic presence are mostly digital factors and they include: (i) number of online contracts between the non-resident and Israeli customers, (ii) number of Israeli customers utilizing the digital service, (iii) websites that contain localized features targeted at Israeli consumers, and (iv) revenue that can be considered to be derived from online activities of Israeli consumers.[325] The circular did not set out any special profit attribution rules, but merely referred to the existing arm's length principle in domestic rule for the purpose of determining profit attributable to significant economic presence. The OECD in its 2018 report noted that it is doubtful if any meaningful profit could be attributed to the Israeli significant economic presence.[326] In view of the conclusion reached regarding application of the AOA to the EU's digital PE, it is the author's view that no meaningful profit can be attributed to the Israeli's digital presence nexus by applying the arm's length principle.

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[322] OECD, *supra* note 22 at 137.
[323] EY, "Israeli Tax Authorities publish official circular on internet activity of foreign companies in Israel", *EY Glob Tax Alert* (2016), online: <https://taxinsights.ey.com/archive/archive-news/israeli-tax-authorities-publish-official-circular-on-internet-activity.aspx> at 2.
[324] *Ibid*.
[325] *Ibid*; OECD, *supra* note 22 at 137.
[326] OECD, *supra* note 22 at 137.

4.1.2.3.2 India's equalization levy and significant economic presence

India adopted two out of the three nexus thresholds proposed by the OECD in its 2015 report – an equalization levy and inclusion of a significant economic presence in its domestic tax rules.

India's equalization imposes a 6% equalization levy on revenue generated from online advertising by a non-resident corporation in a business to business transaction.[327] The levy is administered through withholding obligations on residents and PEs in India, which is triggered when a sum exceeding INR 100,000 is to be paid to a non-resident for online advertising services.[328] India's equalization levy was designed to be outside the scope of tax treaties since it is not imposed on income or capital.[329]

The significant economic presence nexus was introduced through an amendment to India's Finance Act 2018, and it became effective in April 2019. Similar to Israel's approach, India's significant economic presence is subject to the overriding effect of its tax treaties and as such applicable only to a non-resident from a non-treaty country.[330] The significant economic presence nexus creates a taxable presence for India's domestic tax purposes whether or not the non-resident has a physical presence in India.[331] The nexus is characterized by two thresholds – revenue and users. India's Finance Act did not specify a numerical threshold for its revenue or user factor requirements but stated that it would be prescribed from time to time.[332] The profit that would be taxable is that attributable to the significant economic presence. The legislation did not specify special rules that would specifically capture the unique features of a digital PE.[333] Consequently, India's significant economic presence suffers the same defect as Israel's.

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[327] Sarfo, *supra* note 93 at 3.
[328] *Ibid*.
[329] *Ibid*.
[330] OECD, *supra* note 22 at 138.
[331] *Ibid*.
[332] *Ibid*.
[333] *Ibid*.

4.1.2.3.3 The United Kingdom's approach

The United Kingdom (UK)'s first approach to tackling the challenges posed by the digitalized business is its concept of the Diverted Profit Tax (DPT). The DPT, also known as the "Google Tax" was enacted pursuant to the UK Finance Act 2015.[334] The DPT applies where (i) there is a circumvention of the UK PE (avoided PE), and where (ii) profits are shifted from UK using inter-group arrangements that results in excess deduction in UK, especially in situations where the UK finds that the arrangement is devoid of economic substance.[335] In the avoided PE situation, the DPT is triggered if a UK non-resident carrying on business in UK earns profit from UK activities which is diverted by avoiding the existence of a PE.[336] Although the DPT's wide application has the potential to capture the profits of digitalized businesses that generate income in UK without having a taxable physical presence, it is essentially designed more as a tax avoidance mechanism aimed at recapturing profit that would have accrued to UK had the corporation not avoided PE status. Consequently, the DPT does not appropriately address the more specific controversy regarding allocation of taxing right to user jurisdictions.

