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Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy

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Executive Summary

1. Introduction

This paper outlines the core issues of the introduction of a new PE nexus based on digital presence. It puts forward its essential features and rethinks the foundations of the concept of sourcing for income tax purposes in the global economy. Our proposal of a new PE nexus based on digital presence is also supported by a theoretical reconstruction in the light of a new dimension for the benefit theory.

Our work directly relates to Action 1 of the OECD/G20 BEPS Project. However, the development of a new PE nexus is in fact not an instrument to counter BEPS, but reflects a structural revision of the criteria for allocating taxing rights on cross-border business income in the era of the digital economy.

This paper should be understood as a discussion paper and first proposal to shed further light on (i) whether there is a theoretical justification for a new PE nexus based on digital presence, (ii) how a new PE nexus based on digital presence could be defined and (iii) whether and how potential implementation issues could be resolved.

By publishing the present blueprints for a new PE nexus, the authors wish to provoke a more concrete discussion on this particularly important matter.

2. The need for amending the existing PE definition

The current PE definition provided by the OECD Model, as also suggested within Action 7 of the OECD/G20 BEPS Project, requires certain structural changes, including a new framework for the PE threshold, in order to satisfactorily address the new business models developed in connection with the digital economy (*see* section 2. in the main text).

The envisaged amendments to the current PE definition, however, would only affect certain e-commerce enterprises as part of the digital economy, but would not otherwise affect enterprises that do not sell any physical goods (*see* section 2.4.). By amending the current PE definition and still relying on a physical presence threshold, no reallocation of income within the digital economy occurs.

3. Developing a theoretical framework for the new nexus

The immediate goal of the new PE concept is not to strengthen taxation at source, but rather to allow the state of source to preserve its sovereignty on the taxation of business income derived in connection with activities effectively linked to its territory and jurisdiction (*see* section 3.1.).

In particular, our analysis suggests establishing a new PE nexus based on digital presence. Such new nexus finds its inspiration in a revised theoretical framework for the traditional sourcing theory, reflects the benefit theory and reduces the existing bias in the tax treatment

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of cross-border digital and physical business activities with a view to achieving a broader consistency between the two categories.

Theoretical analysis contained in this paper develops a new dimension for the sourcing theory and provides the background for drawing a nexus with the taxing jurisdiction, shifting away from the association of the PE nexus with physical presence and more closely reflecting value creation in respect of business income, taking into account its more prominent role in the era of the digital economy (*see* section 3.2.). Value creation within the digital economy means that not only the supply side of an enterprise but also the market itself enhances the value of an enterprise.

4. Our proposal

The theoretical framework allows this paper to conclude that the new PE nexus should consist of four main elements or requirements: (i) digital services; (ii) user threshold; (iii) a certain time threshold and (iv) a *de minimis* revenue threshold (*see* section 4.2.).

Our proposal supports the introduction of a new article 5(8) of the OECD Model with the following wording (*see* section 4.2.):

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.

Due to the existence of a user threshold, we expect the new PE nexus to eventually cover more enterprises operating B2C than B2B. However, we provide arguments to support that this is also a natural consequence of the theoretical framework. Besides, the e-commerce business (understood in a narrow sense) should not be substantially affected by the new PE nexus. Due to the physical flow of goods, some of these enterprises might already form a PE in the state of consumption on the basis of the traditional criteria currently included in Article 5 of the OECD Model.

Obviously, such definition does not resolve existing and new ambiguities created by the new nexus. Further guidance is required, for instance, with regard to the term “users”, since it would need to be defined whether users having access to the free services also count and whether the user amount is calculated based on sign-ons (*see also* the case studies in the Annex). Other terms contained in the new PE nexus should also be defined in more detail, such as “database”, “advertising services”, “website”, “per month” and “domiciled”.

An Annex with case studies enriches the content of this paper, showing that reference to a time frame is necessary due to the fast growth of certain enterprises within the digital economy, since the risk of non-compliance would otherwise be very large. These case studies

also prove that the new PE nexus should also work if an enterprise offers various digital (and other) services (*see*, for instance, case study "Company H" in the Annex).

We understand that following our theoretical framework, the actual wording of our proposal could also rely on other thresholds such as, for instance, data usage. Nevertheless, we are of the opinion that our proposal is a feasible option and should launch a more concrete discussion concerning a new PE based on digital presence.

Our proposed changes and the specifications of the sourcing theory and benefit theory as guiding justifications for a new PE nexus based on digital presence will also require that further elements of the current PE definition should be subject to revision, including in particular the exemption for auxiliary activities (*see* section 4.5.).

For the purposes of the new PE nexus, it should not be decisive whether the digital service is a main part of the business of an enterprise (*see* section 4.6.) nor may the user requirement lead to an unintended removal of the fundamental distinction between VAT and corporate income tax (*see* section 4.7.).

The innovative approach of this paper to the allocation of taxing powers can be implemented in line with the arm's length principle or through a shift to formulary apportionment. As regards the former scenario, we submit that the current OECD Transfer Pricing Guidelines be amended in order to apply to income allocation between an enterprise and its PE based on digital presence. We suggest that the profit split method, combined with an upfront allocation of one third of the profit to the market jurisdictions, serves as the most suitable transfer pricing method to operate in this framework (*see* section 4.8.).

5. Tax enforcement

Our study recommends extraterritorial tax enforcement by one state on behalf of several other states be considered as a feasible option in order to ensure the taxation of PEs based on digital presence (*see* section 5.2.). Since in some instances enterprises may not have any physical presence in the PE state, we suggest that the group company invoicing the services serves as the taxpayer for the PEs in different jurisdictions (*see* section 5.3.). However, we are also aware of the risk that such a system could lead to "accounting rules shopping".

6. Implementation

The interaction between the new PE nexus, the existing PE definition and other articles of the OECD Model, such as article 12 (*see* section 6.2.), is likely to determine additional repercussions, which are to be addressed more precisely in the framework of a dedicated study. With regard to the implementation process of the new nexus and in order to rebalance the exercise of tax sovereignty, either a soft or hard law approach could be taken, since multilateral action appears required as most suitable in this respect (*see* section 6.3.).

7. The new nexus and international tax law

In order to ensure continuity with the existing standards of international taxation to the highest possible extent, when defining a new nexus, this paper supports the need to comply with the Ottawa principles (*see* section 7.) and with the advantages of the fixed place of business requirement in article 5(1) of the OECD Model, i.e. certainty, enforceability and limitation of fragmentation. This does not mean, however, that the current PE definition is carved in stone and that no deviation from it can be envisaged.

8. Would the service PE or a WHT on (cyber-based) services have the same effect?

Although certain specific issues may require further analysis, we submit that in general terms, the theoretical background allows our proposal to achieve better results than those recently provided in tax literature, such as, for example, the introduction of a new treaty article on cyber-based services (*see* section 8.).

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1. Setting the Framework for the Analysis

As mentioned in the OECD report, *Addressing the Tax Challenges of the Digital Economy*, several opportunities for BEPS exist within the digital economy.[1] In the context of direct taxation, the following goals can be singled out:[2]

(i) eliminating or reducing tax in the market country;
(ii) avoiding withholding tax;
(iii) eliminating or reducing tax in the intermediate country; and
(iv) eliminating or reducing tax in the country of residence of the ultimate parent.

Within the first category, the OECD further differentiates between (i) avoiding a taxable presence, (ii) minimizing the income that may be allocated to functions, assets and risks in market jurisdictions and (iii) maximizing deduction in the market jurisdiction.

All three items falling within the first category have a strong impact on the exercise of the tax sovereignty of the market country. Their exponential growth over the past few years as a consequence of targeted international tax planning and the change in international business models requires prompt action in order to re-establish a fair and unbiased framework of the sovereignty states.

Various theoretical grounds support this action, two of which can be singled out here, namely the benefit theory and the link between sourcing and taxing rights on income. Both will be developed in further specific sections of this paper.[3]

The PE concept was elaborated as a possible tool to strike a balance between the rights of the state of residence and the market country as to the exercise of their respective taxing jurisdictions. Essentially, to the extent that the source of business income arises from the organization of production factors and such organization is usually confined within the state of residence of the enterprise, the PE concept developed as an exception to the exclusive taxation by such country, as being able to encompass all cases in which the exploitation of the market country by an enterprise was habitual and implying a part of the business to be relocated in such country.[4]

The core of the PE concept was gradually adapted over the past decades with a view to reflecting more closely the actual part of business operating from the market country. Accordingly, it was first deprived of the force of attraction principle[5] and then more closely

1 For further details, *see* P. Collin & N. Colin, *Task Force on Taxation of the Digital Economy*, p. 1 et seq. (2013), available at: http://www.hldataprotection.com/files/2013/ 06/Taxation_Digital_Economy.pdf.
2 With further details, *see* OECD/G20, *Addressing the Tax Challenges of the Digital Economy* p. 99 et seq. (OECD 2014).
3 For further details, *see* sections 3.2. and 3.3.
4 For further details, *see* B.J. Arnold, *Permanent Establishment – Global Tax Treaty Commentaries*, section 1.2., last reviewed 3 March 2014 (IBFD); J.F. Avery Jones, *Permanent Establishment: Historical Evolution and Contemporary Relevance*, *in Taxes without Borders: Report of the Proceedings of the First World Tax Conference* section 3.1. (Toronto, Canadian Tax Foundation 2000).
5 This principle has existed since the first version of the OECD Model published in 1963.

linked to the actual situations in which the fixed place of business was in fact directly involved in the business.[6]

The PE concept continued meeting the needs of the economy to the extent that the latter remained mostly physical. However, it slowly turned into a cage for the exercise of the taxing jurisdiction of the market country, which could be targeted by international tax planning aimed at confining business activities of non-residents outside the PE framework. Avoiding a taxable presence means, for instance, that a non-resident company might interact with customers of another country without having a tax nexus with the jurisdiction of such state, i.e. not forming a PE through a fixed place of business.

The digital economy merely enhanced such inexorable process.

There are potentially various ways of addressing the problems of taxation of business profits of non-resident enterprises caused by the erosion of the actual boundaries of the PE concept.

One potential solution is to do away with the idea of linking business profits to a PE concept, for instance by strengthening the use of withholding taxes. The merits of this solution can be manifold and include a simplification in the exercise of taxing powers on business income derived by non-residents, but also manifold are the additional problems this would bring. Furthermore, withholding taxes can be used as a kind of toll charge by the state of source in order to preserve the exercise of its jurisdiction on business income. As we all know, the PE concept currently serves various significant functions in international tax law, such as those of being a nexus rule, a source rule, a threshold rule or a tool to secure net taxation of foreign enterprises, thus securing equal treatment with their local competitors and avoiding trade and investment distortions whose business profits are taxable in the PE state. Such elements show that the path towards the implementation of such solution should also address a much broader change than that which is strictly needed to allow an effective and balanced taxation of business income derived by non-resident enterprises. The use of withholding taxes is not per se incompatible with the PE concept,[7] but the analysis of such issues falls outside the scope of this paper.[8] Besides, and as also argued in detail by Baez and Brauner,[9] the IBFD academic taskforce views the new PE nexus as the superior solution to the introduction of new withholding taxes.

Another option is to restrict the scope of the PE limitation to source taxation of business income in tax treaties; for instance, by including an additional provision on taxation of services based on the model that India consistently follows in its tax treaties. Besides the merits that such position may have in the framework of a policy that strengthens the taxing rights of the state of source, it is undeniable that adding one more treaty article will increase the potential for disputes as to which provision should govern a given income derived by non-residents. The interpretation by Indian authorities and courts has in some cases shown an

6 Such major change to the OECD Model occurred in 2008. For more details about the historical developments in this regard, *see* J. Sasseville & R.J. Vann, *Business Profits – Global Tax Treaty Commentaries* section 3., last reviewed 1 April 2014 (IBFD).
7 Accordingly, a stronger reliance on withholding taxes can be combined with a revised PE nexus on business income.
8 *See* A. Baez & Y. Brauner, *Withholding Taxes in the Service of BEPS Action Item 1*, DRAFT.
9 Id.

inclination to keep taxing powers with the state of source in respect of both types of income, thus reducing the relevance of the dividing line and leading to a general stronger protection of taxing rights in respect of income derived by the non-resident in India. However, this paper will only partly further explore the merits and shortcomings of a solution based of strengthening taxation at source and the interpretative issues arising in such framework.[10]

This paper will instead elaborate a solution that retains the taxation of business income derived by non-residents being regulated by the PE concept, but addresses the shortcomings of the actual boundaries of such concept in a way that deals with its structural deficiencies.

The goal of this paper is to stop the erosion of the taxing sovereignty in respect of income derived by non-residents in the era of the digital economy and that is in general and not with regard to the digital economy also caused by additional factors, such as the exclusion of auxiliary activities from the PE concept, the undesirable side effects of service PE provisions in tax treaties, the time threshold of the construction PE, the change in business models and the more aggressive exercise of international tax planning.

We do not aim at altering the interjurisdictional allocation of taxing powers in a way that strengthens the powers of the state(s) of source in respect of income derived by non-residents. The outcome of our analysis neither prevents a shift in this direction, nor is incompatible with it. It may nevertheless be used as a reference framework for developing a (soft or hard law) multilateral approach in order to rebalance the exercise of tax sovereignty on business income among states worldwide in line with the requirements of the digital economy.[11]

Our research question focuses on how the PE concept can be changed in a way that adapts its boundaries to the new scenario of the digital economy without losing the traditional function that such concept has played in international taxation over several decades. The analysis will do more than merely supporting the opportunity of lowering the PE threshold. It will explore how the features of the PE can evolve towards a potential new PE nexus based on digital presence and able to address base erosion profit shifting activities avoiding a taxable presence in the market country.

Since the focus of our analysis is exclusively on the setting of new boundaries for the PE concept as nexus, all other BEPS-related issues are not directly addressed by this paper. Moreover, one may question whether the new PE nexus linked to the digital presence is a measure that allows countering BEPS and not merely a new income allocation between several jurisdictions. However, in order to focus exclusively on the PE concept and the new PE nexus, all other BEPS aspects, such as Action 2 or Actions 8-10, are therefore disregarded in our study.

10 *See* section 3.2.
11 For further details concerning the potential options of multilateral actions, *see* section 6.3.

