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1 Introduction

1.1 The Subject and Problem

Digital infrastructure is used by some of the fastest growing companies of the 21st century to reach their customers. Digitalization has made cross border trade become easier, cheaper and faster and is a key factor in the evolvement towards a global economy. The electronic aspects of the economy are becoming more and more important, and the market share of electronic commerce is growing at the expense of more traditional businesses. The digital economy is indeed becoming the economy itself.\(^1\)

A main characteristic of the digital economy is the reduced necessity of physical presence in the markets where enterprises operate. At the same time, physical presence is a requirement for taxation in foreign states. This puts significant pressure on how we approach taxation of multinational enterprises operating in multiple markets. It also challenges tax authorities to create innovative solutions when it comes to levying tax upon an increasing amount of digital transactions.

During the last decade, the largest economies have showed an increased interest in how digital business models are able to derive significant revenue, but at the same time being elusive to income tax in the jurisdictions where they are present. International focus was put on big multinational enterprises that would structure their business operations in a way that leaves little revenue to be taxed in the market economies from which they derive substantial profits. Consequently, market jurisdictions suffer a “lost tax revenue” from such transactions. New digital business models were considered part of the problem.

Recognizing the importance of being able to tax the digital economy on an equal footing to traditional business models, work started on building a framework that enables states to collect this “lost revenue”. Amongst other measures, it was suggested to alter the Permanent Establishment (PE)-definition in the OECD Model Tax Convention.

In the start of working on this project, my plan was to determine whether the permanent establishment concept would be suited to tackle the challenges posed by the digital economy. After some time, it became obvious that this was not the case. I had to change my perspective from

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\(^1\) BEPS Action 1 (2015), p. 11
asking whether the PE would be applicable to digital business models, to simply stating the fact that it isn’t and subsequently explain why.

I had also planned to have this thesis focus mainly on how the BEPS project undertaken by the OECD was going to solve these issues and revitalize the permanent establishment. After some work, I discovered that the current BEPS actions will only tackle part of the problem, and cannot be considered the final and permanent solution to international taxation of digital business operations.

This gives rise to a number of interesting questions. How should international tax law frameworks be designed in order to better relate to the economic reality of today? I had to broaden my perspective by digging deeper into the issue and see if I could find other possible measures that could be undertaken to successfully handle the difficult task of establishing a solid and holistic framework for taxation of digital business models. Luckily, a number of theories and approaches have been developed on the subject. I made it my mission to gather various theories and analyse them in an international tax perspective. I also wanted to try to use my knowledge from working with this material to give my recommendation on which approach I find to be the most likely to succeed.

The thesis focuses on presenting the problems caused when tax development and technological development is moving forward at different rates. It will emphasize how and why the traditional nexus approach to taxing business profits is outdated in the digital economy. The questions that will be asked are: To what extent will the proposed changes to OECD MTC article 5 in lieu of the BEPS project be able to tackle the issue presented by the digital economy? Are there other viable solutions that might be able to sufficiently address the challenges of the digital economy? Is the PE-concept still a viable solution to determine the right to source taxation in the digital age?

1.2 Delimitation

This thesis focuses mainly on the way digital business models are able to avoid corporate income taxation in markets where they operate, and what can be done to mitigate this situation. The paper will focus on the challenges tied to designing a nexus approach for source taxation in the digital era. However, this paper cannot be interpreted as trying to give an exhaustive representation of this subject. There are relevant aspects to this subject that cannot be included in a paper like this due to its limited magnitude.
The BEPS project consists of many actions to be taken in relation to digital economy taxation. Discussing all of the proposed changes to the OECD Model Tax Convention in relation to the digital economy could easily result in an analysis too shallow. The main focus in this aspect will be on the changes proposed to article 5 of the MTC. Therefore, none of the other proposed changes to the model tax convention will be discussed in any further detail than what is necessary to understand the changes to article 5.

The main PE provision of OECD model tax convention article 5 (1) will not be addressed in greater detail than necessary in order to comprehend the function of the PE concept in a digital perspective and the proposed changes to article 5 (4), (5) and (6).

The thesis will address problems tied to direct tax only, leaving no space to address issues tied to indirect taxation. Even though a substantial part of securing taxation rights on the profits of digital businesses involve the use of indirect taxes and changes to the transfer pricing principles governing the allocation of profits, this will not be discussed in this thesis. Transfer pricing policies will only be mentioned to the extent that it sheds light on the assessment of the different approaches to digital taxation.

1.3 Fundamental Principles and Concepts

In order to better understand the main discussions and conclusions of this thesis, some fundamental principles and concepts of international taxation should be briefly explained.

1.3.1 Principle of Tax Sovereignty
The fact that a state is sovereign entails that it is independent from other states, and have the power of jurisdiction in their territory. Thus, it has the power to create and enforce legislation therein. This includes the right to impose taxes. States may refrain from exercising this right through international agreements. Through double tax conventions, a state can agree not to tax certain income streams even though they would initially be entitled to do so.

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3 Ibid.
1.3.2 Source Taxation and Resident Taxation
“The resident state” refers to the state where the enterprise is considered resident. Typically, the state will tax the resident enterprises on their global income, regardless of whether the income is derived domestically or from abroad.

The “source” or “market” state or jurisdiction refers to the state in which an enterprise operates in and derives profits from, but is not its state of residency.

1.3.3 Double Taxation
Double taxation is the result of overlapping tax claims between two or more states. For instance, both the source state and the resident state wishes to tax the income. Even though customary international law does not prohibit double taxation, states will generally seek to avoid it through double tax conventions. Double taxation could constitute an impediment to cross border trade.

1.3.4 Ability-to-Pay Principle
This principle indicates that a taxpayer should not be imposed more tax burdens than it has the capacity to pay. In corporate income taxation, the ability-to-pay principle is illustrated for instance in the way the taxpayers normally get to deduct its expenses before paying tax on its income. That way the enterprise will not be taxed in excess of its net profits.

1.3.5 The Benefit Theory of Taxation
This theory refers to the idea that taxpayers who benefit from the use of public services, should contribute to the financing of such services. The use of infrastructure such as roads, healthcare, security etc. is important for taxpayers in a state. Financial infrastructure, such as a well-functioning fiscal system is also a fundamental part of creating a successful economy where taxpayers can prosper.

4 Monsenego (2011), p. 61
5 Ibid., p. 49
1.4 **Methodology and Sources of Law**

The research of this thesis is made on the basis of both literature and relevant sources of international law.

The search for various normative frameworks that could function as a substitute to the PE-concept is based on the solutions proposed by different tax professionals and authorities in literature, such as articles, books and other publications. Thus, literature will be an important source for the research of this thesis.

In order to give an overview of current and proposed tax treaty provisions, the OECD MTC and its commentary will be of importance. The OECD MTC is not an actual treaty itself. It merely serves as a template for the design of bilateral tax treaties. Most tax treaties between developed countries follow the general pattern of the OECD MTC, and its contents is very relevant when discussing international tax law.

The commentary to the OECD MTC will be used in order to interpret the various provisions relevant to the subject of this thesis. The commentary provides a further explanation on the contents of the treaty provisions of the MTC, and is thus an important tool to facilitate the common interpretation of the treaty provisions. The status of the commentary according to the Vienna Convention on the Law of Treaties has been somewhat controversial. For the purpose of this thesis, I consider it sufficient to state that I agree with Vogel in that the commentary constitutes the “special meaning” of the treaty provisions within the meaning of VCLT article 31 (4). Thus, the commentary (and proposed amendments to the commentary) will be considered to be of significant importance when interpreting the various treaty provisions in this thesis.

1.5 **Outline**

In the following, the thesis will be split into four parts. In chapter 2, I will elaborate on the key issue concerning the “fixed-place”-PE and why it does not serve as a good framework for business profit taxation in the digital economy. In chapter 3, different possible solutions and approaches to solving the issue of digital taxation will be presented, including the measures suggested in BEPS Action 7. Chapter 4 will contain my assessment on the different approaches,

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6 Vogel (1997), p. 44, VCLT Article 31 (4)
while in chapter 5, I will conclude on my findings and provide a possible solution for a concept that could take international business taxation into the 21\textsuperscript{st} century.
2 Why the Traditional Permanent Establishment is Outdated When it Comes to Digital Business Taxation

2.1 The Key Problem, in Short Terms

The PE concept is a nexus threshold rule for determining the right of a state to tax the business profits of an enterprise that is not a resident of the state.\textsuperscript{7} Under the current PE provisions, it is a minimum criterion that the enterprise maintains a certain level of physical presence in the foreign state. If no PE exists, the business profits of the enterprise will be taxed only in the state where the enterprise has its tax residency.

Over the course of the last 30 years, developments within information and communications technology has allowed enterprises to derive substantial profits from the territory of a foreign state without having to maintain physical presence therein. The consequence is that the source state misses out on substantial amounts of tax revenue that they feel entitled to and the equality between traditional and digital business models is put under significant pressure.

It has long been a recognised fact that the possibilities created by ICT-developments could give rise to enterprises being able to have extensive involvement in the economy of another state without having to maintain a physical presence therein.\textsuperscript{8} This chapter seeks to give an overview on the fundamental reasons why the current PE concept is an unfit system for the taxation of digital businesses.

2.2 Introduction to the Digital Economy

The concept of digital economy sometimes goes under the name “electronic commerce” or “e-commerce”. E-commerce could be described as “doing business over the internet”.\textsuperscript{9} The definition could also include any commercial act that involves some use of electronic communication or information exercise, like a fax machine or a telephone.\textsuperscript{10} The focus of this thesis will

\textsuperscript{7} Dos Santos and Mota Lopes (2016), p. 296
\textsuperscript{9} Basu (2001), no. 1
\textsuperscript{10} Ibid.
be business models making use of the internet in their operations. The key characteristics of such business models will be further elaborated on below.