Following the global tension and agitation for allocation of taxing rights, the UK made clear its intention introduce a UK DST in April 2020. The proposal was motivated by the perceived need to have digitalized businesses pay taxes for value derived from UK. Like the EC's proposal, the UK DST proposal is an interim measure which would be terminated when a global consensus is reached at the OECD level.[337] According to U.K. Chancellor of the Exchequer Philip Hammond, "progress is painfully slow" at the OECD level, hence the need for UK to adopt an interim measure.[338] According to a summarized version of the UK's Budget 2018, it is expected that the DST will raise about GBP 1.5 billion over four

[334] Uslu, *supra* note 6 at 11.
[335] Burchner, *supra* note 307.
[336] Uslu, *supra* note 6 at 13.
[337] Stephanie Soong Johnston, "U.K. Goes It Alone With Digital Tax Pending OECD Solution", *Tax Anal* (2018) 1 at 1.
[338] *Ibid*.

years and also "ensure digital businesses pay tax in the UK that reflects the value they derive from UK users".[339]

The UK's proposed DST is somewhat different from the EC's DST. The UK intends to impose a 2% DST on revenues of (i) search engines that generate revenue from displaying advertisements against information derived from online searches of UK users, (ii) social media platforms that generate revenue from advertisements targeted at UK users, and (iii) online marketplaces that earn commissions from sales facilitated by user transactions.[340] According to the budget, the UK's ring-fencing of the aforenoted businesses is based on the perception that these businesses derive significant value from user participation. To ensure that online sales that do not necessarily derive value from UK users are not taxed under the DST, the UK specifically noted that the DST will not apply to general online advertising or collection of data unless they are within the aforenoted business models. [341]

The taxable person under the UK proposal has the same structure as the EC's proposal but has some slight differences. Under the UK DST proposal, a digitalized business that performs any of the businesses mentioned above (i.e. search engines, social media platforms and online market places), becomes taxable in the UK if it has a revenue from the businesses that generate at least GBP 500 million. To ensure that start-ups are not captured, the UK DST will not consider the first GBP 25 million of UK revenue as chargeable.[342] Although not explicitly stated, it appears that the revenue that will suffer UK DST would be the that derived from the UK users. The UK DST will also have as a peculiar feature, a safe habour provision that allows business to elect to calculate their DST on an alternative basis so that loss making businesses would be excluded from DST lability while businesses with low profit margin will pay DST at a reduced rate.[343] The UK proposal also

[339] Tax Analysts, "U.K. Issues Digital Services Tax Brief", *Tax Notes Doc Serv* (2018), online: <https://s3.amazonaws.com/pdfs.taxnotes.com/2018/2018-42811_WTDDocs_UK1029BudDST.pdf> at 1.
[340] Burchner, *supra* note 307 at 323.
[341] Tax Analysts, *supra* note 332 at 1.
[342] *Ibid* at 2; Burchner, *supra* note 307 at 323.
[343] Tax Analysts, *supra* note 332 at 2; Burchner, *supra* note 307 at 323–324.

indicated that the DST will be deductible in computing UK corporate income tax, but would not be creditable against it.[344]

As expected, the UK DST proposal raised concern among many commentators. Burchner notes that interaction between UK's DST and other domestic taxes in the UK such as the UK's income tax on offshore receipts from intangible property would occasion multiple taxation on the same revenue unless they are carefully reviewed and harmonized.[345] Glyn Fullelove, Chair of the Chartered Institute of Taxation Committee raised the concern that it may be practically difficult to identify revenues that would be attributable to UK users.[346] Others criticized the tax for targeting digital companies which has the possible consequence of discouraging investments in the UK economy.[347] Accordingly, commentators, whilst hoping that a global solution is achieved before the UK DST comes in force in 2020, cautioned the UK to exercise restraint in implementing its DST.[348]

4.1.2.3.4 Austrian Digital Tax 2020

Just like France, Austria was unhappy with the failure of the EC's DST and consequently set out its own DST proposal which would take effect in 2020.[349] The Austrian DST proposal retained some of the features of the EC's DST but differed in many areas. Similar to the EC DST proposal, the Austrian DST would be payable on revenue. However, the Austrian DST is peculiar in the sense that only online advertising services rendered by online advertising service providers in Austria would be liable to pay DST.[350] According to Mayr, the decision to tax only online advertisement services reflects Austria's practice of imposing tax on "traditional" advertising services dating back to the year 2000.[351] Section 1(2) of the Digital Tax Act 2020 defines online advertising to be advertising placed

