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THE IMPACTS OF DIGITALISATION IN THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENT

Master thesis

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LIST OF ABBREVIATIONS

DAPE	Dependent Agent Permanent Establishment;
DST	Digital Service Tax;
DST Proposal	Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services;
DTA	Double Tax Agreement;
EU	European Union;
GTA	Global Tax Authority;
GDT	Global Digital Tax;
IBRD	International Bank for Reconstruction and Development;
IMF	International Monetary Fund;
MLC	Multilateral Convention to Implement Amount A of Pillar One;
OECD	Organization for Economic Co-operation and Development;
OECD MTC	OECD Model Tax Convention;
Ottawa Framework	Ottawa Taxation Framework Conditions;
PE	Permanent Establishment;
SDP Proposal	Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence;
UBL	Unified Business Locator;
UN MTC	UN Model Tax Convention;
UN	United Nations;
UK	United Kingdom of Great Britain and Northern Ireland;
US	United States of America.

INTRODUCTION

The digitalisation of the economy results in the simplification of information exchange by using the network for interaction between entities and customers, the dematerialisation and increased circulation speed of goods.

From the perspective of the development of economic activity, digitalisation ensures better access to customers, improved quality of existing products, and lower entry barriers to the market.[1] The digitalisation is also beneficial to States since it has the potential to increase the GDP by up to 42%/[2] Such technological development, new materials and the efficiency of means for revenue generation are referred to as the new Revolution.[3]

However, while new technologies are being created to benefit humanity unconstrained by a need to generate financial returns,[4] digitalisation brings more flexibility to international taxation. The concepts of residence and source have been used since the beginning of the 20th century as cornerstones to allocate the portion of profit generated by entities involved in cross-border commercial activity to source States. [5] Nowadays, the digitalisation of relations has reached a level when the old concepts cannot ensure the proper functioning of the international tax system, which is evidenced by the concept of a permanent establishment, the existence of which is a ground for granting a source State taxing rights over the part of the profit, generated in its territory, requiring the human presence in its location to attribute such profit. The permanent establishment concept became archaic[6] since it has no capacity to capture the revenue generated in purely digital relations.

Digitalisation also changes the ways revenue is generated. Information collection, the interaction of customers with an online advertisement, and the potential value of information have not been classified, *per se*, to grant taxing rights over such profit. Additionally, the problem of complex Internet interaction having no primary aim to generate revenue arose, such as CAPTCHA, preventing non-human access to websites, which ensures the collecting of information, forming a

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[1] Luca Dedola et al., “Digitalisation and the Economy,” Discussion Papers (Frankfurt am Main: European Central Bank, 2023), 10–23, https://doi.org/10.2866/93858%0A.

[2] Anca Antoaneta Vărzaru et al., “Digital Revolution, Sustainability, and Government Revenues: a Transversal Analysis of How Digital Transformation and Sustainable Practices Impact Sustainable Government Revenues,” Systems 11, no. 11 (2023): 11, https://doi.org/10.3390/systems11110546.

[3] Klaus Schwab, The Fourth Industrial Revolution (UK: Penguin, 2017), 13.

[4] “Introducing OpenAI,” accessed 8 May 2024, https://openai.com/index/introducing-openai.

[5] Stjepan Gadžo, Nexus Requirements for Taxation of Non-Residents’ Business Income: A Normative Evaluation in the Context of the Global Economy, vol. 41, IBFD Doctoral Series (Amsterdam: IBFD, 2018), https://doi.org/10.59403/emy4w5.

[6] Atanas Atanasov, “Permanent Establishment 2.0 - Is It Time for an Update?” SSRN Electronic Journal, 2017, 24, https://doi.org/10.2139/ssrn.3017892.

database of inputs for artificial intelligence training.[7] Existing value-creation objects are also affected by digitalisation, such as intellectual property involved in the complex transfer of ownership rights in the Patent Box.[8]

Bearing in mind the archaic nature of the regulation of international taxation and the absence of categorisation of new concepts and methods of revenue generation, multinational enterprises obtain more options with regard to tax planning, which might be perceived as tax avoidance under certain conditions. The International Community recognised the consequences of the digitalisation of taxation, which led to the 2015 BEPS Action 1 Report on Addressing the Tax Challenges of the Digital Economy.[9]

However, at the time of the study, no single approach to tackle such challenges has been identified. Under the auspice of the Organisation for Economic Co-operation and Development, the Amount A Pillar One proposal is the primary means to solve the problem of multinational enterprises and digitalisation. The European Union offered the establishment of a digital services tax and significant digital presence, giving the rights to source states to tax the profit generated in their fiscal territory, but neither was adopted. Certain States have opted for unilateral initiatives, establishing digital service taxes, such as China[10], Italy[11] or expanding the concept of PE, such as Slovakia[12] India.[13] Another group of States refused to introduce novelties in order to remain attractive to multinational enterprises both for economic activity and establishment.

In addition to this, the parallelly ongoing problems of taxation, such as the transformation of State aid and reduction of tax rates, only add to the complexity of regulation, given the need to reach a consensus on a universal level.

The new approach for taxation of cross-border digital commercial activity shall respect the cornerstones of international taxation by the International Community in the 1998 Ottawa Taxation Framework Conditions, such as neutrality, efficiency, certainty, simplicity, effectiveness and fairness.[14]

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[7] "How Google Trains AI with Your Help through CAPTCHA," Medium (blog), 8 May 2024, https://medium.com/@yennhi95zz/how-google-trains-ai-with-your-help-through-captcha-876cb4eb4d01.