2. The Current PE Definition in the OECD Model and the Digital Economy

2.1. Fixed place of business and the digital economy

With regard to the fixed place of business as a PE requirement according to article 5(1) of the OECD Model, the OECD Commentary states the following:

> Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated (see below), a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" (see paragraph 2 above) as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.[12]

This means that certain operations of the digital economy, as described below in the case studies in the Annex (besides the support or marketing subsidiaries), do not currently create a fixed place of business and therefore do not constitute a PE or, in other words, "the notion of a fixed place of business hardly ever applies in the digital economy."[13]

Furthermore, with regard to servers, the current understanding of the PE definition leads to uncertainty and confusion. In particular, considering the development of steadily smaller servers, neither the OECD Model nor the Commentary provides certain guidance, the latter being just one aspect of the challenging taxation of server operations.[14]

2.2. Exemption for preparatory and auxiliary activities and the digital economy

The negative list in article 5(4) of the OECD Model has been the object of international tax planning aimed at eroding the sovereignty of the market country. This is particularly the case of the exemption for activities with a preparatory or auxiliary character in article 5(4)(e) of the OECD Model, which also raises specific issues in respect of the digital economy.

The OECD concludes that "tax in a market jurisdiction can be artificially avoided by fragmenting operations among multiple group entities in order to qualify for the exceptions to PE status for preparatory and auxiliary activities."[15]

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12 *OECD Model Tax Convention on Income and on Capital: Commentary on Article 5* para. 42.2 (OECD 2014 [condensed version, 15 July 2014]).

13 Collin & Colin, *supra* n. 1, at 63. For further details see B. Westberg, *Cross-Border Taxation of E-Commerce* (IBFD, 2002), section 5.4.7.

14 For further details, *see* J. Monsenego, *May a Server Create a Permanent Establishment? Reflections on Certain Questions of Principle in Light of a Swedish Case*, 21 Intl. Transfer Pricing J. 4, p. 247 et seq. (2014).

15 OECD/G20, *Addressing the Tax Challenges of the Digital Economy* p. 102 (OECD 2014).

When applying the negative exemption of auxiliary and preparatory activities, it is decisive to distinguish such activities from the core business of an enterprise.[16] The case studies mentioned in the report Addressing the Tax Challenges of the Digital Economy, however, are in principle (besides the case of the warehouse of the online retailer)[17] not related to the question whether activities fall under the auxiliary and preparatory exemption.

All of the mentioned enterprises create revenue in one of the countries without having a physical presence or with having only a limited physical presence (i.e. support or marketing subsidiary). Therefore, the exemption of preparatory and auxiliary activities is not one of the main drivers of BEPS (or low taxation in general) within the digital economy and, as a consequence, it should not be emphasized too much when discussing a potential change of the framework of the PE concept as it would have a limited impact.

The OECD intends to amend five elements/features of the list in article 5(4) of the OECD Model that could have an impact on the taxation of the digital economy:
– the exceptions are not restricted to preparatory or auxiliary activities;
– the word "delivery" in subparagraphs a) and b) of paragraph 4;
– the exception for purchasing goods or merchandise or collecting information;
– fragmentation of activities between related parties; and
– splitting-up contracts.

But as far the pure digital economy and not e-commerce is concerned, these amendments will not much counter any BEPS and would also not change the current income allocation between jurisdictions with regard to the digital economy. The term e-commerce is for the purpose of the present study understood in a narrow sense. This means that it only covers online platforms that buy and sell physical goods in their own name and are fully fledged.[18]

Our focus hereby is therefore on the development of a new potential PE nexus based on the digital economy.

2.3. Article 5(5) of the OECD Model and the digital economy

The EU Commission Expert Group on the Taxation of the Digital Economy – also considering the development at the level of the OECD – stated the importance to ensure:

> [W]here a foreign online seller of tangible or digital products or a foreign online provider of advertising or other services has an established presence in a country, a PE cannot be formally circumvented, for example by concluding contracts via the internet or via a commissionaire agent.[19]

16 *See* with further details J. Sasseville & A.A. Skaar, *General Report*, in *Is there a Permanent Establishment?*, 94a IFA Cahiers de droit fiscal international, p. 40 et seq. (Sdu Uitgevers 2009).
17 For further details, *see* the case studies in the Annex.
18 For more details about the term e-commerce in general, *see* A.Y. Prussak, *Online Advertising: The Implication of Technology for Source-Based Taxation*, 71 Tax Notes International 7, p. 654 (2013).
19 European Commission, *Report of the Commission Expert Group on Taxation of the Digital Economy*, p. 49 (28 May 2014). For more details about the Report's conclusions see also B. Westberg, *Taxation of the Digital Economy – An EU Perspective*, 54 Eur. Taxn. 12 (2014).

Despite the fact that the signing of a contract is an indispensable event for any business, the place of formal signature has lost its importance due to developments within the digital economy. Within the "real economy", it is also obvious that contracts are often "signed" online. This shows that for tax purposes, the current wording of the dependent agent PE definition according to article 5(5) of the OECD Model may also be outdated. The OECD proposes in its public discussion draft on BEPS Action 7, Prevent the Artificial Avoidance of PE Status, to extend the application of the dependent PE by replacing "conclude contracts" and/or the wording "contracts in the name of".[20]

The work of the OECD within BEPS Action 7 needs to be considered when developing a new nexus based on digital presence; however, the focus in the following is on the introduction of a new PE nexus, rather than on amending the current exceptions and specifications in article 5(2) -(7).

2.4. Amending the existing PE definition – some conclusions

For various reasons, some of which have been demonstrated earlier in this paper, the current PE definition provided by the OECD Model is no longer fit to operate in the scenario of the digital economy.[21] Interestingly, in 2003, after having analysed the e-commerce business in detail, the OECD tried to keep the physical presence requirement within the PE concept and put forward some slight amendments.[22]

We believe that the developments of the digital economy show that such attempt has proved unsatisfactory. In our view, as long as the requirement of a fixed place of business remains within the definition, it seems unlikely that amendments of other requirements (e.g. abolish/amend the exemption for auxiliary services or amend the agent PE definition) may significantly improve the critical issues related to business income taxation and affect the jurisdiction of the source state, as described by the BEPS project.

For instance, allocating a certain amount of profit to a server without having personnel in a certain jurisdiction (i) does not solve the issues of the taxation of the digital economy in essence and (ii) even worse, leads to an unfair allocation of taxing rights.[23] Only with regard to certain enterprises of the digital economy would an amendment of the current exceptions limit the risk of BEPS or change the income allocation between jurisdictions. Namely, e-commerce enterprises currently benefit from certain exceptions; for instance, warehouses or show rooms. Moreover, this report does not focus on the potential amendment of the dependent agency PE in general as it does *not* seem to be the Holy Grail for the purpose of addressing the tax challenges of the digital economy.

20 OECD/G20 *Preventing the Artificial Avoidance of PE Status, Public Discussion Draft* p. 11 et seq. (OECD 2014).
21 *See also* OECD/G20, *Addressing the Tax Challenges of the Digital Economy* p. 143 (OECD 2014).
22 *See* with further details N. Gaoua, *Taxation of the Digital Economy: French Reflections*, 54 Eur. Taxn. 1, p. 12 (2014).
23 *See* with further details about a specific case, Monsenego, *supra* n. 14, at 247 et seq.

3. Developing a Theoretical Framework for the New Nexus

3.1. General issues

The starting point of our proposal for a new PE nexus should be the theoretical framework within which the PE concept was developed. While providing for this historical reconstruction, we will also take into account the need to ensure a solution that preserves the effectiveness of the exercise of taxing jurisdiction and fairness in the allocation of taxing rights on cross-border business income.

We certainly agree that the draft of a new proposal for a new PE nexus based on digital presence should be – as far as possible – in line with the general (existing) principles of international tax law. Such compliance increases worldwide acceptance of the new definition and ensures an effective implementation. However, the very foundations of certain existing principles and rules should also be scrutinized, since otherwise the framework for the proposal would be limited.

In our view, the current PE definition is not carved in stone, nor is it a fixed concept. The positive boundaries of such concept do not per se express ontological values of international tax law, but only enjoys a legal status to the extent that the various states retain such boundaries and core essence to PEs within their tax treaties. The concept of PE is rather to be regarded as a compromise that strikes a fair balance between the exclusive taxation of the state of residence of the enterprise and the right of the market country to have a fair share of taxes in respect of business activities that are stably located on its territory.[24] This compromise was reached at a time in which the PE concept was the best possible proxy to determine the existence of a sufficient nexus of business with the taxing jurisdiction of a country other than that of residence of the taxpayer. In other words, without a physical presence outside the country of residence, business income was mainly the outcome of production factors organized under the taxing jurisdiction of such country.

We are certainly in agreement with the fact that almost all tax treaties currently include the PE concept and use it as a key element to determine the allocation of taxing rights on cross-border business income. However, the boundaries of such concept are not always consistent across the world neither as to their wording, nor as to their interpretation.[25]

Furthermore, if the functioning of the PE allows the market country to exercise its jurisdiction, its implications for the resident state differ according to the method used for relieving double taxation, thus not implying some kind of necessary outcome as to the allocation of taxing powers.

In particular, if one views the PE concept from the treaty perspective, one can regard it as a legal fiction created by international tax law in order to allow business taxpayers to link their tax obligation in the market country with that of their residence state and achieve a

24 That a certain amount of profit should also be allocated to the market country will be shown in more detail in section 4.8.

25 P. Pistone, *General Report*, in *The Impact of OECD and UN Model Convention on Bilateral Tax Treaties* p. 13 et seq. (M. Lang et al. eds., Cambridge University Press 2012).

coordinated outcome in the exercise of taxing sovereignties that structurally prevents juridical double taxation. From such perspective, it is no wonder that the concept of PE is hardly regulated by other fields of law,[26] if not for reasons that are related to the need of preserving an effective functioning of domestic or treaty law in tax matters.

However, even if one conceded that the PE is a regular feature of international tax law, this would not necessarily lead to conclude that it constitutes the expression of a kind of customary international tax law.

Analysing whether customary international tax law at all exists is not indispensable for the specific purposes of this study. However, even if one admitted its existence, we question whether the PE concept would fall within the boundaries of customary law. This conclusion could be based on various arguments, including the fact that it is not persuasive to argue that there is an unwritten obligation in the sense of an *opinio iuris* according to which taxation of non-resident enterprises should be limited to cases in which a PE is given.

Furthermore, even if one came to the opposite conclusion, i.e. that the PE concept is as an expression of customary international tax law, nothing would prevent altering the boundaries of its concept in a situation where, in a growing number of cases due to a changed environment, this ends up in preventing the market country from exercising its taxing jurisdiction in respect of income linked to its territory. In our view, especially at a time when international tax law is undergoing a dramatic change of a large number of the existing rules, it is important that the existing concepts are not only interpreted in their current framework, but also to consider whether the theoretical foundations for such concepts still reflect the values and background which existed at the time when they were initially put forward. With special reference to the PE, its function was and should remain that of ensuring a fair allocation of taxing rights between the market country and the state of residence. Therefore, to the extent that international tax planning and the shift to the era of the digital economy have questioned its suitability of reflecting such values, any intervention on the conceptual boundaries of the PE nexus is not only possible, but a desirable goal.

For the purposes of paving the road to a theoretical reconstruction of the PE concept as a new nexus for the exercise of taxing powers on business income in the era of the digital economy, we will now focus on two theories that are of particular importance for bringing the PE concept back to a conceptual framework where it ensures a fair allocation of taxing rights between the market country and the state of residence of the enterprise and, more in general, allows the former state to exercise its taxing jurisdiction on a proper basis.

Such theories are in particular the one that postulates a link between sourcing and taxing rights on income, hereinafter also referred to as “the sourcing theory”, and the one that links taxing rights with the benefits derived by a taxpayer in a given jurisdiction, hereinafter also referred to as “the benefit theory”.

26 Certain jurisdictions, for instance, have specific legislation covering the registration of branches in the commercial register.

3.2. The sourcing theory

At the turn of the 20th century, an Italian tax academic described income to be the new wealth linked to an energy or force of production in the framework of a causal relation.[27] Due to the existence of strong academic links between Latin countries of Europe and South America in tax matters throughout the past century, such vision significantly influenced Latin American scholars at the time in which they defined the justification of the power to tax income, linking it to the production of such new wealth and its relation with the territory upon which a state exercised its jurisdiction.[28] This ad rem nexus was easy to conceive in the framework of systems that were mainly centred on schedular income taxation and did not put emphasis on the personal situation of a taxpayer.

While the relevance of the sourcing theory lost importance in European Latin countries in line with the diffusion of comprehensive income taxation, it retained momentum among Latin American legal scholars of taxation, who went on defending such theory (often known among Latin American scholars as "*teoría de la imposición en el País de la fuente*") from the perspective of allowing the country of source to have a fair share of tax in respect of activities that were essentially carried out on their territory.[29]

From the late 1950s onwards, such position gradually began to conflict with the developments of comprehensive income taxation of individuals and systems that tried to achieve an equivalent justification for the rights of capital exporting countries to protect their taxing sovereignty from relocation of income-producing activities. However, Latin American countries maintained their position for several more decades and used this conceptual framework as a justification for preserving their territorial tax systems,[30] – until they relinquished it on the basis of their double tax treaties or reforms in their domestic tax systems.

The conceptual merits of this theory are to allow countries to exercise their taxing jurisdiction in respect of activities that produce income on their own territory. From the latter perspective, one may also recall a similar position in international tax literature being defended in Indian tax literature as the expression of the right of a country to exercise its taxing jurisdiction on income derived from the exploitation of its territory.[31] However, as rightly indicated in tax literature,[32] the link with territoriality and the potential existence of international customary law in tax matters gradually evolved into a link with the existence of a connecting factor with the taxing jurisdiction.

27 *See* O. Quarta, *Commento alla Legge sull'Imposta di Ricchezza Mobile*, vol. I (Società Editrice Libraria, 1902), p. 111.
28 *See* C.M. Giuliani Fonrouge, *La doble imposición en el primer informe del Comité fiscal de la Organización Europea de Cooperación Económica*, T. 96 Revista La Ley (1959), p. 788.
29 *See* A. Mazz, *Rasgos fundamentales de la doctrina latinoamericana sobre el Derecho Tributario Internacional y los requerimientos actuales de éste*, in *Reflexiones en torno a un modelo latinoamericano de convenio de doble imposición* p. 31 et seq. (A. Mazz & P. Pistone coords., Fundación de Cultura Universitaria, 2010).
30 *See* R. Valdés Costa, *La experiencia latinoamericana en la imposición internacional*, in *Estudios de Derecho Tributario Latinoamericano* p. 281 et seq. (Fundación de Cultura Universitaria, 1982).
31 For further details, *see* R. Rohatgi, *Basic International Taxation*, 2nd edn, vol. I, p. 222 et seq. (Taxmann, 2005).
32 L. E. Schoueri, *Direito Tributario*, 4a edição, p. 791 (Saraiva, 2014).