[344] Tax Analysts, *supra* note 332 at 2; Burchner, *supra* note 307 at 324.
[345] Burchner, *supra* note 307 at 324.
[346] Johnston, *supra* note 330 at 3.
[347] *Ibid* at 2.
[348] *Ibid*; Burchner, *supra* note 307 at 324.
[349] Burchner, *supra* note 307 at 351.
[350] Gunter Mayr, "New Digital Business Tax on Online Advertising in Austria" (2019) 59:7 Eur Tax 350.
[351] *Ibid* at 351.

on a digital interface including - banner advertising, search-engine advertising and comparable advertising services.[352]

The Austrian DST is a 5% tax imposed on entities that have a worldwide revenue of at least EUR 750 million, and at least EUR 25 million of revenue derived from online advertisement services in Austria.[353] In addition to meeting this threshold, to be taxable under the Austrian DST, the entity must also be an online service provider – i.e. a business entity that provide online services for consideration.[354] The online advertising service provider may render the taxable advertising service directly or merely be acting as an intermediary in the provision of the service.[355]

In the same design as the EC's model, users constitute the relevant nexus for the Austrian DST. Thus, for the Austrian DST tax to apply, the online advertising service must be directed at Austrian users.[356] A user is a legal person using a device by which they access a digital interface.[357] The Austrian DST is administered by way of self-assessment by the taxable online service provider. The taxable online advertising service provider is expected to file annual returns indicating online advertising services directed at Austrian users and remuneration paid with respect to the services.

4.1.2.3.5 Spain's Tax on Certain Digital Services

Following the increased pressure on governments to design rules for effective taxation of digitalized businesses, the Spanish government issued a draft bill named "Tax on Certain Digital Services" which sought to tax specific digitalized businesses pending global consensus on the issue.[358] The draft bill was issued on 23 October 2018, and approved by the Spanish Council of Ministers on 18 January 2019. In line with Spanish laws, the draft

[352] *Ibid*.
[353] *Ibid*.
[354] *Ibid*.
[355] *Ibid* at 352.
[356] *Ibid*.
[357] *Ibid*.
[358] Francisco Correa, "The Spanish Digital Services Tax: A paradigm for the Base Enlargement & Profit Attraction (BEPA) Plan for the Digitalized Economy" (2019) 59:7 Eur Tax 341 at 346–347.

would need to be approved by the Spanish Parliament and will become law 3 months after the approval.[359]

Similar to the OECD and EC rules, the Spanish DST was premised on the principle that users in Spain create value for digitalized corporations which value is not subject to taxation because of the lack of presence of these corporations. The Spanish DST was designed based on the EC's DST proposal and has very identical provisions as the proposal.[360] Some of the key provisions as well as the comments regarding the provisions are set out below.

The Spanish DST imposes a 3% tax on revenues generated from specific digitalized businesses all characterized by their provision of a "digital interface" which are accessed and used by consumers in Spain. Specifically, Article 4.5 of the draft bill defines "digital interface" as "any software, including a website or a part thereof and applications, including mobile applications, accessible by users".[361] The specific businesses targeted are: online advertising services, online intermediation service, and transmission of user data.[362] The three services have the same meaning as explained in the EC's DST proposal. However not all digitalized corporations that offer the aforementioned service would be liable to the Spanish DST. To be a taxable person within the meaning of the term in the draft bill, it is expected that the corporation would have a total worldwide revenue of more than EUR 750,000,000 and annual taxable revenue in Spain of more than EUR 3,000,000.[363] Interestingly, this is a lower threshold than the EC's threshold of EUR 50,000,000; apparently an attempt to capture more businesses within Spain's tax net.

Similar to the EC's proposal, the relevant connection for being liable to pay the DST is availability of users in Spain. For all cases, the physical location of the corporation

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[359] Jaume Perello & Florention carreno, "Spain - Plans Regarding Digital Taxes" (2019) 26:2 Int Transf Pricing J 151 at 151.
[360] *Ibid*. Correa, *supra* note 351 at 347.
[361] Perello & carreno, *supra* note 352 at 152.
[362] *Ibid*; Correa, *supra* note 351 at 347.
[363] Perello & carreno, *supra* note 352 at 153.