[8] Hugh J Ault, Wolfgang Schön, and Stephen E Shay, "Base Erosion and Profit Shifting: A Roadmap for Reform," Bulletin for International Taxation 68, no. 6/7 (2014): 276, https://doi.org/10.59403/1qdwj12.

[9] OECD, "Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report," OECD/G20 Base Erosion and Profit Shifting Project, (Paris: OECD Publishing, 2015), https://doi.org/10.1787/9789264241046-en.

[10] Akiko Terada-Hagiwara, Kathrina Gonzales, and Jie Wang, "Taxation Challenges in a Digital Economy: The Case of the People's Republic of China," ADB Briefs, 0 ed., ADB Briefs (Manila, Philippines: Asian Development Bank, 2019), 2, https://doi.org/10.22617/BRF190151-2.

[11] Law no.160/2019, Official Gazette no. 304 of 30 December 2019

[12] Tomáš Cibuľa and Matej Kačaljak, "Tax Treaty Override in Slovakia - Digital Platform Permanent Establishment," *Bratislava Law Review* 2, no. 1 (2018): 82, https://doi.org/10.46282/blr.2018.2.1.95.

[13] Anandapadmanabhan Unnikrishnan and Meyyappan Nagappan, "Virtual Permanent Establishments: Indian Law and Practice," *Intertax* 46, no. 6 & 7 (2018), https://doi.org/10.54648/taxi2018054.

[14] "Implementation of the Ottawa Taxation Framework Conditions" (OECD, 2003).

Research problems:

1. What are the effects of digitalisation on cross-border digital commercial activity?
2. Why does the concept of permanent establishment lack efficiency in addressing the impact of digitalisation?
3. Can the existing proposals ensure the proper functioning of the international taxation system, taking into account the principles identified in the 1998 Ottawa Taxation Framework Conditions?

Relevance of the final thesis. The proper functioning of the international taxation system is a condition for economic growth, especially for developing states. The impossibility of the current system to capture the profit generated from digital transactions requires reconsideration of the rules for the allocation of profit between residence and source States. While existing proposals try to ensure this, they have been criticised both in doctrine and practice due to their discriminatory nature[15] and complexity.[16] The current state of development of international taxation lacks scientific knowledge on the objects which generate revenue in digital commercial relations without financial transactions. Moreover, the proposals, both coordinated and unilateral, lack a unified approach, resulting in the possibility of distortion of taxation and inconsistency with the principle of tax certainty.

Scientific novelty and overview of the research on the selected topic. The research of the final thesis includes the analysis of the consistency of the existing proposal for taxation of cross-border digital commercial activity with the principle of taxation identified in the 1998 Ottawa Taxation Framework Condition. While significant research has been undertaken on the inefficiency of the permanent establishment to capture the value created from transactions without physical elements in the works of Hentschel,[17] Reimer,[18] Pistone,[19] and Ditz,[20] the doctrine lacks the analysis of the irrationality of the concept of permanent establishment due to the presumption of separate legal personality and attribution of profit to it. This thesis concludes that taxation with

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[15] Lorraine Eden, "Winners and Losers: U.S. Country and Industry Estimates of Pillar One Amount A," *Tax Management International Journal* 50, no. 5 (2021): 3.

[16] General Secretariat of the Council of the European Union (Brussels: Council of the European Union, 2018), 9, https://data.consilium.europa.eu/doc/document/ST-11484-2018-INIT/EN/pdf.

[17] Sven Hentschel, *The Taxation of Permanent Establishments: A Critical Analysis of the Authorised OECD Approach and Its Implementation in German Tax Law under Specific Consideration of the Challenges Imposed to the PE Concept by the Digitalisation of the Economy*, vol. 37, Hallesche Schriften Zur Betriebswirtschaft (Wiesbaden: Springer Fachmedien Wiesbaden, 2021), https://doi.org/10.1007/978-3-658-34000-1.

[18] Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective*, 6th ed. (Alphen aan den Rijn: Kluwer Law International B.V., 2018).

[19] Pasquale Pistone et al., "Abuse, Shell Entities and Right of Establishment: A Plea for Refocusing Current Proposals and Achieving Deeper Coordination within the Internal Market," *World Tax Journal* 14, no. 2 (2022), https://doi.org/10.59403/prmqsg.

[20] Xaver Ditz and Carsten Quilitzsch, "The Definition of Permanent Establishment: Current OECD and German Case Law Developments," *Intertax* 40, no. 10 (2012), https://doi.org/10.54648/taxi2012055.

permanent establishment creates an administrative burden due to the need to analyse its existence while sourcing rules become a more efficient method to identify the State of generation of value.

Fleurbaey Maniquet [21] and Alharbi[22] argued the need for a new approach that would respect the principles of taxation and focus on multinational enterprises as the main source of inequality. The doctrine does not describe the need to ensure the equal treatment of multinational and small and medium enterprises since the current proposals for international taxation establish the global and local revenue thresholds for application. In addition, Barake and Pouhaër[23] analysed the economic inefficiency of the implementation of the Amount A Pillar One Proposal, however, the irrationality of the establishment of the global and local revenue thresholds as the cause of the outflow of capital and commercial activity has not been described.

In addition, while Avi-Yonah explains the complex character of the division of profit between residence and source States,[24] there is a lack of theoretical studies on the value creation processes in digital commercial activity and the links to allocating profit to source States. For example, the place of location of the viewer as the criterion for attribution of profit to a State does not take into account the complexity of the Internet and the fact that the revenue may be created with resources located in other States, eliminating the possibility for proportional profit distribution.