Various reasons have contributed to the decline of the sourcing theory in international tax law over the past decades, including the development of comprehensive income taxation and the support of capital-exporting countries for exercising their taxing jurisdiction on the basis of a combination of personal and real connecting factors that softened the effects of tax biases towards business relocations.

Nevertheless, for the purposes of our analysis, the theoretical validity of the sourcing theory remains unaltered. The existence of a genuine link with the taxing jurisdiction of the country where income is sourced and the right of such country to tax business income should never be questioned or put in danger in so far as the presence of a non-resident in the market country is not merely occasional.

The global economy has significantly altered the framework for the source of business income as compared to the one within which the sourcing theory of taxation was developed. Currently, goods are often produced in one country by a resident of another country and sold in yet one or more countries. In particular, the digital economy gives the source of business income a completely new dimension, no longer confined to bilateralism between one country of source and another country of residence, but spreads through more source countries in a multilateral scenario. Besides, the ontological validity of residence as a nexus to the taxing jurisdiction is gradually losing importance, since international tax planning has proved that in some cases, very limited functions are performed in such country, as frequently happens within multinational groups of companies.

Accordingly, we submit that the pendulum could shift back to a stronger reliance on the sourcing theory at least within the digital economy. However, it should do so within a new dimension, where such theory can help in establishing the nexus with the taxing jurisdiction(s) in which business income is created. Since the digital economy allows selling goods, respectively, services in a market without a physical presence of the seller or the service provider, we believe that a modern dimension of the sourcing theory could be invoked in order to justify the exercise of the taxing jurisdiction by the market country in respect of such business income. Likewise, since goods can be produced elsewhere and also in one or more countries other than that of residence of the taxpayer, a modern framework for the sourcing theory can also help in establishing a nexus with such country(ies) in respect of the corresponding portion of business income.

In other words, the new dimension of the sourcing theory provides the theoretical background for drawing a nexus with the taxing jurisdiction that moves away from the association with physical presence and more closely reflects value creation in respect of business income in the era of the digital economy.

This new dimension should also take into account the theory of taxation of income in the country of origin, put forward by Kemmeren, according to whom,

> The principle of origin justifies allocation of tax jurisdiction on income to a state if the income has been created within the territory of that state, i.e. the cause of the income is within the territory of that state. The origin of income is where the intellectual element

(among the assets) is to be found. This intellectual element is provided by the activities of individual human beings. Only individuals can create income and things in themselves cannot.[33]

In Kemmeren's view, the activities of individuals within an enterprise are decisive in calculating the income to be allocated to a certain jurisdiction. The principle of origin can be invoked to back up international income allocation for tax purposes, since people functions are the key factor in calculating the taxable income to a certain jurisdiction.[34]

However, the principle of origin as understood by Kemmeren only relates to the supply side of income creation and ignores that the demand itself also creates value. We therefore submit that an incorporation of the principle of origin in the new dimension for the sourcing theory provides for an important theoretical contribution to achieve a closer link with the nexus on business income in line with the needs of the digital economy, but that such nexus should also take into account additional factors, including those that arise in the market country and that can influence the performance of business and value creation arising in such context.

Once all such aspects will be analysed, a separate section of this paper will address the issues related to the allocation of taxing powers on business income among the relevant jurisdictions.[35] Meanwhile, we find it appropriate to conclude from a theoretical perspective that a modern dimension for the sourcing theory in the era of the digital economy should regard as source all jurisdictions in which value creation occurs in respect of business income either on the supply or on the demand side.

3.3. The benefit theory

When dealing with taxes it is essential to understand taxes "as the price paid for all state services by all taxpayers taken together, and countries obtain their right to tax based on the services (benefits) provided."[36] Following the benefit theory, a potential new PE definition should at least to some extent refer to the services or goods obtained by a taxpayer in a jurisdiction. And, moreover, the benefit theory helps to define the applicable new threshold for the PE; however, the threshold defined in article 5 of the OECD Model will always be somehow artificial.

The approach, i.e. the benefit theory, or a similar exercise of taxing powers on the basis of economic allegiance (*wirtschaftliche Zugehörigkeit*), is not new and has its foundations in theories developed between the late 19th century and the first decades of the 20th century. Von Schanz wrote in 1892 that anyone having a relation to a society, i.e. anyone receiving

33 E.C.C.M. Kemmeren, *Legal and Economic Principles Support an Origin and Import Neutrality-Based over a Residence and Export Neutrality-Based Tax Treaty Policy*, in *Tax Treaties: Building Bridges between Law and Economics* section 5 (M. Lang et al. eds., IBFD 2010).

34 For further details, *see* S. Mayer, *Formulary Apportionment for the Internal Market* p. 29 (IBFD 2009). With further references, *see also* M.F. de Wilde, "*Sharing the Pie*", *Taxing Multinationals in a Global Market* p. 303 (PhD thesis, Rotterdam 2015).

35 For further details, *see* section 4.8.

36 D. Pinto, *The Need to Reconceptualize the Permanent Establishment Threshold*, 60 Bull. Intl. Taxn. 7, p. 267 (2006).

benefits from public community should also bear the costs of such public community (*Gemeinwesen*).[37] Furthermore, Von Schanz also stated the following:

> *Die deduktive Betrachtung hat uns auf die wirtschaftliche Zugehörigkeit geführt und gezeigt, dass diese den Kreis der Steuerpflichtigen in einer Weise umschreibt, welche den beiden Anforderungen einer innerlich begründeten und zugleich wirksamen Abgrenzung der Steuergewalt am meisten entspricht*.[38]

The economic allegiance is accordingly not only an effective instrument in order to allocate taxing rights, but also it is justified by itself. Based on such views, Von Schanz reached the conclusion that taxing powers should be retained by three quarters with the country of source and only the remaining part with the state of domicile.[39]

Without referring to Von Schanz, Harding argued in 1933 that:

> It appears that the State may tax all property, goods, labor, services and the like, which have become identified with the economic structure of the State, by incorporation into or integration with the business mechanism so defined … the right to tax then depends upon the fact that the economic wealth is being used in the coordinated economic task of the social group; that it is producing utility or wealth or service in connection with, as a part of, and because of the economic solidarity of the social group.[40]

The various examples mentioned by Harding,[41] as well as all additional reasons indicated earlier in this document, disclose that the current PE definition is not carved in stone and a more integrated approach based on a new dimension of the economic allegiance could be feasible. For instance, the taxation of chattels, or movable property, not permanently linked to a state, seems, according to Harding, to be justified even without a fixed place of business.

Other scholars have referred to Von Schanz and Harding throughout the last decades. For instance, as emphasized by Vogel, it is the country of source that provided the benefits necessary for the production of goods. This means, according to Vogel, that it "cannot convincingly be denied that providing a market contributes to the sales income at least to some extent as providing the goods does. There is no valid objection, therefore, against a claim of the sale state to tax part of the sales income."[42]

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37 "Jeder, der wirtschaftlich an die Gemeinschaft gekettet ist, d.h. jeder, dem aus der Erfüllung der Aufgaben des Gemeinwesens Vorteile erwachsen, trägt zu den Lasten bei" G. von Schanz, *Zur Frage der Steuerpflicht* p. 372 (Finanzarchiv 1892).

38 "The deductive consideration has taken us to the economic allegiance and showed that it delimitates the circle of taxpayers in a way that in most cases corresponds to both the requirements of an internally founded and meanwhile effective delimitation of the [exercise] of the power to tax", Von Schanz, *supra* n. 37, at p. 434 et seq.

39 Von Schanz, *supra* n. 37, at p. 375. A similar position was also held by M.B. Carroll, *Allocation of Business Income: The Draft Convention of the League of Nations*, 34 Colum. L. Rev. 3, p. 473 et seq. (1934), who essentially agreed on the residual taxing powers of the head office state and suggested all business income components be split between the two contracting states involved.

40 A.L. Harding, *Double Taxation of Property and Income* p. 42 (Harvard University Press, 1933).

41 Id., in particular p. 46 et seq.

42 K. Vogel, *Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part III)*, 16 Intertax 11, p. 401 (1988).

Musgrave also states that source taxation "may be thought of in benefit terms, as a quid pro quo payment for cost/reducing, profit enhancing services provided by the host country."[43] Moreover, the OECD itself accepts that by implementing an agency PE in article 5(5) of the OECD Model that the fixed place of business is not the appropriate threshold for all enterprises. Of major interest also is the Indian approach of a business connection as the threshold for taxation, which seems at first glance to be similar to the integration proposed by Harding.[44] With regard to e-commerce, D. Pinto mentioned that benefits received in a jurisdiction are at least equally relevant as the fixed place of business. [45] The benefit theory not only has advantages, as demonstrated in detail by Schön, but, evidently, if one tries to allocate income to a jurisdiction with a direct and precise link to the benefits obtained, it seems impossible to achieve a perfect result.[46]

When the benefit theory developed and the PE definition was implemented into the OECD Model, neither the digital world nor computers existed. This could be one reason why it is argued that a physical presence is required for source taxation as there had not been any possible benefits besides physical benefits that could occur (e.g. streets, public transport, police, etc.).[47] However, a fixed place of business as a threshold apparently still has certain advantages.

As pointed out by Arnold, the two main justifications of requiring a fixed place of business as threshold are (i) the enforcement of taxes is actually a lot easier if there is fixed place of business in a jurisdiction and (ii) it leads to certainty for both taxpayers and tax officials.[48]

The requirement of a fixed place of business also prohibits a too extensive fragmentation of the tax basis. In this sense, the Swiss Federal Supreme Court stated as early as 1898 that a certain threshold (i.e. a fixed place of business) is required, since otherwise the exercise of taxing powers could lead to double taxation and a significant limitation of trade and business.[49]

The requirement of a fixed place of business has undeniable advantages that have historically contributed to its success in line with the business models that have operated for several decades and which are reflected in the rationale of the present definition within the OECD Model.

However, as indicated earlier in this paper, it does not constitute per se a principle of international taxation according to which source taxation of business income requires a fixed place of business. It rather has the mere value as an expression of positive law included in tax

43 P. B. Musgrave, *Consumption Tax Proposals in an International Setting*, 12 Intl. VAT Monitor 2, p. 57 (2001); *see also* for more details E.C.C.M. Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models* p. 21 et seq. (Pijnenburg 2001).

44 For more details, *see* M. Butani & P. Jain, *Permanent Establishment Concept – An Indian Perspective*, 20 Asia-Pac. Tax Bull. 4, p. 247 et seq. (2014).

45 *See* D. Pinto, *E-Commerce and Source-Based Income Taxation* section 2.1. (IBFD 2003).

46 For more details, *see* W. Schön, *International Tax Coordination for a Second-Best-World (Part I)*, 1 World Tax J. 1, p. 75 et seq. (2009). *See also* I. Roxan, *Limits to Globalisation: Some Implications for Taxation, Tax Policy and the Developing World*, LSE Law, Society and Economy Working Papers 3/2012.

47 With regard to such traditional understanding with further details, *see* Avery Jones, *supra* n. 4, at section 3.3.

48 Arnold, *supra* n. 4, at section 1.1.2.1.2.

49 *See* CH: BGE 24 I, p. 444 et seq.

treaties, which can be the object of changes, just like all other clauses contained therein to the extent that they are unsuitable to achieve a fair and balanced allocation of taxing powers in the digital economy.

For the purpose of framing the benefit theory within a new dimension, which more closely reflects the relevant factors of the business models developed by the digital economy, we now briefly mention that business may receive a number of benefits from the state of residence of the customer and/or user.

In particular, as indicated by scholars, such benefits are:[50]

– *Legal system in general:* Without a legal system allowing a digital world, enterprises could not offer their products online.

– *Enforcement of customers' payments:* Without such guarantee, enterprises would be reluctant to offer their products in certain jurisdictions.

– *Protection of intellectual property rights:* Without such guarantee, enterprises would be reluctant to offer their products in certain jurisdictions.

– *Maintenance of digital environment:* Without sufficient technical infrastructure, no digital products could be offered.

– *Supply of energy:* Without sufficient energy supply, no digital products could be offered.

– *Waste recycling:* Such benefit is essential for the e-commerce industry.

– *Infrastructure* in general.

The existence of such benefits, even in the absence of a physical presence, proves that the new business models developed by the digital economy should not prevent a state from exercising its taxing powers on such business income in order to counterbalance the cost borne to provide its services.

4. Our Proposal

> "The challenge of this 'new economy' is not new, of course. The OECD, together with essentially all countries, struggled with it in the recent past. It was rather successful in reaching some sort of a consensus on some critical issues – mainly those concerning permanent establishments (PEs) – at a time when most countries had remained helpless and unable to act unilaterally. Nonetheless, such success provided only a Band-Aid for a more serious hurt."[51]

Consequently, we agree that – in general with regard to the BEPS Project and in particular with regard to Action 1 – the success of the BEPS Project relies heavily on the possibility to

50 Most of these benefits have already been mentioned by Pinto, *supra* n. 36, at 268 et seq.
51 Y. Brauner, *BEPS: An Interim Evaluation*, 6 World Tax J. 1, p. 15 (2014).

implement new linking rules that are suitable to secure a fair and balanced allocation of taxing rights in line with the new business models developed by the digital economy, instead of adapting the existing rules to the new scenario.[52] However, when dealing with a new nexus based on digital presence, it is by far not only a question of countering BEPS, but also about a new allocation of taxing rights in general.

In the present chapter we will develop a new nexus as the basis for a new PE definition and concept, which no longer requires the physical presence and therefore implies a structural revision to the existing tax treaties categories affecting taxation of cross-border business income.

4.1. A modern theoretical framework for the new PE nexus in a nutshell

Our analysis has shown that a revision to the traditional theories, i.e. the sourcing and the benefit theories, if adapted to the different factual scenario of the digital economy, constitutes a valid theoretical background in international taxation for developing a new PE nexus for the digital economy.