2.2.1 Key Characteristics of Digital Business Models

2.2.1.1 Mobility

Digital business models enjoy increased mobility of their business functions, assets, consumers and operations. Rights to software and other intangibles are easily transported to an associated enterprise situated in a low-tax jurisdiction. The right to derive profits from such intangibles can thus be separated from the activities that resulted in their value.\(^\text{11}\)

Consumers are also mobile. They can carry on commercial activity while on the road, using internet connected mobile devices. Additionally, the increased possibilities of communication enable digital businesses to manage and administrate complex business functions from remote locations. This reduces their need for expensive branch offices, legal entities and local staff.\(^\text{12}\)

2.2.1.2 Reliance of Data and User Participation

Many digital businesses rely heavily on the collection of data. The data is collected from users, customers and suppliers around the world and is subsequently used to improve their products or service and customize marketing. The information could also be sold to interested third parties.\(^\text{13}\)

The data gathering could be executed by using online forms, observations, recording of internet browsing history and preferences or by tracking geographical data. The data would then be combined and processed to get the most precise result. The analysis and possession of data could create huge value.\(^\text{14}\)

2.2.1.3 Network Effects

Network effects refer to the situation where “decisions of users may have direct impact on the benefit received by others”.\(^\text{15}\) By way of example, take YouTube. Videos produced and uploaded by other users increase the variety of the selection of videos available to other users. The more user contribution, the more attractive the service becomes. Another example is a social

\(^{11}\) BEPS Action 1 (2015), p. 65
\(^{12}\) Ibid., pp. 65-68
\(^{13}\) Ibid., p. 68
\(^{14}\) Ibid.
\(^{15}\) Ibid., p. 70
media. It is the nature of a social media that the more users a platform has, the better the platform will be for other users.

2.2.1.4 Multi-sided Business Models
A technology platform where two groups of users meet is characterized by the OECD as a multi-sided business model.\textsuperscript{16} Technological devices of today generally allow users or third parties to develop content for the devices produced by an enterprise (like apps for an iPhone or an Android device).\textsuperscript{17} The platform allows the producers of software and content to reach users. Due to network effects, more content benefits users which in turn benefits the enterprise. The content provided by one user, provides a positive externality for the rest of the users and vice versa.

2.2.1.5 Tendency Towards Monopoly and Oligopoly
Users tend to prefer to use one single provider for services in the similar category.\textsuperscript{18} Network effects often cause consumers to want to use the services that have already been made popular by other users. This often results in the market being dominated by a few large service providers, such as Google, Facebook, Amazon etc. These enterprises use their dominating market position to develop new technology or acquire start-ups in order to stay ahead of potential competitors. Such enterprises might also purchase control over other tech-enterprises in other segments due to the synergic effects they might achieve.

2.2.1.6 Volatility
Despite the tendency towards monopoly and oligopoly, tech-markets are surprisingly volatile.\textsuperscript{19} This means that the value of a company can rapidly increase or decrease due to the discovery of new technology or change in consumer habits. Due to low prices on computer technology and easy access to the network, creative ideas can be turned into marketable products in relatively high speed. Enterprises situated in a dominating position in the market, may thus experience rapid loss of market share due to the emergence of competitive technology. This makes preserving a dominating market position harder, and usually results in innovative ideas and start-ups being acquired by larger market actors.

\textsuperscript{16} BEPS Action 1 (2015), p. 71
\textsuperscript{17} Ibid.
\textsuperscript{18} Ibid., p. 73
\textsuperscript{19} Ibid., p. 73
2.3 Value Creation in the Digital Economy

As is highlighted in chapter 2.2, there is no doubt that a huge portion of the value created by digital enterprises is based on the creative ideas and innovations leading to marketable technology. Research and development is a huge value driver. The immaterial property, brands, web-pages, algorithms, etc. is of significant importance to the large digital market actors, such as Google, Amazon, Facebook, etc. This value could be created in a remote location to where the products are actually marketed.

Further, there can be no doubt that value is also created by user interaction. First of all, the users create the market. Without a market, the technology developed by digital enterprises would have no value. Secondly, multi-sided business models and user participation has made it possible to make a service “free” for the user, provided that the user allows information to be sent to the enterprise, or accepts to be exposed to adverts. This possibility increases the role of the user in the value creation, as opposed to more traditional business models. The possibility to monetize information and data underlines the importance of the consumer, not only as a direct customer of the enterprise, but also by the creation of a market for consumer data and online adverts.

In summary, value of digital business models is created both by the digital enterprise through research and development, immaterial property, and through the cooperation with the customers and users in the market.

2.4 Examples of Digital Business Models

2.4.1 Indirect E-commerce

This example is based on internet sales. The transaction is made by electronic means, but the good is delivered through conventional channels.

For instance, a customer in state B buys a tangible good from an enterprise resident of state A through the use of a webpage. Subsequently, the good itself is delivered from a warehouse located in state B to the customer by the use of a traditional courier service.

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20 This list and contents of this chapter is based on BEPS Action 1 (2015), p. 55, and the presentation given by Barbier (2016), pp. 52-53.

21 Barbier (2016), p. 52
This would be the operating model of digital retailers like Amazon or Alibaba.

2.4.2 Direct E-commerce
Direct e-commerce is the situation when an enterprise provides its products or services to the customer completely digitally. An example of this could be an enterprise resident in State A selling streamed media material (for instance a movie) to customers in State B. The service provided is delivered through the internet, and payment is received using a digital procedure.

This would be the operating model of digital businesses like Netflix or Apple's App-store.

2.4.3 Multi-sided Business Models
Some business models are based on the provision of free content to users, in return for the right to expose them to advertising or collection of information.

Enterprise A, resident of state A, provides a free social network service to users in state B. In return, enterprise A secures the right to use data from the users stored in cookies on the users’ computer. Using this data, Enterprise A is made capable to determine the users’ behaviour and consumer patterns. This can subsequently be used to display targeted advertisement to the individual user.

Enterprise B, resident of state B, purchases advertising space on the service provided by Enterprise A, to be displayed to only users who are located in State B and who might be interested in their products.

This would be a possible operating model for enterprises like Spotify, YouTube or Facebook.

2.5 The Current Legal Framework of the Permanent Establishment

2.5.1 The OECD Model Tax Convention Article 7
Profits derived by digital enterprises by the sale of goods, adverts, services etc will usually be considered “business profits” within the definition of the OECD MTC. The term “business
profits” is defined to be any profit that an enterprise derive and that is not income from immovable property (article 6), dividends (article 10), interest (article 11), royalties (article 12), capital gains (article 13) or income from employment (article 15).

According to the OECD MTC article 7, business profits of MNEs will be taxed solely at the state of residency, unless the business is conducted through a permanent establishment. This means that tax treaties based on the OECD MTC usually allocate the taxing right to business profits to the resident state, with the permanent establishment constituting an important exception to this rule.

2.5.2 Permanent Establishment in the Current OECD Model Tax Convention

Article 5

The PE is governed by the OECD MTC article 5. If a foreign enterprise is considered to have a PE in the state, the company will be deemed to have a tax liable branch in the state. Profits derived from the PE will be subject to CIT in the source jurisdiction, thus enabling source taxation in the market state. The dealings between the branch and the legal entity (the foreign enterprise) will be subject to transfer pricing principles.

According to provision in paragraph 1, a PE will exist if the enterprise has a “fixed place of business through which the business of an enterprise is wholly or partly carried on”.22

The term “fixed place of business” can be broken into two criteria. First, there must be a “place of business”. Secondly, this place of business must be “fixed”, both in terms of a geographical point on the map, and in terms of permanence.23 In addition to these two criterions, the business of the enterprise must also be “carried on through” the fixed place of business.

“Place of business” refers to “any premises or the presence of machinery or equipment”24 maintained by the enterprise for the purpose of carrying out its business. This includes any physical object that serves as a business activity, but is not subject to a business activity.25 For instance, a physical premises where goods are stored or displayed could be a place of business, but the goods themselves will not constitute a place of business, despite being physical objects. It does not matter whether the physical space, facilities or installations are owned by the company,

22 OECD MTC (2014), Article 5 (1)
23 OECD Commentary (2014), C5, p. 1
24 Ibid., C5, p. 2
25 Skaar (1991), p. 112
rented from somebody else or is indeed situated in the facilities of another enterprise. The important fact is that the physical space is at the disposal of the enterprise.\textsuperscript{26}

As indicated in paragraph 2, a “place of business” will typically be a place of management, a branch, an office, a factory or workshop, a mine, and oil or gas well or a quarry. All of these operations will typically be a place of business. However, for a PE to exist in these circumstances, the other criterions of paragraph 1 must also be met.\textsuperscript{27} Other examples are real property, buildings, machines, computers, ships, aircraft, drilling rigs etc. However, securities, bank accounts, patents, software and web pages do not amount to a “place of business” under the provision in article 5 (1) and (2).\textsuperscript{28}

The place of business must be “fixed” in terms of geography. This entails that there must be a connection between the place of business and a specific geographical point on the map.\textsuperscript{29} This does not necessarily mean the exact same spot, but rather a spot that exists within a certain area. By way of example, if employees of an enterprise stay at the same office hotel for a long period of time in a business capacity, it does not matter if they stay at different rooms within the office hotel. In order for the place of business to be “fixed” in terms of permanence, it must be present in the jurisdiction over a certain period of time. Thus, a fixed place will not exist within the definition of article 5 (1) if it is of a temporary character.\textsuperscript{30} The assessment of permanence must be made in the individual case, but in general the perception of six month as a guiding threshold seems to have stuck in literature and case law.\textsuperscript{31} That being said, the nature of the business performed could entail it being fixed even if it exists for a “very short period of time”.\textsuperscript{32} This would for instance be the case for operations that are seasonal in nature, or could be highly profitable even in the short term.