The final thesis proposes the establishment of a model of the Global Tax Authority, inspired by the works of Tanzi,[25] and Horner,[26] with competence which would ensure the effectiveness of the administration of the system of international taxation and communication with national tax authorities and Global Digital Tax, taking into account the ideas of Lucas-Mas and Junquera-Varela,[27] and Ran and, Sam and Avi-Yonah.[28]

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[21] Marc Fleurbaey and Francois Maniquet, "Optimal Taxation Theory and Principles of Fairness" (Voie du Roman Pays: Center for Operations Research and Econometrics, 2015).

[22] Sara Alharbi, "The Principles of Fairness & Efficiency in Designing of Tax Systems," *Journal of Contemporary Scientific Research* 3, no. 10 (2019).

[23] Mona Barake and Elvin Le Pouhaër, "Tax Revenue from Pillar One Amount A: Country-by-Country Estimates," *HAL Open Science*, 2023, https://shs.hal.science/halshs-04039288/document.

[24] Reuven S Avi-Yonah, "After Pillar One," *Law & Economics Working Papers* 247 (2016), https://doi.org/10.2139/ssrn.2783858.

[25] Vito Tanzi, "Is There a Need for a World Tax Organization?" in *The Economics of Globalization*, ed. Assaf Razin and Efraim Sadka, 1st ed. (Cambridge University Press, 1999), 173–86, https://doi.org/10.1017/CBO9780511619946.010.

[26] Frances M. Horner, "Do We Need an International Tax Organisation?", *Tax Notes International*, 2001, https://digitallibrary.un.org/record/505698?ln=en.

[27] Cristian Óliver Lucas-Mas and Raúl Félix Junquera-Varela, *Tax Theory Applied to the Digital Economy: A Proposal for a Digital Data Tax and a Global Internet Tax Agency* (Washington, DC: World Bank Group, 2021), https://doi:10.1596/978-1-4648-1654-3.

[28] Reuven Avi-Yonah, Young Ran, and Karen Sam, "A New Framework for Digital Taxation," *Harvard International Law Journal* 63, no. 2 (2022), https://repository.law.umich.edu/law_econ_current/222?utm_source=repository.law.umich.edu%2Flaw_econ_current%2F222&utm_medium=PDF&utm_campaign=PDFCoverPages.

Significance of the final thesis. This research will be useful for both the doctrinal and practical development of the international taxation system. In particular, it contributes to the studies of the inefficiency of the concept of permanent establishment to tax digital economy and future development, the need to properly identify source States in transactions without the physical element, the development of sourcing rules and the system of administration of international taxation. This thesis formulates the directions of further research and development in the sphere of international taxation, such as the creation of the Global Tax Authority.

This work's conclusions will help legislators to consider the advantages and disadvantages of approaches to taxation of digital presence in source States.

This Master Thesis aims to identify methods of taxation in the digital economy which will meet the requirements of the 1998 Ottawa Taxation Framework Conditions and ensure the continuous development of commercial activity.

In pursuance of the identified aim, the following **objectives** are established:

1. to identify the characteristics of the digital economy;
2. to define the causes of inefficiency of the concept of permanent establishment;
3. to compare the coordinated and unilateral proposals for taxation of the digital economy;
4. to offer the taxation approach which would meet the identified principles.

Research methodology. To achieve the aim of the thesis, the following methods were used:

1. Data collection method. This method is used to collect information on proposals for taxation of the digital economy, doctrinal approaches and opinions, legislative responses, conclusions of international organisations, judicial practice and other sources that were used to prepare this work.

2. Description method. This method is used to provide a general understanding of the current taxation model and explanation of international and national approaches for the taxation of digital economy.

3. Data analysis. This method is used to distinguish the relevant information provided in the doctrine, carry out a consistent presentation of proposals, and lay down the new approach for taxation.

5. Comparative method. This method is used to assess the difference in the proposals for granting source States the right to tax the profit generated by the non-residents and understand their advantages and disadvantages.

6. Logical method. This method was used to establish cause-and-effect relations between the problems of the digital economy and the inefficiency of the current framework of taxation.

Structure of research. The thesis consists of the introductory part, four chapters of the main part, which are divided into subsections, conclusions, recommendations, bibliography, and summary.

The first chapter of the thesis is devoted to the analysis of the concepts of source and residence as the basis categories for the allocation of profit between States, identification of the consequences of digitalisation of cross-border commercial activity, examination of the 1998 Ottawa Taxation Framework Conditions and its practical implications.

The second chapter analyses the current regulation of the concept of permanent establishment as responsible for attributing taxing rights to the source States under the OECD Model Tax Convention and the differences with the United Nations Models Tax Convention. It formulates the consequences of digitalisation for the attribution of profit to permanent establishment, thus defining the weaknesses of the current concept and objects most commonly involved in tax avoidance.

The third chapter focuses on proposals for new models for international taxation by the European Union and the Organisation for Economic Co-operation and Development and analyses the unilateral measures for addressing the challenges by providing the examples of Italy and Slovakia. It formulates the advantages and disadvantages of the current proposals for a new approach to taxation in the digital economy.

The fourth chapter offers the establishment of the Global Tax Authority, which would be responsible for the administration of the global taxation system and be in close cooperation with national tax authorities and international organisations. It also proposes the implementation of the Global Digital Tax consistent with the 1998 Ottawa Taxation Framework Conditions.