The multiple sourcing of business income, which is intrinsic to the business models resulting from globalization and the digital economy, should be reflected in the exercise of taxing powers in order to avoid any unfair erosion of sovereignty of the market jurisdiction in respect of value created by business. Its combination with the benefit theory may allow for an exercise of taxing powers on business income that achieves a fair balance between taxing rights and the services and/or infrastructure provided by each state, including the one whose market is being exploited along the new models put forward by the digital economy, even in the absence of a physical presence.

The overall advantages of a nexus for business income based on the concept of fixed place of business (certainty, enforceability, limitation of fragmentation) should nevertheless be adapted to the new scenario.

4.2. The content of our proposal

Our analysis has clarified that the introduction of a new PE nexus based on digital presence can be considered as being in line with the general principles of international tax law.[53] However, the exact new nexus should be carefully drafted as it could be ring-fencing, i.e. give rise to an infringement of the neutrality principle.[54]

From a theoretical perspective, the slicing of business income in line with its sourcing constitutes the starting point for the allocation of taxing powers. A PE nexus will therefore exist whenever the digital or physical presence of business in a country gives rise to value creation.

52 Id., at 16.
53 Our conclusion matches the one already put forward by Pinto, *supra* n. 36, at 276 et seq.
54 For more details about the neutrality principle, *see* section 7.1.

However, the allocation of taxing powers should also take into account the benefit theory. The main benefits of the digital economy are that the customer and/or user state provides for an infrastructure that allows the enterprise to sell its products (*see* section 3.3.). Such infrastructure not only consists of Internet infrastructure itself, but a state also needs to provide for energy supply in general, streets, a working legal system, etc.

One has to admit that it is impossible to calculate the actual benefit of the various digital economy enterprises on a case-by-case basis. The difficulty is even greater to the extent that one takes into account the potential context of multiple sourcing that arises when goods and services are produced in one or more countries than that of the residence of the taxpayer or of their destination.

Certain objective parameters should therefore be implemented as also required by the principles of efficiency and practicability. Taking into consideration that the use of infrastructure is one of the main benefits of foreign enterprises in the customer's jurisdiction, the threshold when defining the new nexus should also have link to the use of infrastructure as far as this is feasible.

An important particularity with regard to e-commerce business is that due to its physical flow of goods, the enterprise also benefits from other infrastructure such as streets, airports, etc. The question is therefore whether there is a justification to implement a different threshold for different areas of the digital economy. Or whether one could even argue that e-commerce should be excluded (not directly but indirectly) from the new nexus based on digital presence. It is our opinion that in case the current PE definition due to Action 7 of the BEPS Action Plan is amended, the income of the e-commerce business will already be reallocated between the resident and the market country and the market country will at least partly get its fair share of the income. There are obviously cases that would not create any tax liability in the market jurisdiction, such as an e-commerce enterprise with no warehouses in a market country. However, there is no urgent need to include e-commerce in the scope of the new nexus and it would be extremely difficult to distinguish between e-commerce and the "real economy". A clear distinction, however, seems possible between digital services and the supply of physical goods. Yet, there are certain grey areas, for instance, if the company is not actually selling products, but only provides an online marketplace. Further research on these specific issues is required in the framework of a dedicated study.

Considering the above outcome, the new threshold could rely on the following elements:

(1) *Providing access to (or offering) an electronic application, database, online marketplace, storage room to users domiciled in the other contracting state or offering advertising services on a website or in an electronic application used by users domiciled in the other contracting state:* The new nexus should define the actual revenue grounds that shall be affected by the new provision.

(2) Amount of users of the electronic application or website (not customers) (assumption: 1,000 users per month): The problem of having a customer-based and not a user-based threshold is that the customer-based threshold has a less closer link to the benefit

obtained in a certain jurisdiction and is therefore less in line with the present rationale. The more users a company has, the more significant is the digital presence (in general). An even better threshold would be the amount of time spent by users on a specific online platform, be it a website or an electronic application, as this would indicate the level of use of the infrastructure in a specific jurisdiction, i.e. the obtained benefit. Furthermore, we are of the opinion that the more users there are in a certain jurisdiction, the higher is the value creation there and, as a consequence, considering the sourcing theory, the justification for taxation is higher. Another option would be to rely on other thresholds reflecting the benefit theory and the sourcing theory. Data usage, for instance, could be an aspect to be considered. In this respect, the present paper does not call for absolute specifics, but rather pursues the goal of provoking a more concrete discussion on this matter.

(3) *Certain time threshold (assumption: 12 months after the enterprise has breached the user threshold above):* Considering the detrimental consequences of non-compliance in certain jurisdictions and also the fast-growing potential of certain online business, it is worthwhile to include a minimum time threshold. One possible option could be to set it with reference to the 12 months following that in which the enterprise has breached the user threshold indicated above. Such time threshold could also be shorter in order to prevent possible erosions of the nexus through short-duration activities. However, such goal can best be achieved by constructively assembling all activities carried out by the non-resident and related parties.

(4) *Amount of revenue [XXX (EUR, USD, GBP, CNY, CHF, etc.)]:* The setting of a minimum yearly amount of revenue should also be included, since otherwise the tax liability, in particular of SMEs, could be too fragmented. However, we also believe that an alternative approach could be not to set such threshold by making reference to a fixed amount, but rather to include a number with a relation to the overall wealth or economic power of a jurisdiction (e.g. a relation to the average income or the GDP). Furthermore, we also find it important to underline that the revenue must be linked to the digital service. This means *a contrario* that revenues caused by the physical flow of goods shall not be relevant for the application of the new threshold (i.e. a full-fledged e-commerce provider with regard to its own products).

In our view, the new nexus definition in the OECD Model could have the following wording and be provided for in a new article 5(8) of the OECD Model:

> **If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online marketplace, 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.**

Furthermore, inter alia, the following terms would need to be defined in more detail in the respective Commentary:

– To provide access to (or offer) an electronic application
– database
– online marketplace
– storage room
– advertising services
– website
– users
– per month
– domiciled[55]
– total amount of revenue
– due to the aforementioned services.

4.3. Adapting the PE nexus to the new scenario: Some practical issues

4.3.1. Minimum threshold

The report on Addressing the Tax Challenges of the Digital Economy does not provide for a specific threshold of digital presence. According to the OECD, it could be (i) digital sales, (ii) number of contracts, (iii) number of users or (iv) level of consumption.[56]

From our own perspective, if one actually considers introducing a new nexus, a minimum threshold as developed above in section 4.2. should be required in order to avoid an excessive fragmentation of the taxable income worldwide. Therefore, an online advertiser should not form a PE, in so far as such company sells a single online advertising space in a jurisdiction per year, since the latter will be tantamount to an occasional business activity on that market.

4.3.2. Ensure the avoidance of double taxation

As stated by many commentators during the public consultation of the BEPS Project in general, it will be important to change the rules of international taxation without leading to additional (new) double taxation.[57] In this regard, it is of particular interest that not only the PE definition based on digital presence is harmonized, but also the applicable income allocation. At first glance, it seems that the application of identical transfer pricing rules with regard to the new nexus is even more important than in other areas of cross-border transactions, since a potential profit could be divided not only between two countries, but also between several jurisdictions.

55 The term "domiciled" should be defined in more detail. It should be understood in a technical sense in order to achieve that a user is actually using a digital service in a certain jurisdiction. This is why as a consequence the term "resident" as a defined term in the OECD Model was not used for the purpose of the new nexus.

56 *See* W. Hellerstein, *Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments*, 68 Bull. Intl. Taxn., 6/7, p. 348 (2014); OECD/G20, *Addressing the Tax Challenges of the Digital Economy* p. 145 (OECD 2014).

57 E.g. *see* AmCham EU, in *Comments Received on Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 16 April 2014, p. 3 (OECD 2014); BIAC, in *Comments Received on Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 16 April 2014, p. 3 (OECD 2014).

4.3.3. Loss-making business

It should not be neglected that a considerable amount of enterprises within the digital economy are in a loss position, in particular, start-ups operating in several jurisdictions. Therefore, when drafting a potential new PE definition and/or new transfer pricing guidelines, it is to be avoided that loss-making companies will face a significant tax burden in several countries. Moreover, the introduction of a new nexus based on digital presence also requires a detailed analysis of the applicable transfer pricing method in a loss position. In this regard, we develop a potential option in section 4.8.

4.3.4. Allocation of profit in a jurisdiction with several tax rates

In case there is no physical presence in a jurisdiction, it would also be necessary to give certain guidance where a specific profit shall be allocated. We especially bear in mind federalist states that apply various tax rates within their jurisdiction. For instance, if, due to the new PE concept, an online advertiser would form a new virtual PE in Switzerland, it would need to be allocated to a certain canton/municipality due to the various tax rates.

4.4. Comments from the public consultation

The comments during the public consultation on BEPS Action 1 were mainly critical with regard to the introduction of a new nexus based on digital presence and, most of the comments therefore did not deal in detail with a potential new threshold for PE as these commentators generally denied the necessity of a new nexus. Nevertheless, certain comments could eventually be helpful for our work:

> We also recommend reviewing the list of exceptions to Permanent Establishment in particular, so as to avoid/limit cases where a substantial share of an MNE's activity is carried out in a foreign country through direct (internet) [sic] sales to customers, but with no reported tax presence (e.g. no subsidiary or branch) in the said foreign country. The PE definition could possibly be reviewed by introducing some materiality threshold based on the level of business of an MNE in a foreign country in which it has no reported corporate tax presence (subsidiary or branch). As an example, if more than x% of consolidated sales of an MNE headquartered in country A is realized in a foreign country B, and subject to meeting other criteria as per (revised) Article 5 of the OECD Model Convention, the MNE headquartered in country A could be deemed to have a permanent establishment in country B.[58]

These authors therefore agree that a PE concept without any physical presence could be feasible and, interestingly, they also refer to sales as a potential threshold.

58 Association Française des Femmes Fiscalistes, in *Comments Received on Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 16 April 2014, p. 3 (OECD 2014).

Another comment could also of relevance:

> Financial services such as the destination market credit card business described above could easily fall into the category of dematerialized digital activities that maintain a significant digital presence in the jurisdiction where the customer is located. There is, however, no discernible principle of tax policy to subject such enterprises to taxation in a jurisdiction where it has no employees, agents, or tangible assets while at the same time apparently continuing to exclude from taxation enterprises that sell physical products into the jurisdiction without a physical presence there. In addition, it would most likely be very difficult to administer as a practical matter, both for taxpayers required to comply with it and for tax administrators attempting to audit it. Expanding the concept of nexus in this manner would be a radical departure from longstanding [sic] principles of international taxation found in treaties and the internal tax laws of most countries, and we believe if pursued it must be done in a way that fully considers the numerous challenges from both a theoretical and practical perspective, does not disproportionately impact financial services businesses, and is confined to the abusive situations that are within the scope of the BEPS Action Plan.[59]

The opinion of these authors is very much in accordance with the methodology of the present report in the sense that a potential new PE nexus based on digital presence should not only be in line with theoretical aspects but also consider the practical impact.

With regard to the draft of the new threshold, the following comment could be helpful:

> The criteria which we suggest for a Significant Presence should reflect the contribution to value added resulting from the closer and interactive relationships with customers. These should include:
> (a) relationships with customers or users extending over six months, combined with some physical presence in the country, directly or via a dependent agent;
> (b) sale of goods or services by means involving a close relationship with customers in the country, including (i) through a website in the local language, (ii) offering delivery from suppliers in the jurisdiction, (iii) using banking and other facilities from suppliers in the country, or (iv) offering goods or services sourced from suppliers in the country;
> (c) supplying goods or services to customers in the country resulting from or involving systematic data–gathering or contributions of content from persons in the country.
> Although broad, these criteria would still exclude many businesses involved in the digitalized economy. For example, a software designer which supplies a program in digital form to customers all over the world from a single website in the language of its residence country would not be covered. The aim of the definitions is to capture situations where the firm has a significant presence in the host country although digitally, and to include the element of value added from systematic collection of data and contributions of content from persons in the host country.[60]

59 Banking and Finance Company Working Group, in *Comments Received on Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 16 April 2014, p. 5 (OECD 2014).

60 BEPS Monitoring Group, in *Comments Received on Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 16 April 2014, p. 8 (OECD 2014).

Or the following comment with regard to a de minims threshold could also be of interest:

> To the extent that there are any changes to the permanent establishment definition and any new nexus based on some criteria for "significant digital presence", there should be a clear de minimis threshold in each country below which no permanent establishment would be created. Without such a minimum threshold, a business model may create a scenario where, under the proposed options, there are numerous very small permanent establishments across multiple countries.
>
> This will create a significant compliance burden for taxpayers and tax administrations – and will be costly relative to the tax raised in local countries. In addition, as identified in the Discussion Draft administrative challenges, it may not be straightforward to identify if a business has a significant digital presence in a country or where its customers are located.[61]

Importantly, and as also mentioned in the following comment, various case studies should be rendered before the new nexus based on digital presence is implemented.

> Finally, the FFTélécoms welcomes the positive work on the redefining of the permanent establishment criteria for "fully dematerialised digital activity" introducing the concept of "significant digital presence" in the countries where consumption takes place, as well as the tentative definition of "virtual permanent establishment". Whether a new concept of virtual permanent establishment is introduced or whether the criteria of a permanent establishment are defined or any other progressive solution, it appears essential to us that the criteria for defining these concepts be simple, and particularly robust and tested in multiple configurations (by conducting test cases). This will ensure that the criteria apply to all business and attain the objective of re-establishing fair competition, the foundation of economic growth and exchange in the global economy.[62]

4.5. Interaction with other parts of the PE definition

Based on our understanding of the sourcing theory as a guiding justification for a new PE nexus based on digital presence, further elements of the current PE definition should also be reconsidered. This is particularly true if the OECD may want to follow the sourcing theory, as understood in the present paper, in a stringent manner. We have demonstrated that the sourcing theory justifies taxation in a certain jurisdiction if value is created there independent from the fact that an enterprise performs no physical functions in such country. This obviously also has an impact on the "real economy".

As an example, we are of the opinion that the current exemption of auxiliary services according to article 5(4)(e) of the OECD Model should be deleted or amended, since we have demonstrated that the market country creates value even if the functions rendered in such jurisdiction on the supply side (and not the demand side) of an enterprise are minimal (or

61 Deloitte, in *Comments Received on Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 16 April 2014, p. 5 (OECD 2014).