The business of the enterprise must be “carried on through” the fixed place of business, wholly or in part. The wording suggests that the fixed place must have actual business functions and be a part of the operations undertaken by the enterprise. According to the commentary, it is not a requirement that the business activity is of a productive character.

\begin{flushleft}
\begin{footnotesize}
\begin{enumerate}
    \item OECD Commentary (2014), C5 p. 2
    \item Skaar (2006), p. 129
    \item Skaar (1991), p. 123
    \item OECD Commentary (2014), C5 p. 4
    \item Skaar (2006), p. 153
    \item OECD Commentary (2014), C5 p. 6
\end{enumerate}
\end{footnotesize}
\end{flushleft}
2.6 The Rationale Behind the Permanent Establishment

The permanent establishment concept is based upon the idea that taking part in the economic environment and using the economic infrastructure of a state to gain profits, gives the source state a legitimate claim to tax such profits. Operations that exceed a certain amount of business activity creating value and deriving profits from markets in the state, should be taxed therein.

The nexus threshold of article 5 (1) could be viewed as a guide on how to determine if a taxable presence exists. The physical elements constitute the evidence of such presence.

Allowing an enterprise to have the benefit of access to the marked of another state without paying a reasonable tax on its profits, entails that the market state would miss out on potentially significant tax revenue that they feel entitled to.

Additionally, it would seem unjust for enterprises domestic to the market jurisdiction to possibly be subject to a more burdensome tax regime than foreigners. This would impede competition between domestic and foreign enterprises (to the benefit of the foreigner), which in turn could hurt the domestic economy of the market state.

2.7 Why the Current PE Struggles to Deal with Digital Business Models

Recalling that physical presence is a requirement for source tax on business profits in the market state, this chapter will go into further detail on why this circumstance renders the current PE concept obsolete. I will emphasize on whether the application of a “fixed place”-PE to digital business models aligns with the rational and purpose that the PE is based on. The chapter will also address and reveal why the server-PE is not sufficient to create a nexus where value is created.

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2.7.1 The Physical Nexus Threshold

The current nexus threshold is of a qualitative nature. It measures the qualities of economic presence against an agreed upon standard. It is a sliding scale. The contrast would be a quantitative threshold, measuring only whether a number of circumstances are met or not, such as for instance the mere number of employees or assets, creating a more binary system.

The qualitative nexus threshold in article 5, the “fixed place”-PE, does not correspond to the qualities of the modern economy. Physical presence does no longer serve as sufficient evidence of having significant economic presence in a state.

Recalling that parts of the rationale behind the PE is that taking part in the economy of a market jurisdiction, gives that jurisdiction a legitimate claim to tax the income, it does no longer make any sense to apply a nexus rule based on physical presence alone when markets can be accessed without having a physical presence at all. The current PE threshold does not serve as a guidance on when significant economic involvement is present.

From a benefit-theory perspective, one could claim that companies enjoying the services and infrastructure of a market jurisdiction should be liable to pay for the development and maintenance of such services. Under the current PE-provisions, digital businesses do not take part in the financing of such services, even though they are also enjoying the benefits of the services and infrastructures in the source state. For instance, an internet retailer (selling physical goods cross border over the internet), needs roads in order for its goods to reach the customer in the source state. The internet retailer is benefiting from the developed infrastructure in the source state, but is not tax liable for the profits derived from it under the current “fixed-place” nexus threshold.

The qualitative nature of the current PE-threshold also causes enforcement and compliance issues. The threshold can be complicated to deal with for both tax authorities and taxpayers. Small and medium sized companies might find it difficult to expand their operations and at the same time stay compliant to international tax rules. For instance, lack of communication between the different bodies of an enterprise could lead to a company suddenly discovering that their operations in another state amount to a PE, while not initially planning for that to happen. A qualitative and hard-to-interpret PE-threshold thus induce the risk of a company having a “surprise-PE”, undermining the company’s need for predictability in relation to tax burdens.

This also goes the other way around. Tax authorities may not always have the sufficient overview of how many PEs actually exist within their jurisdiction. They might have a different opinion than the taxpayer on whether a PE exists or not, or they may lack the proper information to make the assessment.
Another perspective is that the current threshold bears no coherence to the OECD transfer pricing principles. If the goal of the permanent establishment is to create taxable presence where values are created, one would expect that the nexus would to some extent reflect the criterions of allocating profits and loss between associated parties. However, the transfer pricing guidelines do not put physical presence any special position when determining where value is created.

2.7.2 The Server as Nexus in a Digital World
A website can be accessed from just about anywhere, provided there is an adequate Internet connection. As indicated under chapter 2.5, a website itself has a non-physical existence and can never constitute a “fixed place of business” under the definition of article 5 (1).\textsuperscript{34} However, the place where the server is located is relatively easy to determine, since it has a physical location. In this chapter, I will show that the server cannot serve as an adequate tool to tax digital businesses.

A server is a device that stores information for access by users of a network (such as the internet). In short, a server is a computer.\textsuperscript{35} It could host websites, store information etc. Any digital business based on reaching its customers using webpages, would need to host the website on a server. Will the server constitute a PE, and will the server-PE be a sufficient way to tackle the issues of taxation in the digital economy?

Being a computer, the server needs to be physically present at a geographic location at any time. Thus, it is capable of meeting the physical threshold, provided that the other criterions are met.

The server will normally have definite business functions, providing contributions to the business model of the enterprise. It would not be of passive character, as it is in constant and continued use. According to the OECD Commentary on article 5, the server could constitute a PE even if no personnel is necessary to operate the server.\textsuperscript{36}

Subject to the nature of the enterprises’ business, a server could be deemed a preparatory or auxiliary measure according to the provision in article 5 (4) e). This could be the case if the

\textsuperscript{34} Skaar (2006), p. 131
\textsuperscript{35} Webopedia
\textsuperscript{36} OECD Commentary (2014), C(5) p.24
website is a mere accessory to an otherwise traditional business model. In this case, using servers to host websites purely for the purpose of communications, advertising, relaying or supplying information would normally be considered auxiliary or preparatory.\textsuperscript{37}

For instance, an enterprise providing carpeting services, could have website that displays prices and availability. The website would likely constitute an auxiliary measure under article 5 (4). In digital business models, however, it is unlikely that a server can be characterized as a mere auxiliary measure.\textsuperscript{38}

A server owned by a foreign enterprise could quite clearly meet the PE threshold of article 5. However, the server is not sufficient to deal with the challenges of taxation in the digital economy.

According to Hongler and Pistone, the server PE in the current OECD MTC leads to uncertainty and confusion. The development of smaller servers gives rise to confusion in relation to the amount of presence needed to meet the PE threshold.\textsuperscript{39} This confusion is not addressed in either the current or the proposed commentary.

Also, the server does not have to be situated in close proximity to the customer. Due to the relative ease with which a server can be placed in a remote location, for instance a low-tax-jurisdiction, the server PE would not necessarily be able to create a taxable presence in market jurisdictions where the profit arises.

Additionally, the criterions are quite easy to avoid meeting. A server can be digitally moved between different servers. A webpage could on day 1 be hosted from a server in Bermuda and on day 2 be hosted from Sweden, without any physical manifestation and without the customer even noticing. The habitual moving of the server position allows an enterprise to have server presence without ever meeting the criterion of being “fixed” in terms of permanency.

Also, the possibility of renting server capacity is becoming more and more viable, as prices have dropped due to technical development. Renting server space from a third-party enterprise would not only normally be economically feasible, but would also not result in a PE for the renting party.\textsuperscript{40}

\textsuperscript{37} OECD Commentary (2014), C(5) pp. 26-27
\textsuperscript{38} Ibid., C(5) pp. 26-27
\textsuperscript{39} Hongler and Pistone (2015), p. 12
\textsuperscript{40} OECD Commentary (2014), C(5) p. 25
There is also the question of attributing profits to a server-PE. As the attribution of profits should reflect the functions and risk assumed by the PE, it would be necessary to determine what characterizes the contribution of the server to the value chain. This may become a difficult task, as states might disagree on the value of the contribution made by a server. Should the server be characterized as a distributor, or merely a support service? In any regards, the servers’ function would probably not merit the allocation of significant parts of the company’s profits.

All things considered, the server-PE does not seem like a fitting tool to tackle the nexus issues raised by digital business models. It allows for too many opportunities for artificial avoidance and the attribution of profits will be a complicated and potentially controversial procedure. Additionally, the server is not an element sufficiently significant to be the key determining factor in whether a taxable presence exists or not.
3 Different Approaches to Digital Business Taxation

3.1 Introduction

Various different ways to tackle the challenges of international taxation in the digital economy has been put forward in recent years. Some suggestions involve more or less radical changes to the PE-concept and expanding the application of the MTC article 5. Other alternatives involve abandoning the whole idea of a nexus threshold between the market jurisdiction and the enterprise deriving profits therein.

This chapter seeks to give an overview of different ways in which the PE-concept could be altered or replaced to better cope with the economic reality of today. The OECD BEPS project proposal to change the PE provisions will be analyzed. Also, the chapter will provide for an overview of various alternative ways in which international taxation of digital business models could be successfully designed, with or without the use of a PE-concept.

3.2 The OECD BEPS Actions 1 and 7 - Proposal to Change Article 5 of the Model Tax Convention

3.2.1 The BEPS Project

Part of the mandate of the OECD involves developing tax principles to resolve different problems that may arise in cross border taxation. Their most important tool is the OECD MTC and its commentary. In June 2012, the G20 addressed the “need to prevent base erosion and profit shifting” at the G20 leaders’ summit. They invited the OECD to work on measures to address this topic.41

The OECD released a report on BEPS in early 2013,42 which has later been developed into concrete proposals for actions that can be undertaken in order to prevent base erosion and profit shifting. The final reports were released in 2015.43

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41 G20 (2012), pp. 8-9
42 OECD (2013)
3.2.2 The BEPS Project on the Digital Economy

The issues caused by international taxation in the digital economy is dealt with in BEPS Action 1. However, action 1 does merely describe the problem, and does not provide any recommendations on itself. Instead, the problems caused by the digital economy are dealt with under the other actions of the report. The rationale behind why actions concerning digital economy is not addressed separately is that electronic commerce is becoming the economy itself, and thus the digital economy cannot be “ring-fenced” from the general economy for tax purposes.44

BEPS Action 7 addresses the artificial avoidance of PE status, and contains three different categories of appropriate measures set to tackle the issue. The first measure addresses the commissionaire arrangements, the second measure addresses avoidance through specific exemptions and the third addresses the fragmentation of business activities. In the following, the different proposals will be discussed in further detail.