Defence statement. The lack of physical elements and new methods of value creation as the features of the digital economy require the replacement of the transfer pricing mantra and the concept of permanent establishment with the method of allocation of profit between source and residence States, which ensures consistency with the principles of taxation. Given the political nature of the international taxation field, such a method shall respect the interests of States at different stages of economic development and the International Community as a whole. This requires sound cooperation at national and universal levels, with the creation of the Global Tax Authority ensuring the proper administration of international taxation and communication of national interests to decrease the practice of tax avoidance.

CHAPTER 1. THE PHENOMENON OF THE DIGITAL ECONOMY AND ITS IMPACT ON THE CATEGORIES OF THE INTERNATIONAL TAXATION

In this Chapter, the first part is devoted to the analysis of such categories as source and residence, the basic concepts granting taxation rights. The second part discusses the digital economy and its main characteristics and determines its impact on taxation, permanent establishment (hereinafter – PE) and rules for the allocation of profit. The third part examines the Ottawa Framework for International Taxation (hereinafter – Ottawa Framework) in the digital economy and its importance for a long-term solution to the problem of digital presence in non-resident jurisdictions to address the problem of the concept of PE, which does not capture income obtained from transactions without physical elements.

1.1. Emergence of the Concepts of Source and Residence

With the development of international trade, the League of Nations, in 1920, began to develop standard criteria for international profit allocation for fair revenue distribution.[29] This provides source States with more jurisdictional rights to tax profits generated by non-residents in their respective jurisdictions. The concept of fairness implies balancing the interests of developed and developing States.

After carrying out certain work, the scientific group identified the following potential criteria for regulating international competence in the field of taxation:

- Origin of wealth or income;
- Situs of wealth or income;
- Enforcement of the rights to wealth or income;
- Place of residence or domicile of the person entitled to dispose of the wealth or income.[30]

Scientists paid considerable attention to the first and last criteria. As a result, the location of resources or income evolved into the concept of source, and the criterion of the place where the person who has the right to dispose of the received revenue is located formed the concept of residence.

[29] William H Coates, "League of Nations Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp," *Journal of the Royal Statistical Society* 87, no. 1 (1924), https://doi.org/10.2307/2341293.
[30] OECD, "Fundamental Principles of Taxation," in *Addressing the Tax Challenges of the Digital Economy*, by OECD, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, 2014), 29–50, https://doi.org/10.1787/9789264218789-5-en.

As international trade and business operations become more flexible, giving entities located in residence States the ability to generate revenue in States with lower production costs or abundant resources without being physically present in those jurisdictions.[31] These States, commonly referred to as developing States, have emerged as significant players in the digital economy.

Even though these concepts were recalled as methods of profit allocation, they are methods of conflict resolution between two or more States if an entity carries out economic activities with a foreign element.[32] The main task at that time was to limit the possibility of income taxation in source States. Analysing the current level and methods of taxation, it can be concluded that the goal has been achieved.[33] The beginning of the last century was decisive for the future appearance of the international taxation system. Before the corresponding changes, the advantage in taxation of source revenue was on the side of source States, while the residence States provided credit for the amount of taxes paid.[34]

The primary problem was how to redistribute income in such a way that, on the one hand, it would allow to leave a proportionate part of the revenue for the development of the source States, and on the other hand, so as not to overburden the potential taxpayer with an additional obligation. As a result, these concepts allowed, at that time, the effective resolution of the conflict.[35]

1.1.1. Current Definition of Residence

According to Article 4 of the OECD Model Tax Convention (hereinafter – OECD MTC), a resident is a person (or entity) who, under the laws of the State, is liable to tax therein because of his domicile, residence, place of management or any other criterion of a similar nature.[36] This provision directly establishes the consequence, giving the respective State the possibility to develop the rules for determining residency *ex officio*. The result of such a method has negative implications since the content of the criterion may overlap between jurisdictions, resulting in a

[31] Page Tom, "Manufacturing in Low Cost Country Locations: Costs and Benefits," *I-Manager's Journal on Management* 11, no. 2 (2016): 12, https://doi.org/10.26634/jmgt.11.2.8185.
[32] Committee of Experts on International Cooperation in Tax Matters and Seventh Session, "Note on the Revision of the Manual for Negotiation of Bilateral Tax Treaties" (Geneva: United Nations, 2011), 11.
[33] Charles Irish, "International Double Taxation Agreements and Income Taxation at Source," *International and Comparative Law Quarterly* 23, no. 2 (1974): 293, https://doi.org/10.1093/iclqaj/23.2.292.
[34] Kim Brooks, "Global Distributive Justice: The Potential for a Feminist Analysis of International Tax Revenue Allocation," *Canadian Journal of Women and the Law* 21, no. 2 (2009): 281–282, https://doi.org/10.3138/cjwl.21.2.267.
[35] Reuven S Avi-Yonah, "International Tax Law as International Law," *Tax Law Review* 57, no. 4 (2004): 483, http://dx.doi.org/10.2139/ssrn.516382.
[36] OECD, "Articles of the Model Convention with Respect to Taxes on Income and on Capital" (Paris: OECD Publishing, 2017), Article 4, https://doi.org/10.1787/mtc_cond-2017-en.

potential double taxation.[37] To prevent this, the International Community has formed standards for defining the concept of residency and rules for resolving *ex-post* cases of double taxation.