rendering the service is immaterial. Just like the EC's model, the relevant nexus is the existence of users in Spain that access the services through a digital interface. Thus, for online advertising, the Spanish DST would be payable to Spain if the user's device is located in Spain. For multi-side social networks, the nexus is that: (i) underlying transactions are made using a device located in Spain, or (ii) where there is no underlying transaction, it suffices if the user's account, through which the digital services is accessed was created in Spain. For sale of data, the nexus is whether the data so transmitted was generated by a user in Spain on the digital interface provided by the corporation.[364]

When a taxable person performs taxable services linked to users in Spain, the revenue allocable to Spain (i.e. Spain's tax base) would be determined on a proportional basis having regards to the corporation's worldwide revenue and: (i) the number of times advertising appears on a device located in Spain, (ii) the number of users located in Spain and total number of users involved in the transfer of goods and services on the digital platform, (iii) the amount of revenue obtained from users that opened their accounts in Spain, and (iv) the number of user data that was generated by users in Spain.[365] The proposal failed to identify how these figures would be determined especially given that the information for its determination is within the sole custody of the targeted corporations. In recognition of this challenge, Article 10.3 of the Draft stated that if the tax base in Spain cannot be determined, the taxpayers must calculate same based on "informed criteria". As noted by Perello & Carreno, what would constitute informed criteria was not explained in the draft.[366]

For enforcement, the Spanish DST adopted a carrot and stick approach. Just like the EC model, the Spanish draft relies on the taxpayer for enforcement of the DST by requiring taxpayers to identify as a taxable person in Spain and register in the Spanish tax registry, and other similar obligations. If the taxpayer fails to "introduce effective mechanism that identify the location of users in Spain, then the taxpayer will be liable to a penalty of 0.5%

[364] *Ibid* at 152.
[365] *Ibid* at 153.
[366] *Ibid*.

of the net turnover of the taxable person in a calendar year, with a minimum of EUR 15,000 and a maximum of EUR 400,000.[367]

The comments on Spain's DST reflects some of the views that that have already been highlighted in this paper. Perello & Carreno argued that the designation by Spain of its DST as an indirect tax is inconsistent with the core meaning of the tax. According to the commentators, although the tax targets a certain category of services and targeting certain services is one of the main indicators of indirect tax, the burden of the DST is borne by the digital taxpayers and not the users.[368] Correa, as well as Perello & Carreno observed that the administrative cost of implementing the Spanish tax would outweigh any revenue gain that would otherwise accrue to the Spanish government.[369] These commentators also noted that the Spanish DST would occasion multiple taxation of the targeted businesses leading to economic distortions.[370] Further, on the economic distortions that could arise from the tax especially in the context of online advertisement, Correa noted that the tax would have a "cascading effect that will end with the tax burden being shifted to the final consumer. This will cause a competitive disadvantage for user of the digital interface (the SME), which would have to sell its product at a higher price that can be offered by the company that owns the digital platform, which would have an unquestionable effect on competition and competitiveness".[371] Perello & Carreno condemned the DST's allocation rule arguing that the mere existence of a device in Spain does not equate income or revenue for the targeted taxpayer.[372] In the present author's opinion, this point can also be extended to include the argument that mere existence of user device does not equate value for the targeted service provider.

In summary, the Spanish DST suffers from all the defects identified regarding the EC's DST. It is not clear if these concerns would be addressed or if they can even be addressed before the bill is passed into law. Further, it remains to be seen how the Spanish government

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[367] *Ibid*.
[368] *Ibid* at 151.
[369] Correa, *supra* note 351 at 348; Perello & carreno, *supra* note 352 at 154.
[370] Correa, *supra* note 351 at 346; Perello & carreno, *supra* note 352 at 154.
[371] Correa, *supra* note 351 at 347.
[372] Perello & carreno, *supra* note 352 at 153.

can apply this tax (if and when the law is eventually passed into law) given that the DST is likely to be a violation of the government's existing tax treaties.