3.2.3 Amendments to Commissionaire Provision in Article 5 (5) and (6)

3.2.3.1 Background for the Change

A commissionaire arrangement is a business structure in which a person sells products into a state in its own name, but on behalf of a foreign enterprise (that owns the products). The agent-PE rule of article 5 (5) and (6) expands the scope of the PE provision in article 5 (1).45 It allows a PE to exist even if there is no “fixed place of business”, as required in (1). Such a PE will exist if the agent “habitually exercises” a right to conclude contracts on behalf of the foreign enterprise.46

If the intermediary does not habitually conclude the contracts on behalf of the enterprise, an agent-PE will not exist. This allows a foreign enterprise to sell its products into a state without having a taxable presence therein, as long as the intermediary never actually concludes the contract.

In a digital context, an enterprise could sell its products into a market jurisdiction using an intermediary to solicit sales and convince customers to enter into contractual relationships with the company. The order could then be sent directly to a warehouse that sends the products to

44 BEPS Action 1 (2015), p. 11
46 OECD MTC (2014), Article 5 (5)
the customer and where the contract is routinely approved by the selling enterprise, or it could be concluded directly with the selling enterprise through a webpage. Under the current article 5 (5), this operating model would not create a PE in the market state for the enterprise.

This means that a commissionaire can convince the customer to purchase from a foreign enterprise, negotiating the conditions of the contract and thus play an important part in making the sale, without creating a PE for the enterprise. The conclusion of the contract is at this stage just a formality. This shows that the conclusion of the contract is not suited to be the sole determining factor creating an agent-PE.

Since the commissionaire does not own the products, he will not gain profits from sales, but instead he will receive remuneration for his work for the enterprise. The profits from sales will thus not be taxed in the source jurisdiction. Only the remuneration received by the middle man will. This decreases the taxable base in the market jurisdiction.

3.2.3.2 The Proposed Amendment

3.2.3.2.1 Proposed Changes to Article 5 (5) – Conclusion of Contracts
As the main condition in the current OECD MTC is that a PE will exist if the commissionaire “habitually exercises” a right to conclude contracts on behalf of the foreign enterprise, the suggestion entails changing the conditions by adding the following:

A PE will exist when the person in a contracting state acts on behalf of the enterprise and:

“habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise”

The main difference is that it will no longer be a criterion that the agent habitually concludes the contract, as long as he is playing the principal role in the stages before conclusion. Habitually playing the principal role leading to conclusion, will now create a PE for the principal in the market state.

Habitually playing “the principal role leading to the conclusion of contracts” is aimed at the person convincing the third party to enter into the contract with the enterprise. This would be the person who solicits and receives orders, but does not necessarily formally finalise them. According to Medus, the phrase is aimed at the situation where the conclusion of contracts
“directly results” from the actions that an agent performs on behalf of the enterprise.\textsuperscript{49} The mere participation in negotiations is not sufficient to create an agent-PE in the market state.\textsuperscript{50}

The proposed new commentaries to the provision in article 5 (5) gives examples on the application of the new provision to digital business models. It states that where a subsidiary company takes on the task to convince customers to enter into contract with the enterprise and subsequently directs them to conclude the contract online, directly with the enterprise, they will be playing the “principal role leading to the conclusion of” that contract. Thus, the parent company will have a PE in the state of the subsidiary company.\textsuperscript{51}

The above cannot, however, be interpreted to express that a sole webpage could be considered an agent within the definition of article 5 (5). The way I interpret it, it is necessary that a physical person directs the customer to the webpage. The webpage by itself being considered an agent is not addressed by the OECD. The practical implications of such a rule would probably call for additional research.

\subsection*{3.2.3.2.2 Proposed Changes to Article 5 (6) – The Independent Agent}

The provision in article 5 (5) will not apply if the intermediary performs its business activities in the marked jurisdiction through an \textit{independent agent} and acts on behalf of the enterprise in the ordinary course of its business.\textsuperscript{52}

Under the current OECD MTC article 5 (6) an agent can be considered “independent” even if the agency is owned by the principal. As long as the role of the agent is of a character that could be deemed “independent” under the definition in article 5 (6), it does not matter whether the agent is a closely related party or not.

The proposed changes to article 5 (6) entails changing the definition of an “independent agent”. It will now be a condition for independence that the agent is not acting \textit{“exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related”}.

This excludes the possibility of an enterprise owning a subsidiary company functioning as an agent in the market state without creating a PE for the principal. This might result in companies currently using commissionaire structures to alter their operating models by selling goods into

\begin{flushleft}
\textsuperscript{49} Medus (2016), p. 13  \\
\textsuperscript{50} See Medus (2016), p. 14  \\
\textsuperscript{51} BEPS Action 7 (2015), p. 19-20  \\
\end{flushleft}
the market jurisdictions through low-risk distributors (LRDs), that take ownership of the goods before selling them on to third parties.

The assessment on independence is still made by the same criterions as before the proposed change (the amount of control exercised by the principal, risk and responsibility assumed, freedom to perform its work, etc.), and will not be further discussed in the context of this thesis. Thus, the main change made in the proposed new provision is that the possibility to be deemed “independent” while still a being a closely related enterprise is eliminated.

The measure is not targeted at subsidiary entities serving the function as low-risk distributors. These functions are not considered intermediaries, as they are the legal owners of the items before selling them on to the third party (even if just for a split second).

3.2.3.2.3 Closely Related Parties

The proposed subparagraph b) contains the definition of “a person closely related to an enterprise”. It is similar, but not identical to the term “associated enterprises” as used in article 9.

Article 5 (6) b) will provide for some situations to automatically be deemed as closely related enterprises under certain circumstances: Direct or indirect ownership of 50 % of the beneficial interests, or if a third party owns (directly or indirectly) more than 50 % of beneficial interests in both enterprises. This will be the case if for instance one person “holds, directly or indirectly, more than 50 % of the aggregate vote and value of company’s shares or of the beneficial interest in the company”.53

The definition will also include control based on other legal structures than the ownership of shares. It would also include other arrangements de facto resulting in one company reaching a level of control equal to at least 50 % of the beneficial interests (usually 50 % of the votes in the general meeting) in the enterprise.54 This situation could be reached for instance by a shareholders’ agreement.

54 Ibid.
3.2.4 Adding a “Preparatory or auxiliary” Condition to Article 5 (4)

3.2.4.1 Background for the Change
The provision in article 5 (4) a) to f) contains specific exemptions to any activity that might create a PE under paragraph 1, with the result that such activity can never create a PE. The specific exemptions are related to the “storage, display or delivery” of goods or to the collection of information. However, other activities that can be considered “of a preparatory or auxiliary character” are also exempted from creating a PE.

The listed activities would traditionally be characterized as business functions that are preparatory and auxiliary in nature. However, in digital business models, such activities may actually constitute core business functions. This change in how business is conducted nowadays, gives the possibility for digital companies to avoid creating a PE by only maintaining physical presence that is exempted from PE status according to article 5 (4).

Increased mobility of business functions has enabled enterprises to run a business from a central location, while needing only simple functions performed locally. For an online retailer, the maintenance of a local warehouse could be a large and significant function. When all the other significant sales functions are being performed online or from remote locations, the storage of goods in close proximity to the customer is of key importance. For online retailers, local storage functions should be regarded a part of the core activities of the business, justifying taxation rights in the source state. Accordingly, the activity should not be automatically exempt from source taxation.

The same can be said about the gathering of information. Recalling that information is an important value driver for digital enterprises, exempting fixed places of business with a purpose of collecting information excludes the taxation of value in the place where it is created.

3.2.4.2 The Proposed Amendment
The OECD BEPS action plan of 2015 suggests modifying article 5 (4), making the list of exempted activities subject to a “preparatory or auxiliary” condition. The most important change is that no activities will any longer be automatically exempted from achieving PE-status.

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55 OECD MTC (2014), Article 5 (4) letters a) to d)
56 Ibid., Article 5 (4) letter e)
57 BEPS Action 7 (2015), p. 10
The proposal from the OECD entails changing the wording of article 5 (4) e) and f) and adding the condition that the mentioned activities are only exempted from PE-status as long as they are actually of a "preparatory and auxiliary character".

For instance, a fixed place of business that is maintained for the storage of goods (letter a) will be subject to a test on whether it, in this specific situation, constitutes a “preparatory or auxiliary activity” to the business of the enterprise.

The new commentary indicates that an activity requiring a significant proportion of the assets or employees of the enterprise, is unlikely to be considered to have an auxiliary character. This addition probably only states what is already considered to be the contents of the term “auxiliary”. In any regards, an online retailer with a local warehouse employing a major proportion of the enterprises’ staff, would probably not avoid creating a PE in the warehouse-state due to the importance this function has for the business operating model.

3.2.5 Adding a New Anti-Fragmentation Paragraph to Article 5

3.2.5.1 Background for the Change

Article 5 (4) Subparagraph f) deals with the situation where one company operates multiple fixed places of business within the scope of a) to e). Unless the places of business are separated organisationally and in terms of location, they could be aggregated to constitute one PE, provided that the overall activity is not of a “preparatory or auxiliary character”. Article 5 (4) f) does not apply to the situation where different exempted activities are performed by different (but closely related) legal entities.

A MNE could avoid meeting the current PE threshold by splitting the functions of cohesive business operation between different legal entities. Each legal entity will maintain some degree of physical presence in the foreign state, but will claim that presence to be merely preparatory or auxiliary. Combined, however, the legal entities have significant presence enabling the group to make profits and take part in the economic life of the foreign state without being tax liable therein.