Applying the principle of residency, a person will be considered a resident of a certain State if they are incorporated as a legal entity in a State, has a permanent residence or satisfies the temporal criterion of staying in the State (often national legislation defines 183 days of stay). It should be noted that the temporal criterion is inconsistent in national legislation since, in a constantly developing society, the relevant person may continuously change the place of location. As a result, national legislation may establish exceptions to this rule, for example, if, during this period, the person left the territory of the State for several days.[38] Nationality also plays a role in determining the residence of an individual. According to the legislation of Ukraine, if it is not possible to establish a person's residency based on the criterion of temporary stay, such person will be considered a resident of Ukraine if he possesses respective citizenship.[39]

Some jurisdictions may try to expand the concept of residency by establishing additional criteria, such as the residence of company shareholders.[40] Still, in practice, they are applied only in exceptional cases since such formulation cannot be used to determine residence within a group of companies. In addition, this criterion can be absorbed by the place of incorporation. It will be grounds for challenging the tax authorities' decision if it is applied separately without additional residency links.

Another criterion for determining residency can be central management and control, which is often called the place of effective management. Along with the place of incorporation, this test is most important in common law jurisdictions.[41] The definition and practical application of this criterion can make it difficult to establish the residency of groups of companies. The generally accepted principle is that the place of effective management is considered to be the place where the entity's policies relating to its financial and business affairs, employment and other aspects that directly relate to the existence and implementation of economic activity are

[37] Manoj Kumar Singh, "Conflict of Source versus Residence-Based Taxation in India with Reference to Fees for Technical Service," *Intertax* 44, no. 6 & 7 (2016): 533, https://doi.org/10.54648/TAXI2016042.
[38] David Elkins, "A Scalar Conception of Tax Residence," *Virginia Tax Review* 41, no. 2 (2021): 155, http://dx.doi.org/10.2139/ssrn.3889245.
[39] "Tax Code of Ukraine," Pub. L. No. 2755– VI (2010), Article 14(1).
[40] Clifton J Fleming, Robert J Peroni, and Stephen E Shay, "Defending Worldwide Taxation with a Shareholder-Based Definition of Corporate Residence," *Brigham Young University Law Review* 2016, no. 6 (2016): 1683, https://digitalcommons.law.byu.edu/lawreview/vol2016/iss6/6.
[41] Matthew Collett, "Developing a New Test of Fiscal Residence for Companies," *UNSW Law Journal* 26, no. 3 (2003): 625, https://www8.austlii.edu.au/au/journals/UNSWLawJl/2003/42.pdf.

established.[42] An illustrative example is provided by the legislation of the UK, which will take into account the following factors to determine residency:[43]

- The venue of board meetings for the exercise of decision-making power;
- The location of social and economic interests of the majority of directors;
- The place of general meeting;
- The jurisdiction of holding bank accounts.

This criterion caused widespread public discussion during the COVID-19 pandemic. It raised the question of whether online meetings of shareholders or directors could affect residency in case the physical location of the server is in another jurisdiction.[44]

The application of this criterion may need to be revised for MNEs due to their branching into indirect control by the parent entity from other jurisdictions as it facilitates aggressive tax planning. Because of indirect control and the place of effective management criterion, tax residency becomes flexible and allows for tax avoidance. Solving this problem requires communication between the tax authorities of the disputed residences. An example can be the case of *Koitaki*,[45] in which the question of resolving the residency of the entity that was incorporated in Australia and moved its economic activities to Papua New Guinea, where management activities were carried out, came before the court.

However, the number of disputes of this type decreased with the development of the double tax agreements (hereinafter – DTA) network, which served the role of a preventive agreement between the interested States on applying links and concepts. An example of standardisation is Article 4 of the OECD MTC, which establishes that the place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance. In addition to bilateral treaties, residency disputes can be resolved through judicial or administrative procedures.[46] If the consideration of the case and the decision are public, this ensures the predictability of tax planning and the confidence of taxpayers regarding the immutability of the legislative approach.

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[42] Robert L Deutsch, John C Raneri, and Roger L Hamilton, *Guidebook to Australian International Taxation*, vol. 26 (St Leonards, N.S.W.: Prospect Media, 2001), para. 2.170.
[43] J-M Rivier, *The Fiscal Residence of Companies*, ed. International Fiscal Association, vol. 72a, Cahiers De Droit Fiscal International (Brussels: IFA, 1987), 205–6.
[44] Anne Michèle Bardopoulos, *eCommerce and the Effects of Technology on Taxation: Could VAT Be the eTax Solution?* vol. 22, Law, Governance and Technology Series (Cham: Springer International Publishing, 2015), ix, https://doi.org/10.1007/978-3-319-15449-7.
[45] Koitaki Para Rubber Estates Ltd v. Federal Commissioner of Taxation, 15 CLR (High Court of Australia 1940), https://www.ato.gov.au/law/view/document.
[46] OECD, "Model Tax Convention on Income and on Capital 2017 (Full Version)" (Paris: OECD Publishing, 2019), C(23)-17, https://doi.org/10.1787/g2g972ee-en.