4.1.2.3.6 The French DST

France's DST is one of the most recent attempts at taxing digitalized businesses. The French Senate approved the bill for a digital tax commonly known as GAFA (Google, Amazon, Facebook and Apple) tax on July 11 2019[373], and the bill was effectively signed into law by the French President Emmanuel Macron on July 24, 2019.[374] Although signed into law in July, the bill applies retrospectively from 1 January 2019.[375] Just like the Austrian DST, the French DST was motivated by the failure of the EC's DST proposal. Accordingly, the French government expressed its commitment to terminate the tax when a global solution is reached on the appropriate measures for taxing digitalized businesses.[376]

Just like other DSTs discussed earlier, the French DST is a modified model of the EC's DST proposal. It imposes a 3% tax on the revenue of corporations that render two categories of services. These are: (i) provision of a digital interactive platform that allows users to interact amongst each other "including for the delivery of goods or services directly between those users", and (ii) sale of advertising space on a digital interface to online advertisers for the purpose of displaying targeted advertisements to French users, based on data provided by users on the digital interface.[377] The DST applies to companies with a worldwide annual revenue of EUR 750 million and EUR 25 million of France generated revenue.[378] In line with the EC's proposal, the French DST is premised on a link between

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[373] Teri Sprackland & Stephanie Soong Johnston, "French Senate Passes DST Despite U.S. Tariff Threats", *Tax Notes Int* (2019), online: <https://www.taxnotes.com/tax-notes-international/digital-economy/french-senate-passes-dst-despite-us-tariff-threats/2019/07/15/29qm1?highlight=Digital%20tax> at 243.
[374] Stephanie Soong Johnston, "Trump Uncorks Trouble for France Over Digital Services Tax", *Tax Anal* (2019), online: <https://www.taxnotes.com/tax-notes-today-international/digital-economy/trump-uncorks-trouble-france-over-digital-services-tax/2019/07/29/29sbb?highlight=FRench%20DST>.
[375] Sprackland & Soong Johnston, *supra* note 366 at 243.
[376] Soong Johnston, *supra* note 367.
[377] EY, "French Government submits draft bill on digital services tax to Council of Ministers", *EY Glob Tax Alert* (2018), online: <https://www.ey.com/gl/en/services/tax/international-tax/alert--french-government-submits-draft-bill-on-digital-services-tax-to-council-of-ministers>.
[378] *Ibid*. Sprackland & Soong Johnston, *supra* note 366 at 243.

the revenue of the taxable corporation and value contributed by users. Thus, the French DST provides that the taxable services would be deemed to have been rendered in France if (i) for multi-sided interactive networks the user concluding the transaction on the digital platform is located in France or the account of the users were opened in France, and (ii) for advertising services, the data available to the advertising corporation is data of a user in France, or the advertising services was displayed to users in France.[379] The revenue attributable to France is the proportion of the worldwide revenue from the corporations taxable services that are derived from French user, determined by a percentage that is based on the location of users in France and number of accounts opened in France.[380]

The French administrative mechanism is somewhat different and unique. The new French Law provides that the DST would be administered in the same manner as its value added tax. Specifically, the law in France regarding compliances with VAT requires taxable persons to make two advance payments which must cumulatively be at least equal to the amount of tax paid in the preceding fiscal period.[381] The French DST law provides for an exception to this process by leaving it optional to corporations to elect to file a single group wide tax return.[382]

The French DST received significant backlash from the United States of America which claims that the tax is discriminatory because it specifically targets United States corporations. The United States' displeasure with the French DST was very evident from the message posted on Twitter by the president of the United State; President Donald Trump stating that "France just put a digital tax on our great American technology companies. If anybody taxes them, it should be their home Country, the USA".[383] The United States responded to the French DST by investigating the DST to "determine if it is discriminatory or unreasonable and burdens or restricts United States commerce" under section 301 of the Trade Act of 1974. As part of the investigation, the United States

[379] EY, *supra* note 370.
[380] *Ibid*.
[381] *Ibid*.
[382] *Ibid*.
[383] Soong Johnston, *supra* note 367.

proposes to hold a public hearing on August 19.[384] There are also indications that the United States might activate some of the domestic anti-discriminatory tax provisions in its Inland Revenue Code (IRC). It was reported that the Senate Committee Chair; Chuck Grassley and another ranking member of the Senate; Ron Wyden advised the United States Treasury to activate section 891 of the IRC, which allows the United States to impose a double tax rate on corporations of countries that impose discriminatory taxes on United States corporations.[385] It is not clear which way the United States would go. It is very likely that the United States would attempt to send a message of its stance against unilateral taxes by fighting back the French DST, with the best tools in its arsenal, including trade restrictions and tariffs.