62 Proposal by the Fédération Française des Télécoms, in *Comments Received on Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 16 April 2014, p. 2 (OECD 2014).

auxiliary). Therefore, contrary to the current OECD Model Commentary[63] and based on the sourcing theory, we are of the opinion that even if only auxiliary services are rendered in a certain jurisdiction, a sufficient amount of income can potentially be allocated to the source state and the income would not be so remote that a tax liability could not be justified.

However, other aspects would still need to be considered, such as the avoidance of a too fragmented tax base, the principles of efficiency and certainty, and a proper income allocation system.

4.6. Distinction from other business

4.6.1. OECD approach

Interestingly, the OECD not only aims at introducing a new nexus, but in a first step, it also distinguishes between fully dematerialized digital activities and other activities. According to the OECD, the following elements of a (first) test could be used to elaborate whether a digital activity is fully dematerialized. According to the OECD, the new nexus applies only if the activity is "fully dematerialised":[64]

(1) The core business of the enterprise relies completely or in a considerable part on digital goods or digital services.

(2) No physical elements or activities are involved in the actual creation of the goods or of the services and their delivery other than the existence, use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialisation of location-relevant data.

(3) Contracts are generally concluded remotely via the Internet or by telephone.

(4) Payments are made solely through credit cards or other means of electronic payments using on-line forms or platforms linked or integrated to the relative websites.

(5) Websites are the only means used to enter into a relationship with the enterprise; no physical stores or agencies exist for the performance of the core activities other than offices located in the parent company or operating company countries.

(6) All or the vast majority of profits are attributable to the provision of digital goods or services.

(7) The legal or tax residence and the physical location of the vendor are disregarded by the customer and do not influence its choices.

63 Para. 23 *OECD Model: Commentary on Article 5* (OECD 2014 [condensed version, 15 July 2014]).
64 OECD/G20, *Addressing the Tax Challenges of the Digital Economy* p. 144 (OECD 2014).

(8) The actual use of the digital good or the performance of the digital service do not require physical presence or the involvement of a physical product other than the use of a computer, mobile devices or other IT tools.

4.6.2. Our view

Some of the criteria provided by the OECD are not appropriate and useful from our own perspective and could even lead to an infringement of the principle of neutrality. For instance, it should not be relevant whether digital goods or digital services are the core business of an enterprise (*see* (1)). The same is true for (4). Considering the principle of equality and neutrality, it is moreover not persuading to link the new PE definition to a certain size of the company (besides the aforementioned minimum threshold due to the avoidance of a too extreme fragmentation) and to link the new nexus to the relation between the digital activities and the non-digital activities.

The new nexus should cover various enterprises and not just online advertisers or e-commerce providers; although the BEPS project originally aimed at BEPS of MNEs, the introduction of a new nexus will most likely also affect SMEs.

In order to receive a result that is in line with the principle of neutrality, it seems sufficient to include threshold (1) (i.e. providing access to (or offering) an electronic application, database, online market place, storage room or offering advertising services on a website or in an electronic application) above in order not to ring-fence certain enterprises from the rest of the economy. Such a threshold guarantees that it is not important whether the digital services form a major or only a minor part of the business of an enterprise.

4.7. Distinction from VAT

One could argue that a new nexus based on the amount of users (and considering also further requirements) would mean to implement another consumption-based VAT in the jurisdiction of the users and consequently such new threshold would be a break of systematic continuity within international direct tax law.

However, from our perspective, the new nexus should by no means be seen as creating a new VAT for the following (not exhaustive list of) reasons:

– The calculation of the taxable income would not be the amount of consumption as in the case of VAT. The calculation base could still be the net income and consequently it is *per definitionem* not a VAT.[65] This is still true if one would allocate a third of the profit upfront to the market jurisdictions as proposed in section 4.8.

– Even if a corporate income tax system would fully rely on a destination-based approach, there would still be some differences to a VAT. For instance, the assessment would still be

65 For more details particularly with regard to VAT as an instrument to tax the digital economy, *see* M. Lamensch, *European Value-Added-Tax in the Digital Era: A Critical Analysis and Proposals for Reform*, PhD thesis, Vrije Universiteit Brussel, forthcoming in the IBFD Doctoral Series (Amsterdam 2015).

an annual one and not invoice based.[66] Furthermore, the most important difference of VAT is that the ability to pay principle is obeyed even in case a certain amount of profit is allocated to the PE based on digital presence.

– The origin of the product is not decisive as in a VAT system. By contrast, the benefit obtained in a specific jurisdiction is crucial.

– Furthermore, the new nexus would not lead to a destination-based corporate tax system as argued by certain commentators within the public consultation.[67] The new threshold must be seen as a shift of the artificial PE threshold, considering the particularities of the digital economy. One of the factors of the threshold might be the domicile of the users, but the reason for this is not a fundamental change of corporate taxation but rather the mere fact the domicile of the users is an accurate criteria to elaborate the benefit obtained, respectively, the value created in a certain jurisdiction. As will be shown below in section 4.8.2., it is our suggestion that only a part of the income of an enterprise will be allocated to the market country.

4.8. Income allocation

4.8.1 Introduction

With regard to large MNEs breaching the aforementioned threshold in more than 100 jurisdictions but not having a physical presence in most of these states, the current transfer pricing guidelines of the OECD would not work as there are no traditional risks and functions of the enterprise to be allocated to the digital PE jurisdictions. No detailed analysis is required in order to demonstrate that the current OECD transfer pricing guidelines based on risks, functions and capital allocated to a PE cannot be upheld if a new nexus is implemented based on digital presence; no profit could be allocated to a foreign PE following the current OECD guidelines. During the public consultation process it was also not surprising that one of the major concerns when implementing a new nexus was that the existing transfer pricing guidelines would not work.

However, if a new PE nexus based on digital presence is foreseen, (at least) four options exist to render a profit allocation to the jurisdiction of the PE: (i) formulary apportionment or (ii) gross income taxation or (iii) a redefinition of functions and risks relevant for determining the appropriate transfer price or (iv) a modification of the existing profit split method with an upfront allocation of a partial profit to the market jurisdictions.

The first option will not be discussed in detail as the implementation of a formulary apportionment seems unfeasible from a political perspective (at least at the moment) and the second option of a gross income taxation, i.e. the introduction of a withholding tax in the market jurisdiction, will be dealt with in the paper by Baez & Brauner.[68]

66 For further details, *see* M. Devereux & R. De la Feria, *Designing and Implementing a Destination-Based Corporate Tax* p. 8 et seq., Working Paper 14/07, May 2014, Oxford University Centre for Business Taxation.

67 E.g. *see* Business Europe, in *Comments Received on Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 16 April 2014, p. 2 et seq. (OECD 2014).

68 *See* Baez & Brauner, *supra* n. 8.

The third option also seems unrealistic as there are no functions and risks to be allocated to the jurisdiction of the PE. One could argue that the "free labour" (e.g. that the consumers within the digital economy create value) is also a function that requires income allocation. However, it is not a significant people function rendered by the enterprise itself but by the customers and it would therefore be difficult to adapt the current TP framework to such external functions.

The focus in the following is on the potential application of a modified profit split method with an upfront income allocation of a partial profit to the market jurisdiction in order to determine the taxable income to be allocated to the PE jurisdiction.

It must be stressed that allocation of income as proposed in the following does not need to a have a direct link to the benefit theory in the sense that the tax to be paid should be calculated based on the benefits obtained. This is not feasible in practice as it is impossible to compute the benefits received in various states. The benefit theory serves as the justification to tax an enterprise in a specific jurisdiction and not as a justification for a certain income allocation method.[69] Furthermore, the present income allocation to a PE based on digital presence can also be combined with a withholding tax in order to secure the tax payment.

4.8.2 What is right income allocation from an economic perspective?

It was demonstrated in section 3.2. that a redefinition of the source of income is recommended and by doing so we suggested that the principle of origin should be considered in the sense that if a jurisdiction creates value, a certain income should be taxed. However, it has also be shown that a strict understanding of the principle of origin according to which only individuals on the supply side can create value ignores the fact that the demand side is also value creating. From a mere economic perspective the inputs (i.e. the supply) and the outputs (i.e. the demand) of an enterprise lead to value creation and could guide as a principle of income allocation.[70] As a consequence, it is argued that the market jurisdiction should have the right to tax at least parts of the income of an enterprise and the cross-border income allocation should partly rely on a destination-based key.

From an economic perspective, a destination-based allocation key would require to elaborate what the actual value added is of the market jurisdiction. For instance, with regard to the digital economy, the value added in the market compared to the real economy is that customers can purchase or even use certain services for free and therefore create value. For instance, in simplified terms, the more people use a social media platform, the higher the value of the operating enterprise of such platform.

Apparently, if an international tax system is only based on the principle of destination, the production factors would be irrelevant for the allocation of income. As stated by Mayer[71] with reference to Musgrave, it is also evident that a pure separate accounting approach does

69 In this sense also, Kemmeren, *supra* n. 33, at section 3.3.
70 *See* with further details De Wilde, *supra* n. 34, at 309 et seq.
71 Mayer, *supra* n. 34, at 26 et seq.

not work in case a certain amount of the profit should be allocated to the market jurisdiction where no physical presence exists and no traditional people functions are rendered.

Prime facie, and as developed by others, from an economic perspective, neither an origin-based allocation understood in a strict sense as proposed by Kemmeren[72] nor a sole destination-based allocation of income can be justified by objective reasons as the only feasible income allocation method. Various studies have shown that both approaches might be justified from an economic standpoint.[73] There are arguments in favour of an origin-based income allocation and arguments against it.

As a consequence, it is our understanding that the allocation of a certain percentage of income to the market jurisdictions would be in line with underlying economic principles. It could even be seen as a combination of or a compromise between the principle of origin and the principle of destination.

In the following, we assume that based on the existing transfer pricing guidelines that refer to people functions, risks and capital, the value creation of the market jurisdiction should be considered as it is of great importance within the digital economy. And, even more important, the value adding of the market jurisdiction is not reflected in sales activities or the retail market compared to the real economy. The latter means that a certain deviation from the existing transfer pricing guidelines is feasible and appropriate regarding the digital economy.

4.8.3. Amendment of the current transfer pricing guidelines

As has already been shown, the current transfer pricing guidelines based on risk, functions and capital would lead to the conclusion that no income is to be allocated to the PE based on digital presence. As has just been demonstrated, however, there are also economic reasons to allocate a certain profit to the market jurisdiction even without having any physical presence there.

In the real economy this occurs through taxing the retail market, for instance, or warehouse activities in case article 5(4) of the OECD Model is amended. As no retail market exists within most of the case studies mentioned below in the Annex, the following amendment of the profit split method seems a feasible solution and reflects a consistent allocation mechanism.

Assuming that a significant part of the value of digital services is created in the market jurisdiction it seems persuasive that part of the overall income is allocated upfront to such jurisdictions. The exact amount of such upfront allocation is a matter of negotiation and potential economic studies could give more guidance.

For the present study it is assumed that one third of the profit of an enterprise within the digital economy is created by the market jurisdictions. The market jurisdictions (fulfilling the

72 *See* section 3.2.

73 E.g. *see* in favour of the principle of origin, Kemmeren, *supra* n. 43; in favour of the principle of destination Devereux & De la Feria, *supra* n. 66, at 8 et seq. Or, with further details about both theories, *see* De Wilde, *supra* n. 34, at 302.

new PE nexus) will therefore split a third of the profit among themselves following the relation between domestic revenues and overall revenues.

The other residual two thirds of the profit are split in accordance to the already existing principle of transfer pricing.

Such approach should not be misunderstood as an introduction of a formulary apportionment and therefore the denial of the arm's length principle. But it is the intention of the authors to bring more "formula elements into the profit based methods endorsed by the OECD."[74]

4.8.4. What can be learnt from article 7(4) of the old OECD Model?

Article 7(4) of the old OECD Model related to the allocation of profits to a PE in case it is customary in one of the contracting states not to apply a separate entity approach but to use an apportionment of the total profit of an enterprise. Such apportionment is in some situations still applied in Switzerland in order to calculate the profit allocation amongst the Swiss cantons.

As an example, the overall income of an enterprise having several PEs might be allocated based on auxiliary factors such as revenues or production factors such as rents and/or personnel expenses. In this case, in general, a certain amount of profit is allocated to the place of residence as a pre-allocation (so-called *Präzipuum*). The used auxiliary factors depend on the business of the enterprise. For instance, the income of a service provider might be allocated based on revenues or the income of an industrial enterprise might be allocated based on production factors. Furthermore, the pre-allocation, i.e. *Präzipuum*, to the canton of residence also depends on the enterprise at hand.

One could now argue very much in line with such intercantonal income allocation in Switzerland but using it in a vice versa manner that a certain amount of the overall profit should be (pre) allocated in the sense of an upfront allocation to the market countries as it is difficult (or impossible) to calculate their exact value creation. The reason of such pre-allocation to the countries of consumption is that the current methods of transfer pricing are not able to mirror that the market jurisdiction within the digital economy actually creates value and should be remunerated as a consequence.

4.8.5 What can be learnt from article 8(2) of the UN Model (alternative B)?

The UN Model also provides for an allocation of profits based on an appropriate allocation of the overall profit. However, the following provision provided for in article 8(2) of the UN Model (alternative B), as far as can be observed, has not had a great impact in practice and also the UN Commentary does not provide for further guidance that could also be helpful for the aforementioned allocation method.

74 J. Owens, *The Taxation of Multinational Enterprises: An Elusive Balance*, 67 Bull. Intl. Taxn. 8, p. 443 (2013).

> Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ___ per cent. (The percentage is to be established through bilateral negotiations.).

5. Tax Enforcement

5.1. In general

As demonstrated by Hellerstein in respect of the new definition of a virtual PE, we also believe that taxes levied in connection with such digital presence pose significant problems of enforcement. In particular, Hellerstein posed the following questions:

- Are there available technologies that can block or interfere with the company's virtual presence in the country if the company fails to comply with its tax obligations?

- Assuming such technologies exist, are countries willing to employ them to enforce compliance with the country's tax obligations?

- If not, are companies, nevertheless, likely to comply with such obligations to avoid exposure to risk and unresolved tax debts, and might the answer to this question depend on the nature of the penalties imposed for noncompliance, the size of the company, and other factors?