1.1.2. Current Definition of Source

In contrast to residency, source taxation is associated with the territorial-jurisdictional aspect. The main justification is that a particular jurisdiction is a place where income is generated for the foreign resident.[47] Historically, there are three types of taxation at the source:

- The profit of the PE, which can also be attributed to the profit of the main enterprise. To simplify tax reporting and the administrative burden, some source States set profit or income thresholds for the emergence of financial obligations. This is also consistent with the fact that the existence of a PE in the source State does not necessarily lead to the obligation to pay taxes in accordance with Article 7 of the OECD MTC but primarily to the burden of tax reporting, which is usually established in national legislation;[48]
- The second type of taxation is related to the resident's passive economic activity in the source State. The result of such activity may be the receipt of dividends, interest, and royalties that may be taxed under withholding tax;
- Income received from movable and immovable property. Taxation of objects in these categories may vary. While immovable property is taxed according to its location, due to the strong connection between the property and the source State, movable property is taxed by the State of the source of income.[49]

Some authors support exclusive taxation on the source principle, arguing for the efficiency and equality of this method.[50] It establishes an equal revenue distribution between States according to the place of income withdrawal. However, due to the conflict between developed and developing States, which are the States of residence and source, respectively, this approach is unlikely to gain popularity, as it will reduce revenue obtained by formers. However, current proposals for taxation of the digital economy upheld the same idea, enabling source States to receive a proportionate share of the revenue generated in their territory, whether digital or physical.[51]

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[47] Richard A Musgrave and Peggy B Musgrave, "Inter-Nation Equity," in *Modern Fiscal Issues: Essays in Honour of Carl S. Shoup*, ed. John G Head and Richard M Bird (University of Toronto Press, 1972), 85.

[48] Luis M Almeida and Perrine Toledano, "Understanding How the Various Definitions of Permanent Establishment Can Limit the Taxation Ability of Resource - Rich Source Countries," *Columbia Center on Sustainable Investment*, 2018, 15, https://doi.org/10.7916/D82R57ZK.

[49] Ruud A de Mooij, Alexander D Klemm, and Victoria J Perry, *Corporate Income Taxes under Pressure: Why Reform Is Needed and How It Could Be Designed* (US: International Monetary Fund, 2021), 231, https://www.elibrary.imf.org/display/book/9781513511771/9781513511771.xml.

[50] Klaus Vogel, "Worldwide vs Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part I)," *Intertax* 16, no. 8/9 (1988): 4, https://doi.org/10.54648/taxi1988056.

[51] Assaf Harpaz, "Taxation of the Digital Economy: Adapting a Twentieth-Century Tax System to a Twenty-First-Century Economy," *The Yale Journal of International Law* 46, no. 57 (2021): 68.

Source taxation is regulated by Articles 5 and 7 of the OECD MTC, according to which a source State may impose taxes on the income of a non-resident if such non-resident carries out economic activities in the relevant State through a PE. The definition of PE is given in Article 5, describing that PE is a fixed place of business in which the business of an enterprise is wholly or partially carried on.[52] The analysis of the PE is provided in Chapter 2.

In addition, the development of restrictions on the rights of source States to tax non-residency income generated in their territory is implied in Articles 10-13 of the OECD MTC, defining a source State can receive 5% of the gross amount of the dividends if the beneficial owner is an entity which holds directly at least 25% of the company's capital, paying the dividends within 365 days or 15% in all other cases. At the same time, Article 11 of the OECD MTC similarly sets a limit on the revenue the source State can receive at 10% of the gross amount of the interest.[53]

Generally, there are several reasons why source States are limited in their taxation options and must follow the model adopted by the resident States. The first circumstance concerns effective control or access to information regarding non-residents. This fact deprives the source States of the possibility of controlling the economic activity of legal entities that have their factual or legal seat in a State of residency. On the other hand, this allows resident States to encourage entities to have their seat in their territory by providing tax advantages.[54]

The control over MNEs can be pointed out, which has become especially important with the development of globalisation since more transactions lose physical elements. As a result, the system of international taxation becomes more complex to, in particular, regulate the allocation of profit between the States and avoid the situations of double taxation, which is a consequence of the lack of cooperation between tax authorities.

The development of the rules for allocating profit between source and residence States aims to equalise them since without those, even though the source State obtains the right to tax revenue generated in its territory, nothing prevents the resident State from taxing the same profit.

The need for a proportionate profit allocation between States results in various methods of determining residence and source. Most scientists agree that the current system of distribution of revenue does not ensure the fairness and objectivity of international taxation, in particular, because of the flexibility of definitions.[55] For example, Article 4 of the OECD MTC links to the national legislation of a State to determine residency and does not establish an exhaustive list of

[52] OECD, *supra note*, 36: Article 5.
[53] OECD, *supra note*, 36: Article 7.
[54] Klemm, *supra note*, 49: 229.
[55] Nancy H Kaufman, "Fairness and the Taxation of International Income," *Law and Policy in International Business* 29, no. 2 (1998): 147.

circumstances.[56] As was demonstrated, Ukrainian legislation uses the concept of citizenship (nationality) as the criterion of last resort. However, the emergency of naturalisation by investment programs[57] enables the change of nationality in a relatively short period of time, which cannot ensure the stability of the application of the definitions.

Economic presence and the source of revenue are considered the main criteria for determining the type and scope of States' taxation rights.[58] These criteria ensure the objectivity of the taxation and do not depend on the interpretation adopted by the national legislation. In addition, the disproportionate distribution of profits cannot result in the consistent development of jurisdictions. However, the spread of digitalisation to social life inevitably contributes to changes in economic activity. The effectiveness of international taxation requires changes in the criteria for determining the jurisdictions eligible to receive the portion of the revenue since more commercial activities lose the physical connection for revenue generation. Therefore, to determine the effectiveness of the proposed changes in taxation, the elements and features of digitalisation shall be analysed.

1.2. The Impact of Digitalisation on Cross-Border Commercial Activity

Digitisation of social relations and the economy is an inevitable result of the development of technologies, the purpose of which is to improve economic and social life.[59] A rapid change in the means of information exchange, the appearance of the product, and the creation of digital goods requires adapting the regulatory framework to the needs of the proper functioning of the market. Digital goods acquire unique characteristics, allowing them to be less stable and faster in circulation, precluding current regulation from capturing them.[60] This also provides advantages compared with economic activity with physical elements reducing the associated business costs.[61]

The critical subject of digitalisation for international taxation is MNEs since they control a relatively significant part of commercial operations and the movement of capital globally.[62] The exercise of State powers and the right of enforcement is limited by the territorial jurisdiction of

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[56] OECD, *supra note*, 36: Article 4.