By way of example, Company X, resident in state A, manufactures and sells goods. It has a wholly controlled subsidiary in state B, Company Z. Company Z owns a pilot store where it sells and displays goods acquired from Company X. Company X owns a warehouse in state B,

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59 BEPS Action 7 (2015), p. 30
where it stores items that are subsequently sold by Company Z in the pilot store. When a customer buys an item from Company Z’s store, employees from Company Z get the item from the warehouse. Company Z becomes the owner of the item once the item has left the warehouse. The warehouse is digitally managed, automatically keeping track of stock and ordering resupply when necessary, leaving no management functions to the jurisdiction of state B (which might otherwise give rise to a PE).\textsuperscript{60}

Even though the warehouse is clearly a part of a cohesive business operation in state B, the activity taking place in the warehouse (which might be of significant importance to Company X’ profits), is not being taxed in state B. This is made possible by article 5 (4) specifically exempting the warehouse activity from creating a PE for Company X in state B.

With the possibility to use subsidiary entities to split up a cohesive business operation, and argue that each measure is auxiliary and preparatory, the possibility of artificial avoidance of subparagraph f) is present.

3.2.5.2 The Proposed Amendment
In order to prevent the circumvention of PE by splitting up functions between different group enterprises, the OECD proposes to add a new paragraph 4.1 to article 5. The amendment will provide that if closely related parties engage in business activity that, in reality, constitutes a cohesive business operation in the state, a PE could still exist, even if the individual activity of each legal entity arguably only constitutes an “auxiliary or preparatory” measure.

According to the proposed new commentary to the OECD MTC, the term “closely related parties” of paragraph 4.1 is the same as is defined in the proposed paragraph 6, subparagraph b), see chapter 3.1.3.2.3.

Applied to the situation described above (see 3.1.5.1), the aggregated operations of both enterprises X and Z would have to be assessed to see if the entire operation could be considered “preparatory or auxiliary” according to article 5 (4). Since the operation likely will be considered geographically or economically coherent, Company X will create a PE in state B under the proposed new article 5 (4.1).

\textsuperscript{60} BEPS Action 7 (2015), p. 41
3.3 Virtual Permanent Establishment

The idea of altering the Permanent Establishment concept into something more suitable for the modern economic era is not a new one. The main characteristic is that it involves adding to the traditional PE threshold by including a nexus for allowing source taxation of business profits even in the absence of a “fixed place of business”.\textsuperscript{61}

Hinnekens presented a possible addition to the PE definition in 1998. His suggestion involves adding a new definition based on digital presence as a nexus to tax profits derived from e-commerce. Hinnekens highlights that there is nothing sacred about the “fixed place”-PE, and that it could be altered or re-invented to better apply to digital business models.\textsuperscript{62} Abandoning the “fixed place of business”-test as a sole threshold for source taxation was also suggested by Skaar as early as 1991.\textsuperscript{63}

3.3.1 Task Force on the Digital Economy Suggestion in BEPS Action 1 draft – “Significant digital presence”

The development of a new nexus based on “significant digital presence” was discussed in the draft report to BEPS Action 1. The concept would involve that enterprises whose business model is fully digital and non-material would have a PE if the enterprise maintained a “significant digital presence” in the economy of a foreign state.\textsuperscript{64}

Early suggestions proposed the following elements for the significant digital presence test:

- Core business functions being digital goods or services
- No physical activities in the value chain except servers, websites, IT tools and location relevant data.
- Contracts concluded remotely via Internet or telephone
- Payments made through electronic solutions
- No physical stores, agencies etc. are used to enter into a relationship with the enterprise.
- The vast majority of profits are attributable to provision of digital goods or services
- The residence or physical location of the vendor does not influence the consumer’s decision to purchase.

\textsuperscript{61} Pinto (2003), p. 191
\textsuperscript{62} Hinnekens (1998), p. 195, Concurring, see Monsenego (2011), p. 58
\textsuperscript{63} Skaar (1991), p. 573
\textsuperscript{64} BEPS Action 1 Discussion Draft (2014), p. 65
- The use of the digital good or service does not require physical presence or the involvement of a physical product other than a computer, mobile device or other IT tools.\(^{65}\)

The concept is still on the sketch board, and will require the combination of elements which should result in the creation of a virtual PE for the enterprise to be addressed. It would also require addressing the rules of profit allocation to branches.\(^{66}\)

### 3.3.2 Hongler and Pistone Suggestion on a new Article 5 (8)

Hongler and Pistone released a proposal of adding a paragraph 8 to article 5 in the OECD MTC. It is suggested to have the following wording:

“\textit{If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum.}”

The further contents of the wording used in the paragraph would need to be elaborated on in the respective commentary.\(^{67}\)

The threshold has qualitative and quantitative elements. The way I interpret it, it is aimed at fully dematerialized business models, like direct e-commerce and multi-sided business models, see chapter 2.4.

### 3.3.3 European Union on Virtual PE

The European Union’s Economic and Financial Committee (ECOFIN), put taxation on the digital economy on the agenda for their meeting of September 2017. In this session, the ECOFIN agreed that it is important to abandon the physical presence criterion for PE, and replace this concept with a “Virtual Permanent Establishment”.\(^{68}\) The aim is to follow up with a more final direction for this work in December 2017.

\(^{65}\) BEPS Action 1 Discussion Draft (2014), p. 65  
\(^{66}\) Ibid., p. 66  
\(^{67}\) Hongler and Pistone (2015), p. 26  
\(^{68}\) ECOFIN (2017a), ECOFIN (2017b)
3.4 Diverted Profits Tax

The diverted profits tax has been implemented by The United Kingdom in an attempt to counter aggressive tax planning.

The tax is based on principles establishing a nexus between the entity producing the income and the place where the income originates.69 It is specifically aimed at MNEs that seek to circumvent the PE status despite having significant economic presence, and those that enter into business models that lack economic substance in order to make use of tax mismatches or diversion of income within a group.70 The tax is set to claw back the profits that would otherwise be “diverted” from taxation in the UK.

The income liable to tax under these provisions will be set to the profits the enterprise would have achieved, if it were to have an actual PE in the UK that the company carried out the trade through.71 In order to incentivize the use of corporate business models that are subject to CIT, the tax rate is higher than the UK CIT (25% vs the ordinary 20%). The tax is also required to be payed up front. This gives the tax a punitive character.72

The tax is levied if certain conditions are met. The first condition is that the enterprise is purposely avoiding triggering the PE status in the UK despite having significant business activity in the state. The second condition is addressing the cases where entities or transactions are lacking economic substance, and mismatch arrangements are used to shift profits and erode the UK tax base.73

Similar taxes have been implemented by Australia and recently also by New Zealand.74

69 Greggi (2015), p. 9
70 HMRC (2015), p. 4
71 Ibid., pp. 22-23
72 Greggi (2015), p. 11
73 Ibid., pp. 11-13
74 EY Global (2017)
3.5 Equalization Levy

The BEPS Action 1 report briefly discussed the possibilities of implementing an “Equalization Levy”. The idea is based on equalizing the market conditions for domestic and foreign enterprises. The tax could be designed in various ways, depending on what is the main objective with the tax.\textsuperscript{75}

Equalization levy on “hard-to-tax” digital business models could be designed by taxing every transaction between a domestic customer and a foreign supplier. The scope of the tax could for instance be limited to only cover transactions made online or through electronic means.\textsuperscript{76}

India has in the fall of 2016 implemented an equalization levy aimed at digital business models. Foreign enterprises providing online advertising to Indian business customers will be levied a 6\% tax on the gross value of such transactions. It differs from an Indian withholding tax in that it is imposed on gross value of payments which is the full and final tax, whereas Indian source taxation would entail mechanisms to refund the taxpayer if the withholding tax exceeds the tax liability determined by the Indian CIT.\textsuperscript{77} India has declared that the scope of the tax might be expanded in the future.\textsuperscript{78}

3.6 Withholding tax on digital sales

An option considered by the Task Force on the Digital Economy (TFDE) examined an approach where a withholding tax would be applied on all or certain cross-border transactions related to e-commerce.\textsuperscript{79} This means that income from e-commerce would be taxed regardless of physical presence in the market jurisdiction, since a PE would no longer be a condition for the right to tax such income streams.

\textsuperscript{75} BEPS Action 1 (2015), pp. 115-116
\textsuperscript{76} Ibid., p. 116
\textsuperscript{77} Government of India (2016), p. 85
\textsuperscript{78} Ibid., pp. 81-91
\textsuperscript{79} OECD (2003a) pp. 51-52
It is implemented by adding a flat rate tax withheld by the resident (or foreign PE) in the source state (the receiver of the digital service). The tax would be levied on the gross amount of the deductible payments which it makes to the foreign enterprise performing the digital service.80

This approach would entail preserving the PE concept, but modifying the way business profits are taxed by facilitating the sharing of the tax base generated by electronic commerce.81

### 3.7 Destination Based Corporate Taxation and Global Formulary Apportionment

Destination Based Corporate Tax (DBCT) is an umbrella term, consisting of various different approaches. Avi-Yonah developed a concept of destination based tax in 2000.82 Various concepts under the same fundamental idea have later been developed through articles and other publications,83 and the DBCT exists in different versions. Some key characteristics will be discussed below. Thereafter the EU concept of Common Consolidated Tax Base will be addressed, followed by an example of a nexus threshold and some considerations regarding the allocation of profits.

DBCT involves leaving the principles of source and residence taxation, concluding that these principles are no longer suited to deal with taxation in a globalized and increasingly digital economy.84 The tax involves changing the perspective from focusing on the location of the enterprise to focusing on the location of the customer. This approach is meant to be better adjusted to cope with the reality of the modern economy, where functions of enterprises are easily divided and placed in different jurisdictions.85 Since the customer cannot be moved by the enterprise, tax should be based on the destination of the sales. This would better reflect the economic reality of today. The key point of the DBCT is that the income from the sale of goods or services should be taxed in the jurisdiction where the good or service is consumed.