- Alternatively, would countries be willing to employ indirect measures to induce compliance with the country' s tax obligations, such as imposing withholding requirements on the company' s resident customers, and are such indirect measures likely to be successful?[75]

In the present authors' view, the use of digital technologies or alternative measures for tax enforcement should be conceived in a way that reflects coordination at the global level, since otherwise critical biases could arise.

5.2. Extraterritorial tax enforcement ("Rubik system" or "one-stop-shop")

As was shown in section 4.8., the present paper suggests as one possible solution of income allocation within the digital economy to apply a profit-split method combined with an upfront allocation of a third of the profit to the market jurisdiction where an enterprise has no physical presence. The profit to be allocated to the market jurisdictions might need to be split

75 Hellerstein, *supra* n. 56, at 348. *See also* Collin & Colin, *supra* n. 1, at 68 et seq.

between dozens of countries; but it is not necessarily required that each state levies its own income taxes.

The Rubik agreements signed by Switzerland with the United Kingdom and Austria have shown that the application of an extraterritorial tax enforcement mechanism could be feasible and lead to a higher degree of enforceability. If so, the tax due to digital presence is collected by one or several states on behalf of the others. One might call this a one-stop-shop enforcement system as also used within the European Union for VAT purposes.

Obviously, this requires that consent exists among the participating states to refrain from their enforcement sovereignty and to delegate certain traditional state's competence to a foreign authority. The advantage of such system is the simple and cost-efficient collection of taxes. Furthermore, based on the assumption that the taxes are levied at the level of a qualifying company, the risk of non-enforceability is low (*see* with further details of the term "qualifying company" section 4.3.1.).

5.3. Who is the taxpayer?

5.3.1. In general

To date, the authors are not aware of any detailed study as to who the actual taxpayer should be in case of a new nexus based on digital presence. In case of moving forward with a potential introduction of a new PE nexus in the digital economy, we believe that further analysis would be required in order to determine which entity within a group of subsidiaries should be subject to corporate income taxation due to digital presence.

From an enforcement perspective, it makes sense that the company collecting the revenue should be taxed as the risk of loss for the tax authorities is the lowest. Furthermore, considering the entire BEPS Project as a measure to align substance and taxable income, it seems reasonable that the company collecting the revenue might also render significant people functions ("qualifying company"). In case the company invoicing the revenue is a mere shelf company with no significant people functions, the tax liability should be shifted to another company within the same group. The latter of course needs some further guidance and also the interaction with other BEPS Action items.

5.3.2. Risk of "accounting rules shopping"

The authors are aware of the risk that a group might place its qualifying company in a jurisdiction with very beneficial accounting rules in order to lower its taxable profit. As a consequence this could lead to distortions.

However, considering the BEPS Project and the fact that deemed or artificial expenses, i.e. unrelated to an actual expense, should not be possible in the future, the planning opportunities might be limited. Furthermore, a benefit due to the applicable accounting rules might also be limited as it would only be deferral and not a final tax benefit.

Nevertheless, the risk of "accounting rules shopping" is obvious and before implementing an extraterritorial tax system, certain measure to avoid such opportunities should be discussed and potentially be implemented.

6. Implementation of the New Nexus

6.1. Increased complexity due to existing differences within international double tax treaties

A yet unresolved question is how the OECD, or another international body, could efficiently implement a new PE concept worldwide. Obviously, it would not be sufficient to amend the OECD Model, but further action would be needed, for instance, through commentaries or concrete recommendations on how domestic provisions should be drafted. We believe that delicate issues can arise when using soft law in this respect, which can potentially increase the uncertainty as to the implementation of issues related to the BEPS Project.

Furthermore, we do not think that certain jurisdictions may start taxing the digital economy[76] until an international consensus can be reached on how this may be done, since otherwise a unilateral action will most likely lead to double taxation and not necessarily just with regard to the global players but more in general also affecting SMEs that provide cross-border services within the digital economy. Furthermore, unilateral measures are likely to infringe existing double tax treaties.

We assume that further work and research should particularly focus on the interaction of a potential new PE based on digital presence with other provisions in the OECD or UN Model. In order to accelerate the discussion, we will in the following touch on certain unclear implementation issues (not exhaustive).

6.2. Interaction with the other provisions of the OECD or UN Model

6.2.1. With the nexus based on a fixed place of business as per article 5(1) of the OECD Model

Certain enterprises will not only meet the threshold of sufficient digital presence, but could also have a fixed place of business in the same jurisdiction in the sense of article 5(1) of the OECD Model, e.g. through a sales person or support activities.

This also apparently leads to uncertainties with regard to the formal procedure. However, some of these issues relate to the domestic tax treatment of a PE. For instance, one could question whether in case a company has a PE due to its physical presence and due to its digital presence, if from a formal perspective such company is considered as two taxpayers in the PE jurisdiction.

76 *See* the proposals of Collin & Colin, *supra* n. 1, at 113 et seq.

Before implementing a new nexus, states should elaborate in more detail how an additional tax liability is going to interact with the existing domestic procedures also with regard to the carry forward of losses or the offsetting of losses in general.

6.2.2. With article 6 of the OECD Model

Case study Company J[77] shows that the new nexus based on the digital economy could also be in conflict with article 6 of the OECD Model in the sense that a state could assume that Company J receives income that falls under article 6 and, furthermore, Company J would form a PE due to digital presence in the same jurisdiction. In this regard, paragraph 4 of the Commentary on Article 6 of the OECD Model could be of relevance:

> 4. It should be noted in this connection that the right to tax of the State of source has priority over the right to tax of the other State and applies also where, in the case of an enterprise, income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the Article do not prejudge the application of domestic law as regards the manner in which income from immovable property is to be taxed.

6.2.3. With article 12 of the OECD Model

Assuming that a jurisdiction levies a withholding tax on payments (i.e. royalties) of a customer to an enterprise of the digital economy and such an enterprise forms a PE based on digital presence in the jurisdiction of the customer, it needs to be analysed whether the enterprise is forced to apply the relevant treaty in order to request a refund or reduction of the withholding tax levied or the PE can apply domestic law when requesting a refund or reduction. This also relates to the application of article 12(3) OECD Model.

6.2.4. With articles 10(4) and 11(4) of the OECD Model

Prima facie, we do not see that articles 10(4) and 11(4) of the OECD Model should be of relevance in case an enterprise has a PE due to digital presence, since it seems difficult (or impossible) to imagine that a dividend or interest can have a close connection with a digital PE. Obviously, if a financial institution offers online services one would need to analyse whether or not the payment of the customer relates to the digital services (*see* case study Company L).

6.2.5. Other aspects

77 *See* Annex.

Apparently, other issues could arise such as the interaction of the new nexus with article 15 of the OECD Model in case an enterprise forming a PE based on digital presence sends personnel to a customer and such personnel becomes subject to income tax in the jurisdiction of the digital PE.

6.3. Multilateral implementation

From a governance perspective, an extraterritorial tax enforcement (*see* section 5.2.) as proposed in the present paper, and considering the aforementioned transfer pricing approach, could be achieved internationally in different ways. In general, a multilateral action seems beneficial as it would lower the risk of juridical double taxation significantly and would also likely reduce the overall compliance costs of the enterprises of the digital economy. Considering such a multilateral action, we will differentiate between potential multilateral hard or soft law instruments in the following sections.

6.3.1. Hard law

States could consent through a multilateral convention, i.e. a binding hard law instrument, to shift part of their enforcement sovereignty with regard to the taxation of the digital economy as proposed in this paper to other states. As a consequence, through such a hard law instrument certain states would also face the legal duty to collect taxes on behalf of other states.

A multilateral binding instrument would need to contain provisions with regard to the concrete procedure of the proposed extraterritorial taxation. For instance, it should also contain specific rules stating if and in what manner the state collecting the taxes should be remunerated for its services. Furthermore, it should provide for safeguarding provisions to ensure, inter alia, that the exact amount of taxes is actually collected and in a timely manner distributed among the participating states. Importantly, it should also be regulated in which jurisdiction a taxpayer could appeal against an assessment.

The efficiency of such an instrument depends on various factors. For instance, it relies on the possibility of exchange information in order for the participating states to control the appropriate application of the consented provisions. The introduction of such binding hard law instrument could potentially also be combined with an arbitration clause in case states cannot agree on either the exact income calculation or the applicable allocation key.

If a hard law instrument is chosen, it needs to be considered that the development process (i.e. multilateral negotiations and domestic ratification processes) might take years and could trigger difficult intertemporal issues if certain states implement other measures to tax the income of the digital economy in the meantime.

6.3.2. Soft law

Through a global forum (or the OECD/G20) and using soft law recommendations states could try to achieve an efficient implementation of the aforementioned transfer pricing

approach combined with an extraterritorial taxation as mentioned in section 5.2. Such recommendations would therefore relate to the actual procedure of the collection of taxes and also elaborate the distribution mechanism of the collected taxes among the participating states.

However, compared to other areas of international tax coordination such as the fight against harmful tax practices, the aforementioned transfer pricing approach and the extraterritorial tax collection as proposed in the present paper require a highly technical international coordination. One would need to further elaborate whether soft law might indeed be the right instrument in this regard.

Furthermore, the fiscal revenue amount at stake is large so states might prefer having a normative base that could also allow them to potentially appeal at the level of the ICJ or at an arbitration court in case a state is blocking taxes collected on behalf of other states or miscalculating the taxes to be paid to another state. Also, the implementation of an extraterritorial taxation derived from a traditional understanding of tax sovereignty seems to require a hard law instrument.

7. The New Nexus and International Tax Law

Several commentators have argued that the introduction of a new nexus based on digital presence would infringe international tax standards and/or fundamental principles of international tax law.[78] Furthermore, some have also indicated during the public consultation process that such nexus would be in conflict with the so-called Ottawa principles of taxation.[79,80]

While briefly mentioning such principles, we also put forward some comments on these in the following sections.

7.1. Neutrality[81]

In its report on the digital economy arrangements, the OECD indicates that the "same principles of taxation should apply to all forms of business."[82] With regard to the digital economy, the neutrality principle is the key element of the Ottawa taxation principles and, most likely, the most difficult to be obeyed. Certainly, differences exist between the digital economy and the real economy, so that there could indeed be potential justification for a different treatment, such as the introduction of a new nexus.[83]

78 E.g. *see* United States Council for International Business, in *Comments Received on Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 16 April 2014, p. 29 (OECD 2014).
79 E.g. *see* AmCham EU, in *Comments Received on Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy*, 16 April 2014, p. 3 (OECD 2014).
80 *See* OECD, *Electronic Commerce: Taxation Framework Conditions, A Report by the Committee on Fiscal Affairs* (OECD 1998).
81 *See* with further details with regard to inter-nation neutrality, capital import and export neutrality within the e-commerce business Pinto, *supra* n. 36, at 269.
82 OECD/G20, *Addressing the Tax Challenges of the Digital Economy* p. 30 (OECD 2014).
83 *See* with further details id., at 123 et seq.

Nevertheless, the new nexus shall not lead to ring-fencing of certain enterprises. Therefore, and this is a consequence of a neutral tax system, no specific rule affecting only specific companies should be implemented. Moreover, it seems unpersuasive that an additional threshold based on digital presence would per se give rise to an infringement of the neutrality principle. Such new threshold would apply to all enterprises and not with regard to specific companies. For instance, an MNE selling mobile devices and offering online services could not argue that it sells physical goods and therefore is not affected by the new definition. However, such enterprise would be affected by the new nexus only with regard to its digital services.

Furthermore, if the mere introduction of a new nexus were to be regarded as an infringement of the neutrality principle, the current PE definition would also be an infringement of the neutrality principle, as it only affects enterprises operating abroad through a fixed place of business. Accordingly, with regard to the agency PE, it is also not argued that such additional nexus leads to ring-fencing, as it only affects enterprises operating through an agency structure.

We would recommend that some further research is rendered in this regard since the allocation of a partial profit upfront to the market jurisdiction, as proposed in this paper, could indeed lead to distortions between the "real economy" and the digital economy. For instance, an e-commerce enterprise understood in a narrow sense that does not fall under the new PE definition might be subject to a very limited taxation in the market jurisdiction due to a cost-plus taxation of its warehouse activity compared to an enterprise meeting the new threshold of a PE based on digital presence.

7.2. Efficiency

The introduction of a new nexus should also be efficient in the sense that compliance costs should be minimal. The principle of efficiency requires, for instance, that the digital presence needs to be significant, i.e. reaching a certain threshold before a tax liability is triggered. Furthermore, efficiency is a major concern in case the current transfer pricing guidelines are amended as suggested in section 4.8.

7.3. Certainty and simplicity

The digital economy is a very complex and highly integrated industry and it is an undeniable fact that the new solution will lead to uncertainties and grey areas. However, if there is consensus about a reallocation of income within the digital economy, one should also accept that a potential new nexus will raise certain ambiguities. Besides, the current PE definition is also artificial in the sense that it appears to be a given concept but it is a mere man-drawn line.

7.4. Effectiveness and fairness

Importantly, and also mentioned in section 4.3.2., double taxation should be avoided in a cross-border situations, as this would lead to an unfair taxation and would create trade

obstacles in a globalized world. Furthermore, a tax system should also be effective in the sense that tax enforceability and administrability are essential for an effective tax system. Our analysis above referred to the principles of fairness and effectiveness while also demonstrating that the new nexus as proposed in the present paper obeys these principles. In particular, we have elaborated that from a fairness perspective, the benefit theory as well as the sourcing theory would justify allocating a certain amount of profit to a PE based on digital presence.

7.5. Flexibility

The provisions within the commentary concerning e-commerce show how quickly a certain rule can be outdated.[84] In particular with regard to the digital economy, the new PE definition should be drafted in a way that it is sufficiently flexible to cover future developments.

8. Would the Service PE or a WHT on (Cyber-based) Services Have the Same Effect?

8.1. Legal background

The services PE definition according to article 5(3)(b) of the UN Model has the following wording:

> The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

For the purposes of this analysis we will not elaborate on the implications that the very features of the services PE – and the minimum time threshold contained therein – may have as to the erosion of taxation of income derived by non-residents in respect of activities falling within its scope.[85]

The services PE, as provided in the current UN Model, will not significantly impact the income allocation within the digital economy due to the requirement of personnel in the source state. Or, as it is also stated by Zhu:[86]

> The possible meaning of wordings used by the existing provisions of the UN Model dealing with services, which is restricted to the physical factors in physical space, has no possibility of covering the virtual factors included in the cyber-based services performed in the cyberspace created by the current computer and information technology.