[57] "B.8 Recording Citizenship-by-Investment Programs" (International Monetary Fund, 2022), 3, https://www.imf.org/-/media/Files/Data/Statistics/BPM6/approved-guidance-notes/b8-recording-citizenbyinvestment-programs.ashx.

[58] Kaufman, *supra note*, 55: 147.

[59] Marko Janković, Dejan Dimitrijević, and Bratislav Joksimovic, "Development of New Economy - Digital Economy," *KNOWLEDGE* 26, no. 1 (2018): 100, https://ikm.mk/ojs/index.php/kij/article/view/2993/2991.

[60] "World Trade Report 2018" (Geneva: World Trade Organisation, 2018), 3, https://www.wto.org/english/res_e/publications_e/world_trade_report18_e.pdf.

[61] Eli Hadzhieva, "Tax Challenges in the Digital Economy" (Brussels: European Parliament, 2016), 3, https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698761/EPRS_BRI(2021)698761_EN.pdf.

[62] Christine Zhenwei Qiang, Yan Liu, and Victor Steenbergen, *An Investment Perspective on Global Value Chains* (the World Bank, 2021), 71, https://doi.org/10.1596/978-1-4648-1683-3.

each State, which implies the impossibility of imposing taxes beyond the geographical borders of a State as explained by the International Court of Justice, a State "may not exercise its power in any form in the territory of another State. In this sense, jurisdiction is certainly territorial; it cannot be exercised by a State outside its territory except by a permissive rule derived from international custom or a convention."[63] On the other hand, the fiscal jurisdiction of a State is an essential feature for ensuring the population's standard of living.[64] Because of this general rule, the well-being of society, the freedom of economic activity, and, on the other hand, the State appear to be on the scales of contradiction.

MNEs use the advantages of individual jurisdictions to obtain benefits globally and reduce the costs of carrying out economic activities. The International Community's lack of a unified position regarding the legal nature of digital transactions only supports aggressive tax planning. The primary classification of transactions in a digitalised society can be divided into electronic services, supply of goods ordered online, and commerce of diverse legal nature.[65]

Firstly, it should be noted that digitalisation has spread so widely in social life and economic activity that it is almost impossible to single out the digital economy as a separate socio-legal phenomenon. Therefore, only the characteristics of the digitalisation of the economy relevant to the international taxation system will be analysed. The Organisation for Economic Co-operation and Development (hereinafter – OECD) and the European Union (hereinafter – EU) identify such peculiarities of the digital economy:

- *Mobility*. The essence of business and economic activity has not changed due to the acceleration of information exchange. To generate income, an entity has to go through the same stages: obtaining a resource, creating value or adding it, advertising, selling, and performing supplementary services.[66]

On the other hand, the form of economic activity underwent significant changes. This is explained by the widespread use and distribution of intangible assets, which have a much higher exchange rate than physical assets.[67] The circulation speed of these assets and the chain's complexity imply the possibility of shifting them to jurisdictions with low tax rates. Given the State's interest in increasing revenue taxes, the possibility of taxing such assets in a way that

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[63] This case did not directly concern the extraterritorial rights of the state in international taxation. However, the interpretation of the ICJ provides an understanding of the limits of the sovereignty of states, since often this principle is not enshrined in the Basic Laws, but follows from the interpretation adopted in the Case of the S.S. 'Lotus' (France v. Turkey), Judgment No. 9, 1927, P.C.I.J., Ser. A.

[64] Kevin Holmes, *The Concept of Income: A Multi-Disciplinary Analysis*, vol. 1, IBFD Doctoral Series (IBFD, 2001), 136.

[65] Hadzhieva, *supra note*, 61: 14.

[66] OECD, *supra note*, 9: 100.

[67] Michelle Markham, "Tax in a Changing World: The Transfer Pricing of Intangible Assets," *Kluwer Law International* 40 (2005): 6.

complies with the recognised principle of taxation is limited. For example, to attract foreign investment or revenue, a State may grant aid, which does not satisfy the principle of equality of market participants.[68] In addition, the detection of illegal aid is a complicated issue, given the territorial limits of sovereignty. The disclosure of Double Irish and Dutch Sandwich[69] schemes happened due to the existence of an obligation under Article 107 of the Treaty on Functioning of the European Union to inform the European Commission of the cases of the aid granted by a State.[70]

Due to the development of information and communications technology, the concept of shell companies has significantly expanded since it allows business activities to be conducted remotely.[71] For example, the place of incorporation, the place of operation, and the place of provision of service and sale of goods can be located in different jurisdictions. This also allows for the possibility of reducing associated costs, such as the number of employees or transferring them to jurisdictions with low labour costs.[72]

The result of the digitalisation of economic relations is already evident. In particular, in the Google case, the entity was able to avoid the status of a PE while providing digital services in the United Kingdom of Great Britain and Northern Ireland (hereinafter – UK) by having employees sit in Ireland. Hence, the company was able to avoid attribution of revenue generated in the digital space of the UK with customers located there.[73]