The system could seem similar to a VAT. However, DBCT is not meant to be a tax on consumption. The taxable transactions under VAT and DBCT could in principle be the same, but

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80 Hinnekens (1998), p. 195
81 Pinto (2006), p. 27
82 Avi-Yonah (2000)
83 Devereux and de la Feria (2014), p. 8-9
84 Ibid., p. 2
85 Ibid.
the DBCT system allows deductions to be made, whereas a consumption tax does not. Which expenses should be deductible varies between the different theories, and will not be elaborated on in the context of this thesis. However, there seems to be some level of agreement that labor costs should be deductible.\textsuperscript{86}

According to Devereux and de la Feria, the implementation should be executed along the lines of already existing systems like the VAT/GST or similar indirect taxes.\textsuperscript{87} As the worldwide implementation of such a tax would entail a change in how taxation rights on business profits are allocated, it would render the PE concept obsolete. The DBCT would violate most tax treaties, as it would tax profits from enterprises not having a PE in the state.\textsuperscript{88}

3.7.1 Common Consolidated Corporate Tax Base

The Common Consolidated Corporate Tax Base (CCCTB) is a concept developed by the EU, and holds a destination focus. The basic idea is that every enterprise in the EU should only have to comply with one common set of tax rules in relation to all their EU activities.

Enterprises would be able to offset their losses in one EU country in the profits in another. Profits of the company raised within the EU would be consolidated and allocated between the member states using an apportionment formula.\textsuperscript{89} Thus, it could be characterized as a “regional formulary apportionment”-concept.

CCCTB will be mandatory for all groups with a global consolidated revenue of more than 750 million euros. The proposed formula for apportionment is based on assets, labor and sales, equally weighted.\textsuperscript{90}

States would still be able to apply different tax rates, as it is only the portion of taxable income that will be allocated to their tax jurisdiction, and not the actual tax revenue.

In September 2017, ECOFIN stated that Virtual Permanent Establishment would be the preferred way in which to deal with taxation of digital businesses. This might seem somewhat confusing, although it was said during a press conference that a virtual PE solution could be

\textsuperscript{86} Devereux and de la Feria (2014), p. 10, Avi-Jonah (2015), no. 3 a
\textsuperscript{87} Devereux and de la Feria (2014), p. 9
\textsuperscript{88} Avi-Yonah (2015), no. 3 c
\textsuperscript{89} EU (2016)
\textsuperscript{90} European Commission (2016)
combined and implemented in a CCCTB concept.\textsuperscript{91} CCCTB and Virtual PE could be combined: Virtual PE could constitute the nexus threshold, deciding whether a country is eligible to be allocated part of the profits of the company. Further development under this discussion is expected in December 2017.

3.7.2 Nexus Threshold - The United States of America: Multistate Tax Commission

A nexus threshold is probably needed to determine a state’s right to tax an income stream under the destination based corporate tax system. One possibility is to use a virtual PE-concept to include taxation of digital business models, which seems to be the preferred option by the EU ECOFIN. Another possibility is to take inspiration from the system of dividing taxation rights within the United States of America.

The states in the USA enjoy substantial tax autonomy, and the US has found that the following is an acceptable and fair way to allocate tax revenue between the states.\textsuperscript{92} The concept uses a nexus threshold that consists of four alternative criterions: \textsuperscript{93}

“Substantial nexus is established if any of the following thresholds is exceeded during the tax period:

1. A dollar amount of $50,000 of property; or
2. A dollar amount of $50,000 of payroll; or
3. A dollar amount of $50,000 of sales; or
4. Twenty-five percent of total property, total payroll or total sales”

The test is based on typical quantitative data: a certain number of assets, functions or sales, instead of qualitative data (such as the traditional PE rule).\textsuperscript{94} This might be a simpler way to determine the right to tax the business profits of an enterprise than having to address any complicated qualitative PE-concept.

3.7.3 Allocation of Profits – Global Formulary Apportionment

After having established a nexus to a source state, the question of profit allocation arises. How much profit should be taxed in each state? One problem of the existing PE framework, is that

\textsuperscript{91} ECOFIN (2017b)
\textsuperscript{92} Barbier (2016), p. 74
\textsuperscript{93} Multistate Tax Commission (2002), p. 1
\textsuperscript{94} Barbier (2016), p. 74
the nexus threshold bears little relation to the subsequent profit allocation. Thus, a new nexus threshold should be aligned with the rules governing profit allocation. The USA Multistate Tax Commission approach considers sales, assets and labor to be of importance. Thus, aligning this threshold with profit allocation rules, would necessitate a larger focus on the achieved sales in a marked.

Avi-Yonah is of the opinion that the allocation key should be comprised of not only sales, but also of other production factors.95 This also seems to be the opinion of the EU, which advocates an equally weighted split between assets, labor and sales,96 whereas Avi-Yonah suggests a 50%-50% split between sales vs. assets and labor.97

3.8 United Nations on Digital Taxation

The UN Model Tax Treaty is meant as an alternative model for Tax treaties entered into by a developed and a developing country. As developing countries could constitute a significant market for some MNEs, it is relevant to investigate how the UN tackles the issues tied to taxation of digital enterprises.

Inspired by the OECD work on BEPS, the United Nations’ Committee of Experts on international Cooperation in Tax Matters (a committee under the Economic and Social Council – hereinafter referred to as ECOSOC) has been working on how to tackle the tax challenges of the modern economy. During this work, the committee has discussed different approaches to digital taxation.

The committee has proposed to implement more or less the same changes to the UN Model Tax Treaty article 5 as the OECD suggested for article 5 of the OECD MTC.98

The UN Model Tax Treaty includes a services-PE, governed by article 5 (3) b). In short, a PE will exist according to the provision, of one enterprise provides services through employees situated in the state for more than 183 days in any 12-month period. The implications of the services-PE will not be discussed in further detail for the purposes of this thesis.

95 Avi-Yonah (2015), no. 4
96 European Commission (2016)
97 Avi-Yonah (2015), no. 4
98 ECOSOC (2017a), pp. 1-56
Referring to BEPS Action 1 Final Report (2015), the committee has worked out a proposal for a new article 12A in the UN Model Tax Treaty, expanding the withholding tax on services. Article 12A gives the source state a right to tax outgoing payments for certain “technical services”. The term “technical services” is defined to mean “managerial, technical or consulting services”. The provision entails granting the source state the right to a withholding tax on income streams that would otherwise not be taxed in the source state in the absence of a PE therein.

The nature of the services that will be deemed “managerial, technical or consulting” is not elaborated on as of the present time. As the provision is aimed at digital business models, it will likely include many remotely deliverable services. It is unknown whether the term “technical service” is meant to include for instance the transfer of a computer file. Considering the wording of the provision, I am inclined to think that such a transaction is not covered by the provision.

Hongler and Pistone are under the perception that “automatic services” are not within the scope of the article. This seems a reasonable conclusion. In absence of a commentary with a closer description of the provision in 12A, I will refrain from drawing any further conclusions on the topic.

In a report published ahead of the Committees fifteenth session on October 2017, it is stated that a key objective of the report is to address the different states’ approach to taxation of digital business models and the possibilities of adding to or reinterpreting the PE-provisions of the treaties. This shows that taxation of the digital economy is high on the priority list of the UN at the moment. Further development on this matter can be expected in the time to come.

99 ECOSOC (2017b), p. 3
100 Ibid., p. 18
101 Ibid., p. 6-10
102 Hongler and Pistone (2015), p. 44
103 ECOSOC (2017c)
4 Evaluation of the Different Approaches

4.1 Introduction

In order to give a consistent evaluation of the various options, some criteria need to be established for the analysis. For the context of this thesis, I would like to evaluate the different options through the following criteria: Tax neutrality, enforceability, effectiveness and fairness. The criterions are inspired by the Ottawa Taxation Framework Principles,\(^\text{104}\) and will be further commented on below.

In this chapter, I will apply these principles to the various proposed tax frameworks listed above, and try to single out the option I think is most likely to succeed in providing a fair and holistic framework for taxation of digital businesses.

4.1.1 Tax Neutrality

Tax neutrality will refer to the aim that taxation should be neutral between electronic commerce and more traditional forms of commerce.\(^\text{105}\) Company A operating a chain of coffee shops should not be treated any differently than Company B selling online adverts for the purposes of CIT. Businesses should not need to think about mismatches or misalignments in tax systems when deciding their business strategy.

4.1.2 Enforceability

A tax system needs to be certain enough to allow states to claim their legitimate tax revenue without having to be impaired by lack of information and possibilities for mismatch situations. Enforceability will also refer to the potential for artificial avoidance by large and resourceful enterprises and the possibilities of double taxation.

Another point is how likely it is that taxpayers will actually comply with the obligations made by the authorities. This could be decisive for how much work the tax authorities will have to put down in securing the fair enforcement of the tax rules.

\(^{104}\) OECD (2003b), p. 12

\(^{105}\) Ibid.
4.1.3 Effectiveness
This criterion refers to the administrative costs for both tax authorities and taxpayers. Paying taxes is a burden on itself, and there is no reason to implement a tax system that increases this burden by imposing unnecessary compliance costs to the taxpayers in addition to the payable tax.

In order to achieve desired effectiveness, it will be important to assess the simplicity of the framework. The taxpayer is more likely to thrive economically if the tax system is predictable and easy to understand.

4.1.4 Fairness
A tax should produce the right amount of tax at the right time.\textsuperscript{106} In the context of this thesis, “fairness” will refer to the way in which the tax enables income to be taxed where the value is created. Recalling that value is created on both the supply and demand side, a tax concept should be designed to take into account sales, assets and other value creating functions.

The tax should also be in line with the ability-to-pay principle, and not unnecessarily impair the economic growth of enterprises. Especially growing enterprises in the crucial start-up phase.

4.2 BEPS Action 7

BEPS Action 1 did not suggest any measures set out to deal specifically with the concerns regarding the digital economy. As the digital economy is such an integrated part of the economy itself, the OECD found it would be wrong to “ring-fence” the digital economy. Instead, the problems of taxing digital business models fairly would be addressed through the remaining BEPS actions, such as artificial avoidance of PE-status, transfer pricing regulations and CFC rules. Seen isolated, the changes made to article 5 entails limited changes to the taxation of digital business operations.