4.2 **Concluding comments**

It has become apparent that the clamour for a digital tax have only two possible endings. The first possible ending is a global solution fostered by the OECD's programme of work. The second possible solution is a variety of domestic DST statutes, and possibly, a harmonized DST for the EU member states. The author agrees with the view that DSTs is not the best solution for a number of reasons. First, the designation of the tax as an indirect tax which is outside the application of tax treaties would lead to unpredictable challenges, and of course, multiple taxes on the same income stream. Further, there is the unsavoury possibility that the DSTs would trigger retaliatory responses, just like the kind currently going on between France and United States. The inevitable consequence may include restriction in trade, which would effectively hamper global economic growth. The OECD reaching global solution may therefore be the best way out. This is an optimistic view given the significant issues and dissent that have been raised regarding the OECD's proposals. But there is even a more difficult question that is still being taken for granted: how much consensus is required for the OECD's project to be considered successful?

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[384] Sprackland & Soong Johnston, *supra* note 366 at 243.
[385] *Ibid*.

5 CONCLUSION

The digitalized economy has a posed significant challenge to the existing traditional rules for allocating taxing rights. A combination of the physical and tangible nature of the PE concept, and the ability of digitalized businesses to operate without a tangible presence, has limited the taxable income available over the years to source countries. This concern did not start with the OECD BEPS project. As noted in the earlier part of this work, the concern to tax online activities dates as far back as the 20th century as a result of which the OECD introduced the Server PE concept. The Serve PE introduced by the OECD following its Ottawa Taxation Framework did not solve the problems of digitalization because it maintained the physical character of the nexus for source-based taxation. Consequently, when the chance presented itself again in the OECD's BEPS project, aggrieved governments and stakeholders reactivated the push for a change in the status quo. Although the OEC's BEPS project did not start off to correct the perceived unfairness with the existing principles for allocation of taxing rights, it presented a platform for conversations on this point. To address these issues, the OECD is working on a number of proposals which would be the basis of a global consensus on these concerns.

The OECD's proposal has been very controversial. In the author's view, introducing new and undefined concepts as justification for seeking reallocation of taxing rights has not been helpful to the OECD's project in this area. Particularly, the idea that allocating taxing right based on value creation does not seem to have a sound basis when one considers the historical evolution of the PE concept. It therefore does not come as a surprise that almost 6 years after the introduction of OECD's Action 1 project, the concept has remained undefined and subject to speculations. The OECD's objective may have suffered less attack if was direct in its goals; which is mostly realigning taxing rights based on the principle of ability to pay. The EU's projects was very explicit on these objectives and perhaps this objective would have been a more determinable policy rationale and may have saved some time in the OECD's project.

There is an interesting contradiction in the OECD's plans for reallocating taxing right. The OECD set out with the intention not to "ring-fence" the digitalized economy, but at the same time recognized that features of digitalized businesses cannot be accurately captured by existing international tax framework. In other words, the OECD seem to be saying: the rules are not good enough, but we don't want to develop new rules that are inconsistent with existing principles. In the author's view, this contradiction is a result of the dilemma being faced by the OECD. The OECD is in a really difficult position because it is faced with two strong competing interests. On the one hand, there are jurisdictions who have benefitted and still benefit from the existing principles, and on the other hand, there are countries that believe they have gotten the shorter end of the stick. Additionally, as evident in some of the comments noted earlier, there is a tension between the ideal of ensuring fair taxation; taxation based on an ability to pay and ensuring tax neutrality and administrative efficiency. As noted by Sapirie, achieving these ideals simultaneously is impossible and the goal should be to achieve a reasonable balance of the objectives.[386]

In the author's opinion, balancing the above competing interests and policy objectives pose a real challenge to OECD's ability to gain global consensus. Indeed, when one looks at the events that has transpired so far, it becomes very doubtful if global consensus can ever be reached on the issues. This doubt is evident in the fact that countries have decided to take interim unilateral measures, which means that the OECD may be faced with one option: develop rules that will allocate more taxing rights to market jurisdictions. It will be interesting to see how the OECD would achieve consensus and how things would play out in the international tax law realm in the coming months.

[386] Sapirie, *supra* note 11 at 3.

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