84 *See* section 2.
85 Essentially, such issues concern the fact that when the activity is carried out for a short duration of time, the services PE turns out to shelter business income from the exercise of the sovereignty by the PE state.
86 Y. Zhu, *Proposed Changes to the UN Model Tax Convention Dealing with the Cyber-based Services, Report to the Committee of Experts on International Cooperation in Tax Matters*, p. 8 (30 September 2014).

Moreover, the UN intends to implement a new article for technical services. Paragraph (1) of the current proposal has the following wording:

> Payments for technical services arising in a Contracting State and paid to a resident of the other Contracting State who furnishes [in consideration of] those services may be taxed in that other State.

Considering the draft of the commentary on the new article it seems likely that automatic services are not within the scope of the new service PE and therefore the new proposal would not change much within the digital economy but still could have an impact on certain business models. Apparently, there is a thin line between the services mentioned within the first requirement of the new nexus based on digital presence and services subject to the new technical services article as proposed by the UN.

8.2. Proposal of Y. Zhu[87]

Based on the lack of rules to tackle the digital economy, Zhu proposes to include a provision dealing with fees for cyber-based technical services and to extend the royalty definition to payments received for the use of an online database.

The proposed article dealing with all cyber-based services according to Zhu could have the following wording:

> (1) Fees for cyber-based services arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.
>
> (2) However, such fees for cyber-based services may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees for cyber-based services is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the fees for cyber-based services. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
>
> (3) The term "fees for cyber-based services" as used in this article means payments of any kind received as a consideration for the provision of any cyber-based services by a resident of a contracting state to consumers in the other contracting state, including the provision by such a resident itself or other personnel employed or engaged for such a purpose.
>
> (4) Provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the fees for cyber-based services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for cyber-based services arise, through a permanent establishment situated therein, or performs in that other State independent

87 *See* id.

personal services from a fixed base situated therein, and the right or property in respect of which the fees for cyber-based services are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of article 7. In such cases the provisions of article 7 or article 14, as the case may be, shall apply.

(5) Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the fees for cyber-based services, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

8.3. Assessment

Several reasons lead us to conclude that the proposal is not entirely persuasive. In particular:

- The proposal seems to lack a proper theoretical background. There is no threshold within the aforementioned article that has a link to the benefits obtained or the value created in a jurisdiction.

- The variety and various sizes of enterprises require that a certain threshold is met. Assuming that a digital service provider has one customer in Liechtenstein, its revenue in Liechtenstein would become subject to a WHT. Or, as mentioned by Arnold:[88]

  > The tax authorities may also encounter difficulties in collecting taxes from non-residents who do not have any fixed place of business or any significant physical presence in the state. A state may attempt to deal with the enforcement problem by imposing a withholding obligation on residents making payments to non-residents carrying on business in the state. Such a withholding obligation has problems of its own, such as the compliance burden for residents.

- The implementation of a WHT on services requires that the paying agent would possibly be aware of its withholding obligation. Paying agents would be obliged to levy withholding taxes on millions of payments (even with various rates) and to transfer the withheld sum to more than 100 states. We are not sure as to whether this is indeed feasible from a practical point of view.

- A WHT does not refer to the ability to pay principle. This could have a detrimental effect on certain enterprises since even large players in the market have had problems reaching the break-even point. Obviously, such arguments have their limits as, for instance, the cost-plus taxation of a PE of a foreign enterprise in a loss position is in general also not in line with the ability to pay principle from a consolidated perspective. Furthermore, the

88 Arnold, *supra* n. 4, at section 1.1.2.7.2.

discussions within the UN show that taxation of the gross revenue might be the only feasible solution regarding enterprises operating in multiple jurisdictions.

A WHT without requiring a certain threshold seems not in line with the Ottawa principles of certainty, simplicity and efficiency. It seems too difficult to implement a WHT on the various payments within the digital economy – at least with no direct involvement of possible paying agents.

The introduction of a new WHT on the aforementioned payments would furthermore require a feasibility study including the paying agents such as VISA and Mastercard. Nevertheless, we otherwise regard the paper of Zhu of great importance for the present study, since it points out that before introducing a new nexus, it should in detail be elaborated whether the new nexus fits into the framework of the existing OECD Model. In particular, it should be analysed in detail how the new nexus interacts with the (new) article 12 of the UN Model.

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Annex – Case Studies

In the following we partly make reference to the case studies of the OECD mentioned in the report on the taxation of the digital economy[89] and discuss further examples. However, compared to the remarks of the OECD, the focus here is only on the new PE nexus and not on avoiding BEPS through, for instance, hybrid mismatches or transfer pricing.

(A) Cloud computing

(i) In general

In its report on the challenges of the digital economy, the OECD provides an example of an MNE providing cloud computing services.[90] In simplified terms and leaving aside other aspects of BEPS, RCo resident in state R is a developer of software (online games) which it operates on servers worldwide. The products are sold against consideration to various customers through various client interfaces. In the jurisdictions of the clients, RCo operates subsidiaries that promote the software services and offer online customer's care.

The decisive question for our research (which remains unanswered in the BEPS Report) would be whether RCo or another company of the group would form a PE in State S considering the new nexus based on digital presence. In the following, we will develop the answer to such question based on a few examples demonstrating the actual differences between enterprises of the digital economy and the "real economy", but not with regard to their corporate structure, rather with regard to their services offered.

(ii) Examples considering the new threshold

(1) Company A

Description

Company A (based in State A) provides cloud computing services and web-based IT systems for various enterprises worldwide. The company offers cloud servers for computing and cloud sites for website hosting, file back-ups and various other B2B cloud services. Company A sells the services to small and medium-sized businesses, as well as large enterprises. More than 25% of the revenue stems from outside of State A. Moreover, Company A has operations in State B and in State C – mainly R&D.

The cloud services are operated through a subscription-based business model and generate the biggest part of the profit of Company A. The customers of company A pay a recurring fee in relation to the capacity and complexity of the used IT systems. Moreover, the level of service intensity is also relevant for pricing.

89 OECD/G20, *Addressing the Tax Challenges of the Digital Economy* (OECD 2014), p. 181 et seq.
90 OECD/G20, *Addressing the Tax Challenges of the Digital Economy* (OECD 2014), p. 191 et seq.

Company A offers raw infrastructure, i.e. data storage centre, and also managed storage. The involvement of personnel of Company A depends on the services rendered. The support services are mainly rendered online but Company A does also send personnel to its customers.

Application of the new threshold

– *Nature of services:* Company A indeed offers access to an online storage room/database and is therefore within the scope of the new nexus. It seems that all services of Company A would fall under the new nexus. Even if Company A would provide its customer with hardware in connection with its service, such goods would need to be seen as ancillary. It would need to be elaborated in more detail how a potential (traditional) server PE would interact with the new nexus.

– *User threshold:* Furthermore, Company A in certain jurisdictions will have more than 1,000 users; however, the question is how to count the number of users. For instance, Company A offers a raw infrastructure to an SME resident in State B with 200 employees. Such SME is rendering IT support services to financial institutions. Consequently, most of these employees will work directly with the cloud services provided by Company A. It would need to be defined whether or not they count as users.

– *Time frame:* The time frame should not lead to any major issues.

– *Amount of revenue:* The amount of revenue should not be a major issue with regard to the business model of Company A. However, certain aspects should be considered. For instance, the service fee paid to Company A shall be divided if it offers its service to a major client resident in the State D and such client has subsidiaries in certain other jurisdictions in case these subsidiaries also use the services by Company A. However, we assume that when negotiating a contract with Company A it will always be discussed as a part of the agreement if there is a possibility that the service can be used by foreign subsidiaries. Therefore, the relevant data should be available.

(2) Company B

Description

Company B is one of the leading interactive entertainment companies. It sells its dozens of online games in 200 countries. In the second quarter of 2014, Company B had 300 million average monthly unique users across web and mobile platforms. Most of the games are available for free; however, players can purchase virtual items priced relative to the entertainment value. Some games, however, are subject to monthly subscription fees. Company B operates game studios in seven different states on three continents. Company B does not provide physical support services to its customers.

Application of the new threshold

– *Nature of services:* Company B clearly and solely provides access to electronic applications and is therefore within the scope of the new nexus.

– *User threshold:* The present case study is of interest as Company B has not only paying users but also non-paying users that have access to certain services free of charge. How should such a case be handled? From our point of view, as mentioned above and based on the benefit theory, the non-paying users should also be calculated as Company B also benefits from the infrastructure. The same is true following the sourcing theory – the more users (including free users) a certain game has, the higher is its value as the likelihood increases that other players will start using a certain online game.

– *Time frame:* The time frame is also of particular interest regarding Company B. For instance, in 2011, Company B had revenues of USD 50 million and losses of 1 million. In 2012, it already had revenues of USD 150 million and a profit of USD 10 million. In 2013, the company even had revenues of USD 2 billion and a profit of USD 500 million. The online gaming industry is a good example to demonstrate that the revenue can rapidly and extremely increase in one period within the digital economy and therefore the tax liability should only be triggered in the second period after reaching the threshold.

– *Amount of revenue:* It is difficult to assess in how many countries Company B would be above the minimum threshold. However, assuming revenues of 2 billion in 2013, it is likely that, depending on the threshold, the company could be subject to taxation in more than 50 countries.

(3) Company C

Description

Company C is a leading international developer and publisher of software and content in particular games. The games are sold through retail channels and via digital download. Furthermore, Company C is the leader in the subscription-based massively multi-player online role-playing game. Company C receives subscription fees and retail sale revenues and it also receives licence payments from third-party sellers of online games.

International sales are a fundamental part of the business of Company C. Net revenues from international sales accounted for approximately 50% of the total consolidated net revenues in the last recent years. The group maintains significant operations in 10 states worldwide.

Application of the new threshold

– *Nature of services:* Company C indeed provides access to electronic applications. However, it is important that the electronic services are distinguished from the physical retail business. Certain issues could arise as the distinction between retail income and online income could be difficult. For instance, if a customer purchases a game in a retail store and pays EUR 50, he might also receive access to an online multiplayer mode.

Therefore, a certain key would be required in order to distinguish between fees paid for an online subscription and for the purchase of physical hardware.

– *User threshold:* Further guidance is required regarding the calculation of the user threshold. For instance, it should be decided whether paying and non-paying customers are relevant when calculating the user threshold. It is our understanding that the non-paying users should also be relevant based on the benefit theory and following the sourcing theory.

– *Time frame:* The time frame should not lead to any major issues.

– *Amount of revenue:* It should be decided whether the entire sales in a jurisdiction or only the online sales are considered. From our perspective, it would reflect a more concise rule if only the revenue that falls under the first requirement, i.e. providing access to an electronic application, is considered.

(B) E-commerce or online retailer

In the report on the challenges of the digital economy the OECD also discusses the case of an online retailer.[91] It is our opinion that in case the current PE definition due to Action 7 is amended, a certain reallocation of income will already occur between the resident and the market country. Therefore, and as already mentioned in section 4.2., there is no need that the new PE nexus affects e-commerce. However, there are certain grey areas; for instance, if the company is not actually selling products but only provides for an online marketplace not acting as full-fledged distributors.

(C) Internet advertising

(i) In general

In its report on the challenges of the digital economy the OECD also discusses the case of an online advertising enterprise.[92] In simplified terms, and leaving aside certain other BEPS issues such as dual resident companies and also BEPS Actions 8-10, the enterprise sells online advertising services to clients in states in which the group has no physical presence or solely owns a sales and support company.

The decisive question (which remains unanswered in the BEPS Report) for our research would be whether one of the group companies forms a PE in a state considering the new definition of a PE with regard to the digital economy. We will develop in the following based on various case studies how the new PE nexus would operate with regard to enterprises providing online advertising services.

91 OECD/G20, *Addressing the Tax Challenges of the Digital Economy* (OECD 2014), p. 182 et seq.
92 OECD/G20, *Addressing the Tax Challenges of the Digital Economy* (OECD 2014), p. 186 et seq.

(ii) Examples considering the new nexus

(1) Company D

Description

The revenue of Company D mainly consists of revenue from advertising income from the search engine website operated by Company D and other network websites. However, Company D (besides its advertising business) also has other revenues such as from selling mobile phones. Company D sells its services in nearly all countries worldwide and has over a billion users worldwide.

Application of the new nexus

– *Nature of services:* Company D offers advertising services on websites or in an electronic application and is therefore within the scope of the new nexus. One would need to further elaborate whether and which part of the other revenue and of the mobile phone business falls within the scope as well.

– *User threshold:* Due to the underlying benefit theory as the potential rationale for a new nexus, it seems appropriate to refer to the amount of users, i.e. people actually using the online search engine and not the customers of Company D. The same is true considering the sourcing theory. The more people actually use a search engine, the higher seems the value of such search engine.

– *Time frame:* Assuming that there is still a new market for Company D, the minimum time frame could be relevant as well but should not lead to major issues.

– *Amount of revenue:* We assume that Company D calculates internally how much the percentage of the advertising revenue was triggered due to users in a specific jurisdiction. However, it might be a more practical solution (also considering the other case studies) to actually refer to the origin of the income flow, i.e. the domicile of the customer.

(2) Company E

Description

Company E operates an online platform that allows users to implement a personalized website and to easily connect with other users. The main income stems from advertising servicing on such platform.

Company E has operation teams to provide support for users, developers and marketers in four different states. Company E calculates its revenue by user geography based on their estimate of the geography in which ads are delivered or virtual and digital goods are purchased.

Users in different geographies are monetized in different geographies at different average rates. For instance, in 2013, the value of an average user in State A and State B is more than five times higher than for an average of a user in State C. Company E also generates income from games played on its platform on personal computers.

Application of the new nexus

– *Nature of services:* Company E clearly offers advertising services on its website and, furthermore, it provides access to an online marketplace and access to applications.

– *User threshold:* Again, further guidance would be needed regarding the calculation of the user amount. Considering the benefit theory as one of the underlying principles behind the new nexus based on digital presence, it should be decisive where the users of the website of Company E or the online applications are domiciled. The same is true considering the sourcing theory. The more persons actually use such platforms, the higher seems the value of the enterprise. Regarding the calculation of the users per month, some further guidance is required whether this means sign-ins per month or user per months, not relying on the actual amount of sign-ins per user.

– *Time frame:* Assuming that there is still a new market for Company E, the minimum time frame could be relevant as well but should not lead to major issues.