The proposed changes to the commissionaire structure is probably the most significant amendment of BEPS Action 7. Any business, digital or more traditional, using commissionaire structures will probably have to restructure their business model or accept an increased number of PEs. It is likely that many enterprises will abandon agents and commissionaires, and access market jurisdictions through “flash title” LRDs instead. Making it more difficult to achieve

\textsuperscript{106} OECD (2003b), p. 12
direct sales in market jurisdictions without triggering a PE is a step in the right direction and will bolster the taxable base of market jurisdictions.

The new requirement that listed activities must be of a preparatory or auxiliary character if it is to be exempted from PE status, should have implications on businesses selling physical goods over the Internet and delivering the goods from a warehouse located in the market state. Thus, this change includes creating a PE for some models based on indirect e-commerce, see chapter 2.4.1. It does not, however, provide for a framework enabling the source taxation of digital profits derived from fully dematerialized digital activities, such as direct e-commerce or multi-sided business models (see chapter 2.4.2 and 2.4.3). The proposed PE-provisions will still discriminate between traditional and digital business models, and will still allow a vast number of untaxed sales happen in market jurisdictions.

Further, it gives rise to avoidance and arbitrary treatment. Online retailers operating within an indirect e-commerce model would not necessarily need one local warehouse in each jurisdiction they are operating in. An enterprise selling physical goods into Europe using the internet would in practice only need a warehouse close enough to the customer to enable reasonably quick delivery from an independent courier. Today, the whole of Europe could probably be serviced from one sole warehouse located centrally therein.

This situation could lead to the enterprise having one PE to serve a whole region, giving the result that value created in the region as a whole is only taxable in one of the value creating jurisdictions. This seems to be in disharmony with the principle of fairness, and that profits should be taxed where the value is created.

The anti-fragmenting amendment in article 5 (4) seems more like an anti-avoidance rule, sealing a loophole, than it is actually addressing the challenges of electronic commerce. This might be all it is actually intended to do, but it the contribution to digital taxation seems negligible.

All in all, this leads me to consider that the changes to the OECD MTC article 5 (4), (5) and (6) will not be at all sufficient to deal with the challenges of taxation in a global, digital economy. Will the number of worldwide PEs increase as a consequence of these changes? Probably. But as long as there is a condition of physical presence for a PE to exist, the post-BEPS PE will not be able to tax fully dematerialized digital activities, which is a large and constantly growing part of the global economy.
4.3 Virtual Permanent Establishment

Initially, the Virtual PE-concept initially looks like it’s a step in the right direction. Such a concept, if implemented correctly, would probably be able to better reflect the modern economic reality than the “fixed place”-PE. However, it has some weaknesses that I would like to point out in the following paragraphs.

4.3.1 Task Force on the Digital Economy Discussion

Given that the concept presented by the TFDE is a work in progress, this assessment can only be based on what is already indicated in the discussions leading to the BEPS Action 1.

The suggested elements of the nexus threshold indicate that the Virtual-PE discussed by the TFDE is primarily aimed at fully dematerialized digital business models. This has been criticized by Hongler and Pistone, suggesting that implementing a requirement of digital business as a “core function” and making it a criterion that payments are made through electronic means, might be in breach of the principle of tax neutrality. It would possibly discriminate between the enterprises that are based on fully dematerialized business functions and the ones who operate in a more mixed operation (and thus not necessarily having digital business are a “core function”).

Such a nexus rule would also potentially involve “ring-fencing” the digital economy, creating one set of rules for digital businesses and another for more traditional business models.

As indicated in section 2.2.1.6, low market barriers facilitate the creation of value in the digital economy, challenging existing market actors to constantly develop new technology. This benefits consumers worldwide. A Virtual PE concept should thus, in my opinion, be designed not to impede the early growth of startups. This could be done by adding a threshold stating that the Virtual PE will only be imposed on enterprises that have a certain minimum worldwide revenue (like in the suggestion of Hongler and Pistone, see chapter 3.2.2). I would suggest it is likely that a final proposal from the OECD regarding the Virtual-PE will include quantitative thresholds in addition to the qualitative one.

4.3.2 Hongler and Pistone’s Proposed Article 5 (8)

The Hongler and Pistone proposal is based on a nexus threshold that is consists of both qualitative and quantitative elements.

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107 Hongler and Pistone (2015), p. 31
The qualitative element might cause the provision to be difficult to enforce, considering the possibilities of different interpretations of the wording of the suggested article 5 (8). This is something that could be mitigated by a comprehensive commentary, but the potential for dispute is present. This could otherwise create a situation where it is difficult for the taxpayer to predict its tax responsibility, or it could potentially lead to double taxation.

Additionally, questions could be raised as to how the concept would deal with business models based on both traditional and digital elements. For instance, where an enterprise offers goods for sale through digital solution but also through traditional retail. The distinction could be difficult (for instance where the purchase of a good in a physical store gives rights to an associated online service).

Would the company then have one or two PEs? How would profits be allocated under such circumstances? These discussions show that the approach might be complicated and expensive for authorities to enforce and for enterprises to comply with.

If the future should show that the article is indeed not sufficient to deal with new emerging business models, changing the paragraph would need to be done bilaterally in every tax treaty. Would the definition in the paragraph be sufficient to tackle the possible business models of the future, which might involve extensive use of advanced robotics and 3D-printing?

I fear that this proposed paragraph might lack the desired flexibility, which once lead to the obsolescence of the current PE-concept. One possible solution to this problem is the multilateral instrument that is expected from the OECD, which might provide the possibility to implement changes as they are required. I will not elaborate further on this matter.

4.4 Diverted Profits Tax

As it is a requirement that the enterprise has some sort of physical presence, the tax is not applicable on enterprises that derive profits from fully dematerialized digital activity. Thus, the DPT does not fully address the problems caused by the increasingly digital economy. It would enable taxation on an “Internet Retailer” (“e-tailer”) with a local warehouse exempted from PE status, but it would not enable taxation on income streams derived from economic

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108 Hongler and Pistone (2015), p. 52
activity that is solely digital, such as direct e-commerce or multi-sided business models (see chapter 2.4).

It could seem that the DPT does not offer any additional taxation rights for the market jurisdiction than after the implementation of the BEPS proposed changes made to the PE. One possible benefit being that the DPT might be implemented faster, considering it only requires changes to domestic law.

The DPT consists of a complicated legal framework, making it a burdensome procedure for a taxpayer to predict its tax liability under the provisions. If every jurisdiction created its own version of the DPT, this would probably create a high level of uncertainty which might impair world trade. It is not a desired concept for worldwide implementation.

The DPT would probably be in breach of existing tax treaties that deem business profits to be taxed in the resident jurisdiction in absence of a PE. This gives rise to possible controversy between contracting states, and creates a risk of double taxation.

As it does not alter the nexus threshold of the PE, it has the character of an anti-avoidance provision more than a concept that could align the nexus threshold with the modern economic reality.

### 4.5 Equalization Levy

This approach does tackle part of what is the problem with taxing the digital economy. Is it the final solution to digital taxation? I consider this unlikely. Indeed, the equalization levy has been mentioned by the ECOFIN to possibly be able to serve as a temporary measure until a more solid and holistic framework can be established. However, it is not likely to be the desired solution in the long term.

The equalization levy involves discriminating between foreign and domestic enterprises, leading to unequal treatment. This could impair cross border trade. Inside the EU, levying a tax upon foreign enterprises only, might breach with the principles of free movement of establishment.

Also, implementing an equalization levy while preserving the physical nexus PE-concept doesn’t mitigate the fact that the qualitative requirements for meeting the PE nexus threshold
does not match economic realities of the modern economy, or the profit allocation guidelines of the OECD.110

As with the withholding tax, the equalization levy is revenue based, meaning that it is levied upon the gross value of payments exiting the source state. Therefore, it could mean imposing a tax exceeding the net profit gained on the transaction. This does not resonate well with the ability-to-pay principle. It could make it harder for growing companies to expand into foreign markets. A worldwide implementation of this tax could thus impede the development and worldwide availability of new technology.

The equalization levy might help secure some revenue from otherwise untaxed income streams in the short term, but it is not the desired holistic long-term approach we are looking for.

4.6 Withholding Tax on Digital Sales

This approach would necessitate new definitions as to what should be characterized as a “digital transaction” (or whichever wording may be used) as opposed to other transactions. This could possibly be a complicated process, as the digital element is more or less a part of every transaction these days. A common definition would be very important to avoid mismatch arrangements. Otherwise, this could produce a risk of artificial avoidance which impairs the effective enforceability of the system. This could also lead to double taxation.

The tax seems similar to an equalization levy, being revenue based (levied on gross value of the transaction). This raises the same concerns in relation to the ability-to-tax principle, possibly creating a tax burden too high for the enterprise to handle. It could also impair the early growth of start-up companies, who tend to suffer heavy losses in a start-up phase. If implemented, these issues must be mitigated. Indeed, I consider the similarities to the equalization levy to be so apparent that it is to some extent two different names on the same concept.

Another possible challenge tied to enforcement is the way digital payments are made. Since such transactions are often made using credit cards or other electronic means, it would probably have to involve the cooperation of financial institutions.111 Even with the cooperation of financial institutions, the possibilities of anonymous payments may lead to difficulties tracking the

110 Barbier (2016), pp. 86-87
111 BEPS Action 1 Discussion Draft (2014), pp. 66-67
source of a payment, for instance by the help of a Virtual Private Network (VPN – a service that allows you to disguise your whereabouts).

This approach would entail preserving the “fixed place”-PE threshold of today. In my opinion, a withholding tax on digital sales is not the desirable way to tackle the long-term challenges posed by the digital economy.

4.7 Destination Based Corporate Tax with Global Formulary Apportionment

Any system based on taxing an income stream where the product is consumed will have to rely on fairly accurate data in order to identify where consumption takes place. The use of already existing frameworks in VAT-systems and accounting software could be of help in this respect. The possibility of using a VPN, might cause some problems in determining where the consumption takes place, especially in business to consumer (B2C) situations. This could induce the risk of artificial avoidance. New requirements for transparency and information, like country-by-country reporting (BEPS Action 13) might be able to mitigate some of these issues.