– *Amount of revenue:* We assume that Company E calculates internally how much of the advertising revenue was triggered due to users in a specific jurisdiction. However, it might be a more practical solution (also considering the other case studies) to actually refer to the origin of the income flow, i.e. the domicile (or residency) of the customer.

(3) Company F

Description

Company F traditionally publishes a daily newspaper in State A and worldwide but it also operates a news website. Print advertising amounts to approximately 75% of total advertising revenues of Company F. Therefore, quite a significant part of the advertising income of Company F stems from its digital appearance. With regard to the online news website, Company F operates a digital subscription system with approximately 700,000 subscribers per annum. The news website of Company F had a monthly average of approximately 30 million visitors in State A, respectively, 45 million visitors worldwide.

Application of the new nexus

– *Nature of services:* Company F clearly offers access to a website (or even database) to its subscribers with an online access and it offers online advertising services to enterprises asking for online advertising.

– *User threshold:* There should be further guidance on how Company F should count its users. Does it mean subscribers or users worldwide? Considering the benefit theory as the rationale of the new nexus, it seems to be more appropriate to refer to all online users.

– *Time frame:* The time frame should not lead to major issues.

– *Amount of revenue:* Some further guidance is needed with regard to the question whether the entire revenue or only the online revenue from the online subscriptions are considered.

(4) http://www.ifa2014mumbai.com/

Description

The IFA India Branch organized the annual IFA Congress in 2014. Besides subscription fees paid the by the participants, income was also generated by providing advertising services online on the above-mentioned website.

Application of the new nexus

– *Nature of services:* The IFA India Branch offers online advertising services and is in principle within the scope of the new nexus.

– *User threshold:* During the Congress and also shortly before it, it could be that the user threshold is met in certain large states.

– *Time frame:* The time frame could be relevant as the above-mentioned website will frequently be used only during the year of the Congress. Therefore, it is unlikely that PE taxation, for instance, in one state is triggered.

– *Amount of revenue:* The IFA India Branch will most likely not breach the amount of revenue as most of the advertising income stems from India itself (assumption).

(D) Internet app store

(i) In general

In the report on the challenges of the digital economy, the OECD refers to a case in which a group (RCo Group) operates an online app store.[93] RCo Group is the owner of an operating system for mobile phones and other portable devices. The users may download various applications through an app store maintained by RCo Group. The applications are either owned by RCo Group or by third-party developers. RCo Group has incorporated a subsidiary, TCo, and transferred certain of the IP rights to TCo. TCo, on the other hand, established local affiliates in larger markets to assist the group with promoting the operating system and the app store. In the following, we will also describe the case of an enterprise operating an online

93 OECD/G20, *Addressing the Tax Challenges of the Digital Economy* (OECD 2014), p. 194 et seq.

app store but with a greater focus on the actual services provided and not on the corporate structure in place.

(ii) Examples considering the new nexus

(1) Company G

Description

Company G produces and sells computers, mobile devices and various electronic applications. Furthermore, Company G operates an online app store. The annual sales of Company G amounted to USD 50 billion and partly (i.e. approximately 10%) consisted of net sales of online applications or music downloads. It is our understanding that the sale of physical products such as computers or mobile devices should not be affected by the new nexus provision; however, the amendment of the current PE definition, i.e. Action 7, could have an impact on the e-commerce business of Company G. Company G sells some of the various electronic applications in its own name and some on behalf of third-party developers.

Application of the new nexus

– *Nature of services:* At least parts of the business of Company G falls under the scope of the new nexus based on digital presence. The income from the app store, i.e. approximately 30% of each app (assumption) being sold (also in case of monthly payments) is clearly related to a digital presence in a certain jurisdiction and Company G provides access to an online marketplace. The same is true if Company G sells online applications in its own name. In this case, the income is related to the sale of online applications.

– *User threshold:* As Company G operates the payment services of its app store, Company G should be able to track whether it has more than 1,000 users per month in a certain jurisdiction. The term "user" would also need some further definition.

– *Time frame:* Assuming that there is still a new market for Company G, the minimum time frame could be relevant as well but should not lead to major issues.

– *Amount of revenue:* The amount of revenue means the amount of revenue sourced in a specific jurisdiction. Importantly with regard to the app store, it should not be decisive where the developer is located but rather where the paying users are domiciled even if there is contractual relation between the developer and Company G.

(E) Further case studies

(i) In general

Even if not discussed in the report on the challenges of the digital economy, we deem that the following examples may help in further enlightening the outcome of our research.

(ii) Examples considering the new nexus

(1) Company H

Description

Company H divides its income into various segments:

– *Segment 1 (search engine and other advertising-generating websites):* Company H operates various websites and earns income from selling advertisement opportunities on these websites. A considerable amount of revenue is attributable to an agreement with another huge provider of online advertising services.

– *Segment 2 (online dating platform):* Company H operates various online dating platforms. Singles pay an annual subscription fee in order to have access to these websites.

– *Segment 3 (media):* Company H operates various media platforms which allow, for instance, that a user can publish its self-made videos.

– *Segment 4 (other):* Company H has various other sources of income due to its digital activities.

Application of the new nexus

– *Nature of Services:* Certain services of the Company H are clearly within the scope of the new nexus as these services grant access to an electronic application or to a website or even offer advertising services on a website. However, it would be necessary to analyse in detail whether all the aforementioned services would fall under the new nexus.

– *User threshold:* It is quite difficult when dealing with a group offering 20 or more different online services to elaborate whether the user threshold is met. Considering the digital presence as the new nexus, one could conclude that a consolidated approach would be appropriate. Based on the assumption that the user requirement is necessary to reflect the underlying benefit theory, it is moreover relevant to also take into account the free users. This is also true considering the sourcing theory, since, for instance, the value of an online dating platform seems to increase the more users sign on.

– *Time frame:* Company H is also a persuading example that a certain time frame is necessary within the (extremely) fast-growing digital economy.

– *Amount of revenue:* Company H received a significant part of its advertising income from another online advertising provider. This means, for instance, that on a website operated by Company H, adverts of another service provider pop up. The problem is that (assumption!) the other service provider will not provide Company H with a detailed

overview on the place of resident of the advertisers. It should further be elaborated how these difficulties could be approached in a practical manner.

(2) Company I

Description

Company I is an on-demand taxi service operating through mobile devices. Using the software of Company I allows finding the nearest driver to a certain location. Company I provides a no-cash-payment solution. This means that the services are charged through credit card operations. Company I has more than 400,000 active users and it had more than 1 million annual requests.

Application of the new nexus threshold

– *Nature of Services:* Company I provides access to an electronic application and/or to an electronic marketplace and is therefore within the scope of the new threshold.

– *User threshold:* Company I should have access to the necessary information about its users, being the persons looking for a taxi (i.e. place of domicile). Obviously, the place of domicile leads to certain distortions as the digital presence and place of domicile might not be identical (e.g. a person domiciled in Amsterdam uses the app in New York City). However, the question whether the place of domicile or the place of use is more practical is a highly technical one.

– *Time frame:* Company I is also a persuading example that a certain time frame is necessary within the (extremely) fast-growing digital economy.

– *Amount of revenue:* Following the proposal of the present study, the revenue flow will be decisive in order to judge whether the revenue threshold of XXX (EUR, USD, GBP, CNY, CHF, etc. is met.

(3) Company J

Description

Company J connects people offering accommodation to tourists or business travellers. It operates its service in more than 30,000 cities and 190 countries. It is a marketplace for people that want to rent out parts of or their entire (private) apartment.

Company J charges a 3% service fee from host payouts every time a reservation is made. Such deduction should cover the cost of processing guest payments. Furthermore, Company J adds a 6%-12% service fee to guest payments every time a reservation is booked. Such payment is due to cover the cost of running the site and services.

Application of the new nexus

– *Nature of Services:* Company J provides access to an online marketplace and is therefore within the scope of the new nexus based on digital economy.

– *User threshold:* As shown in other case studies, guidance would be required regarding the definition of the term "user". Considering the benefit theory as one of the underlying principles behind the new nexus, it is probably decisive where the end users and not the hosts are located as the digital presence is mainly in such jurisdiction. Furthermore, one would need to decide whether users are counted per sign-ins or users actually using Company J, i.e. booking an accommodation.

– *Time frame:* Company J is also a persuading example that a certain time frame is necessary within the (extremely) fast-growing digital economy.

– *Amount of revenue:* As shown above, Company J receives a twofold income consisting of a host fee and a guest fee. As also shown in other cases, according to our understanding, the income flow is decisive, i.e. the domicile (or residence) of the payor, i.e. the guest.

(4) Company K

Description

Company K operates an online music streaming platform through which artists can offer their songs to users worldwide. Users either pay a monthly fee or they only have access to the free services of Company K, which is regularly interrupted by adverts. Company K distributes approximately 70% of its revenue to the holders of publishing rights, respectively, music labels. The exact amount of remuneration also relates to the particularities of certain jurisdictions. In the last month, Company K had over 40 million global users; 30 million of them were using the free service. The services of Company K are available in approximately 60 countries worldwide.

Application of the new threshold

– *Nature of Services:* Company K clearly offers access to an electronic database to its customers.

– *User threshold:* As already mentioned above with regard to the Company B case study, it will be decisive whether only users paying a subscription fee are relevant for counting or also users with free access. Based on the assumption that the user requirement is necessary to reflect the underlying benefit theory, it is also relevant from our perspective to take into account the free users.

– *Time frame:* Company K is also a persuading example that a certain time frame is necessary within the (extremely) fast-growing digital economy. For instance, Company K has doubled its paying users per year.

– *Amount of revenue:* An important issue to be resolved is whether the labels or artists in a contractual relationship with Company K will become subject to the new nexus. In principle, a label receiving a considerable royalty payment from Company K does not have a significant digital presence in a certain jurisdiction as the digital presence is operated by Company K and not by a music label or a specific artist; therefore, it would not be appropriate to tax the music label in the user's jurisdiction.

(5) R&P

Description

In the following we refer to the case study of Falcao and Michel concerning a global enterprise named R&P operating in the field of legal information and documentation.[94]

> Research and Publishing (R&P) is a not-for-profit foundation based in Luxembourg, with subsidiary offices in Singapore, New York (USA), and Mumbai (India). R&P began operations as a centre for specialized legal information and documentation, its greatest asset being its documentation centre which amalgamates in one place historical legal documents, publications and archives from all over the world. Having started as a research centre for access and consultation of physical documents also responsible for the publication of many books, articles and journals of a legal nature, the scope and nature of its services has expanded to include many activities which are currently deemed to be included within the field of digital economy.
>
> R&P currently offers a number of international legal services to customers located all over the world, which are only viable due to the current technological development and that are thus susceptible to the taxing challenges posed by the digital economy. Amongst those services are:
>
> (i) A legal documentation database (LDD) with contents driven both from in-house researchers and from external contributors. The LDD contains journals, academic publications, international legal news, individual countries' juridical analysis, analysis of specific topical issues, international treaty analyses and documentation centre, case law and online books, which may be accessed by the subscribers twenty-four hours a day, seven days a week, from all over the world, according to the scope and extent of the client's subscription.
>
> (ii) A range of online courses in international law, which may be streamed from R&P's main headquarters in Luxembourg to its clients from all over the world via the internet.
>
> (iii) An International Law Academy with a tailored research and training service team that provides private clients with customized courses and legal research services on the application of arbitration and international law. They are also responsible for the legal courses held in "hub", locations around the world.

94 T. Falcao & B. Michel, *Assessing the Tax Challenges of the Digital Economy: An Eye-Opening Case Study*, 42 Intertax 5, p. 317 et seq. (2014).

(iv) Research services: R&P offers tailored research services on national and international legal issues for clients worldwide. The clients include governments, companies, advisory firms, non-governmental organizations and individuals.

(v) Policy Advisory Services, providing legal advice and supporting governments from around the world in complying with international standards and aiding in the development of policy, legislative and administrative issues particular to their domestic legislations.

Application of the new threshold

The following outcomes refer to the various services mentioned above:

– *Nature of Services re (i):* R&P provides access to a database and is therefore within the scope of the new nexus.

– *User threshold re (i):* With regard to the user threshold it is decisive whether one contracting party counts as one user (*see also* Company A case study above) or whether the amount of users with access to the database are relevant. From our perspective, based on the benefit theory and considering the fact that demand also creates value in accordance with the sourcing theory, the amount of individual users should be decisive.

– *Time frame re (i):* The time frame should not lead to any specific issues.

– *Amount of revenue re (i):* Considering the flow of income, it would be decisive whether R&P receives more than XXX (EUR, USD, GBP, CNY, CHF, etc.) in revenue in one jurisdiction.

– *Nature of Services re (ii):* The mentioned services would not be within the scope of the new nexus and therefore no taxation would occur in the source state.

– *Nature of Services re (iii):* The mentioned services would not be within the scope of the new nexus and therefore no taxation would occur in the source state.

– *Nature of Services re (iv):* The mentioned services would not be within the scope of the new nexus and therefore no taxation would occur in the source state.

– *Nature of Services re (v):* The mentioned services would not be within the scope of the new nexus and therefore no taxation would occur in the source state.

(6) Company L

Description

Company L is a bank and financial service provider. It offers an online application for mobile devices that allows the following actions:

– access trading accounts directly;
– place entry and market orders;
– manage open orders and positions; and
– view account balance, equity and margin details.

Depending on the traded products, the commission might deviate. For instance, if one purchases NASDAQ shares, the commission will be 0.10% (minimum USD 15). Company L might also offer other online services such as e-banking in general.

Application of the new threshold

– *Nature of Services:* Company L offers access to an online application and also access to an e-banking website.

– *User threshold:* As shown in other case studies, guidance would be required regarding the definition of the term "user". Considering the benefit theory as one of the underlying principles behind the new nexus, it is probably decisive where the end users are located.

– *Time frame:* The time frame should not lead to any specific issues.

– *Amount of revenue:* Company L is an excellent example to discuss the actual link of the digital service and the revenue received. It also articulates that further research is required in order to have more clarity in this regard. For instance, how much is the percentage of the commission that relates to the digital services provided by Company L? Also, if a person uses the app of Company L and pays a commission, what is the part of the commission that should be relevant for the calculation the amount of revenue? From a practical perspective, the entire revenue flowing from one jurisdiction to the other should be relevant. Nevertheless, commissions are a good example that the actual income due to the digital service might be minor compared to the income in relation to other services.