If it works in the United States, and some variant is suggested to be implemented in the EU, this begs the question: Could it work as a worldwide concept of sharing taxing rights of profits derived from multinational enterprises?

The enforceability of such a system would be subject to the successful worldwide implementation. It would require substantial changes to the international taxation of business profits, which is unlikely to be welcomed by every state involved.

Additionally, allocating taxation rights from a worldwide consolidated corporate tax base would likely require international enforcement mechanisms. The CCCTB-concept could work because the EU would function as a conflict resolution body, where states and taxpayers can file complaints and negotiate remedies. Outside unions like the United States or the EU, it would probably be harder to convince states to give up part of their tax jurisdiction (see 1.3.1) and trust an international tax enforcement body. The formation of an international enforcement body to fill this function in a global scale could constitute a great challenge for the worldwide implementation of such a tax system.

Having a quantitative nexus criterion (like the one used by the US, see chapter 3.6.2) instead of a qualitative criterion would make the threshold much easier to deal with for both states and the
taxpayer. It would mitigate the “surprise PE” situation and it would be easier for the source state to determine that a PE indeed exists. I would assume it to be much more effective than the compliance heavy system of today.

The concept provides a framework to secure taxation more in line with where the value has its origin and where the infrastructure is used. The further conclusion on this topic will probably depend on how the profit allocation formula is designed. It is likely that some states will feel like winners and others will feel like losers.

It has been argued that taxation based on destination discriminates against developing countries, that export more than they import (and will therefore lose tax revenue). According to Avi-Yonah, this is not true, as BRICS countries are immense markets and will therefore benefit from such a tax system. Some adjustments would perhaps have to be in the case of other developing countries.112

4.8 United Nations Technical Services Tax

The main manner in which it affects digital business models looks to be to limit the deductions made by subsidiaries or existing PEs in the source jurisdiction for technical services provided by the parent company, making such fees subject to a withholding tax. Thus, the measures’ main contribution to tackling the issue of base erosion and profit shifting, is that it limits the moving of profit from the source state through income deductions.

The new article 12A does not involve changing the PE or the threshold. It is adding a tax, creating a more complex international tax system, possibly increasing compliance costs creating yet another unique rule to interpret and deal with for the taxpayer operating in multiple jurisdictions. Thus, this cannot be the permanent solution we are looking for.

112 Avi Yonah (2015), no. 3 e)
5 Conclusion and Proposed Solution

5.1 Introduction

In this chapter I will draw some conclusions from the above presented options. Some of the new approaches involve leaving the PE-concept all together. Other entail altering the PE to better cope with the current economic reality. Some involve the implementation of other source taxes to mitigate the fact that some digital business profits currently go untaxed in the marked jurisdictions. This leaves the questions of whether there should be a threshold for when a source state should have taxation rights to the business profits of a foreign digital enterprise, how that threshold should be designed, and some pointers on how profit allocation guidelines should be shaped.

5.2 Should there be a nexus threshold?

This is the choice between having a withholding tax (WHT) on digital business profits as a whole, or to limit source taxation to the cases where the foreign enterprise meets a threshold criterion based on economic presence in the state.

Keeping the current “fixed place of business”-threshold for traditional business models, while implementing an unconditional withholding tax to digital businesses would be treating digital businesses different from traditional ones. This would probably be in breach of the principle of tax neutrality and principles of fairness.

The implementation of a WHT usually entails taxing revenue, and not the net income. Leaving international taxation to be solely revenue-based, and not allow for expenses to be deducted, could impede cross border trade and be in breach with the ability-to-pay principle. Additionally, start-ups could be imposed unreasonable burdens in an early phase, potentially impairing their growth. It could also cause massive compliance costs for digital companies selling products across the world.

From a tax jurisdiction perspective, one could argue that tax jurisdiction only exists where there is a certain minimum connection to the state. This speaks against the use of a sole WHT when the presence in the state could be considered insignificant, and below a “de minimis” threshold. Even though Monsenego correctly indicates that such a minimum connection is probably not
required to exercise jurisdiction in international law, I am of the opinion that a minimum threshold is required to prevent unnecessary barriers to international trade.

My conclusion is that some minimum threshold should be included in any new framework on international taxation of business income.

5.3 How should the nexus threshold be designed?

The main question that needs to be answered is whether a nexus should be of qualitative or quantitative nature. My opinion is that the threshold should be a quantitative one. A quantitative nexus threshold facilitates the easy recognition of a nexus for both the tax authority and the taxpayer.

The Virtual PE suggested in literature and considered by the OECD might be able to alleviate the key problem of non-taxation of digital business models. But it begs the question: Do we really need to desperately insist on keeping the permanent establishment? In my opinion, adding to an already complicated and compliance heavy provision is not the solution. A quantitative threshold based on facts that are easy to determine is more desirable.

Another question is what should be the contents of such a criterion. As has been highlighted in this thesis, one of the main issues of the current nexus threshold is that it does not correspond well to the economic realities to which it is applied. Thus, a new nexus threshold should reflect the modern economic environment.

One of the main challenges of the digital economy has been the way digital business models allow enterprises to sell their products into a foreign state without being tax liable therein. The availability of a market to sell products into is part of what creates value for the enterprise. Thus, the threshold should take into account the amount of sales made into a jurisdiction.

However, one should not forget that other factors also contribute to the creation of value, such as assets and labor. I would assume that the threshold used in the US for sharing tax revenue between federal states could serve as a model for how a new worldwide treaty provision should look. This nexus threshold takes into account sales, assets and labor. My conclusion is that this is the most appropriate way of shaping a nexus threshold rule.

113 Monsenego (2011), pp. 40-41, 54-60
5.4 Some considerations on the allocation of profits

Since transfer pricing principles do not fall within the scope of this thesis, this will only touch the surface of what is a more technical and challenging discussion. Only some key points may be highlighted in this context.

In short, the allocation of profits should correspond to where the value driving functions are taking place. Recalling that sales, assets and labor constitute significant value driving factors, the transfer pricing guidelines should be based on these elements in a “global formulary apportionment”-design, based on sales, assets and labor (see section 3.6.3). This would align the nexus threshold with the principles of transfer pricing, both corresponding with actual value creation.

5.5 Conclusion

This thesis has shown how the rise of new digital business models has put a strain on traditional methods of international sharing of the tax base. This has been the result of economic development and tax framework development moving at a different pace. Even though the economic development has led to a fundamentally different situation in the last four decades, the qualitative criterions of the permanent establishment has remained fundamentally the same. The drastic transition from “brick and mortar”-businesses into the digital business models of the late 20th century merits drastic alterations in the framework allocating business taxation rights between states.

Different approaches were presented. Some suggesting drastic modifications and alterations on how international taxation of business profits should be executed in the digital economy. Others suggesting more modest solutions. It was pointed out that the BEPS project by the OECD and the G20 on altering the permanent establishment would not be sufficient, and that other and stronger efforts will need to be made in the future. The OECD and the G20 has stated that the TFDE will continue its work on the issues of digital taxation. A final report is expected by 2020.\textsuperscript{114}

\textsuperscript{114} OECD (2017), p. 1
I will offer my recommendation: The destination based corporate taxation with a quantitative threshold consisting of sales, assets or labor, where profits are allocated based on a global formula apportionment principle (see 4.7). The task of putting such a concept into action is an ambitious one. It would mean a radical move away from the permanent establishment. But it would also mean implementing an up-to-date and holistic framework that better reflects the realities of the modern economy.

Will such a change be feasible? Can the states of the world unite in the backing of one common system to share taxation rights between all the different states? Can states agree on a common enforcement body to ensure the effective implementation of such a taxation system?

The OECD is in a prime position to continue the development of international taxation of business income. The tendency towards a more unified worldwide tax cooperation is shown by, for instance, the implementation of country-by-country reporting (BEPS Action 13). This nourishes the hope of one day achieving a consolidated tax base for the largest international enterprises.

Every state is likely to want to protect their own interest. Since some states would possibly lose tax revenue with the introduction of this system, it would probably be a complicated and time-consuming process. Considering the many various interests that needs to be taken into account in order to achieve worldwide consensus concerning such a system, I believe the OECD will have to implement other measures for the short term. I find it hard to believe that the member states will be able to agree on such a holistic approach in the near future.

However, they should be reminded that economic development is constant. Tax development should follow. Sealing loopholes as they are discovered is no viable solution in the long term. This will only result in a complicated and comprehensive network of rules which will be difficult and costly for taxpayers to comply to, and for tax authorities to enforce.
## List of Abbreviations

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<tr>
<th>Abbreviation</th>
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<tbody>
<tr>
<td>BEPS</td>
<td>Base Erosion and Profit Shifting</td>
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<td>CCCTB</td>
<td>Common Consolidated Corporate Tax Base</td>
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<td>CFC</td>
<td>Controlled Foreign Company</td>
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<td>CIT</td>
<td>Corporate Income Taxation</td>
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<td>DBCT</td>
<td>Destination Based Corporate Taxation</td>
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<td>DPT</td>
<td>Diverted Profits Tax</td>
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<td>EU</td>
<td>European Union</td>
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<td>ECOFIN</td>
<td>Economic and Financial Affairs Council (EU)</td>
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<td>ECOSOC</td>
<td>Economic and Social Council (UN)</td>
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<td>ICT</td>
<td>Information and Communication Technology</td>
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<td>LRD</td>
<td>Low Risk Distributor</td>
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<td>MNE</td>
<td>Multi-National Enterprises</td>
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<td>OECD</td>
<td>Organization of Economic Cooperation and Development</td>
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<td>OECD MTC</td>
<td>OECD Model Tax Convention</td>
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<td>PE</td>
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<td>TFDE</td>
<td>Task Force of the Digital Economy</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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<td>VPN</td>
<td>Virtual Private Network</td>
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<td>WHT</td>
<td>Withholding Tax</td>
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<td>BRICS</td>
<td>Brazil, Russia, India, China and South Africa</td>
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### Bibliography

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