- *Creation of value with data*. Information appears to be the most uncertain novelty in the digital economy. On the one hand, the rise of exchange information speed proportionally results in higher revenue obtained either by minimising associated costs or by new business models. On the other hand, the information itself can be a source of profit generation.[74] This form of exploitation is problematic from the point of view of taxation because, at the moment of study, it is not clear how to evaluate information and its relations with other risks. In some instances, the information and, accordingly, the generated value can be attributed to the entity that directly receives the revenue. However, since such profit is not connected to tangible assets, it might not

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[68] Vasile Popeangă, "Public Financial Aids - State Financial Support Policy," *Annals of the "Constantin Brâncuşi" University of Târgu Jiu*, Economy Series, no. 4 (2012): 238, https://taxprof.typepad.com/taxprof_blog/files/2005-21882-1.pdf.
[69] Ambareen Beebeejaun, "The Double Irish and Dutch Sandwich Strategies and Tax Avoidance in Mauritius," *Journal of Money Laundering Control* 24, no. 4 (2021): 737–751, https://doi.org/10.1108/JMLC-09-2020-0103.
[70] "Consolidated Version of the Treaty on the Functioning of the European Union," 2008/C 115/01 § (2007), Article 107.
[71] Pistone, *supra note*, 19: 204.
[72] OECD, *supra note*, 9: 66.
[73] "Oral Evidence" (London: Public Accounts Committee - Minutes of Evidence, 2012), https://publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/121112.htm.
[74] Jayanthi Ranjan and Foropon Cyril, "Big Data Analytics in Building the Competitive Intelligence of Organizations," *International Journal of Information Management* 56 (2021): 1, https://doi.org/10.1016/j.ijinfomgt.2020.102231.

be possible to fit such profit into commonly accepted categories for the purpose of taxation.[75] However, the OECD upholds the approach of creating separate categories for such profit depending on the activities performed in digital commerce. For example, it considers revenue derived from such activity as advertising when using information for advertising purposes.[76] In this case, the revenue is generated by the operation of information. The entities may exchange the databases of consumers with a higher ability to buy certain products.

- *Complicating the characterisation of transactions*. Introducing new methods of transmission of intangible goods and contracts with a complex composition increases the possibility of a non-harmonized approach in national legislation,[77] explained by the archaism of the definition used for categorising profit. This can be especially observed in service-oriented businesses in the field of electronic processing of information that provides services in different jurisdictions.[78]
- *New business models*. Technologies' impact cannot be limited to a particular sphere. According to the OECD, digitalisation has mostly affected the retail sector, transport, logistics, financial services, manufacturing, agriculture, education, healthcare, and media. New business models are also emerging, with a new way of creating value or communicating with customers. For example, Remané, Schneider, and Hanelt identified 49 business models genuinely impacted by digitalisation that no longer can fit into classical categories involved in vending digitally enabled products and services as providers of resources, goods and facilitating intermediary services.[79]
- *Indirect network effect*. A multi-sided business model began to develop with the emergence of non-physical interaction methods to increase turnover efficiency. The interaction model is based on a common platform between suppliers and buyers. The actions of the participants of this model are more interconnected than those of the physical economy since demand and prices can be adjusted much faster. If the demand for a particular offer is realised, it can affect the price reduction in the entire segment. As the OECD emphasises, the digitalisation of the economy will positively affect the decrease of prices for end consumers, which is explained by the absence of intermediary fees and the efficiency of transactions. Due to the lack of a physical

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[75] Klemm, *supra note*, 49: 194.
[76] OECD, *supra note*, 9: 104.
[77] Geetanjali Phadke, "Benchmarking Marketing Intangibles: Need for Coordinated Transfer Pricing Regimes," *VISION: Journal of Indian Taxation* 3, no. 2 (2016): 99, https://doi.org/10.17492/vision.v3i2.7902.
[78] Hadzhieva, *supra note*, 61: 17.
[79] Sabrina Schneider and Andre Hanelt, "Digital Business Model Types: Understanding Their Mechnisms as Recipes to Commercialise Digital Technologies" *International Journal of Information Management* 26, no. 3 (2022): 9, https://doi.org/10.1142/S1363919622400199.

element, there is also a reduction in the time required to form demand and offers.[80] However, the negative consequences are the protection of personal data and the amount of information passing through the platform. This is also influenced by the fact that value is created not only in the case of a transaction for a product or service but also in the case of interaction with information (online advertising).[81] In addition, to more efficiently combine the interaction of suppliers, a multisided platform can automatically redistribute the demand between the participants.[82]

However, this issue requires compliance with competition laws in the States of actual presence, especially if some platform suppliers function as one group of companies. This type of business activity is the main addressee of new changes in international taxation because of the possibility of generating profit in different jurisdictions simultaneously. For example, suppose the website provides the possibility to acquire goods while incorporating advertisements in the process of purchasing. In such cases, the value can be generated in place of the location of the buyer from the purchase of goods and the server's location from the interaction with the advertisement and in the location where the advertisement was physically displayed. In addition, the potential value is generated from interaction with the advertisement if it reproduces some goods or services, which results in the successful purchasing of the product on the website, where the buyer was transferred. The situation becomes even more complex in the case of shared digital space for advertising purposes between the entities. In addition, interaction on multisided platforms can also cause the violation of competition law in the form of predatory pricing if an entity lowers the prices on the multisided platform to eliminate competitors.[83]

Multi-sided platforms can be divided according to their functional direction into information systems, systems for attracting new suppliers and buyers, and general ecosystems.[84] The first platform type involves the entity providing information about the demand to potential sellers of goods or service providers. In this form, the platform functions as a data transmission system with uniaxial control. A feature of this model is the ability to limit access to sales opportunities, which requires correlation with other areas of law.

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[80] Philipp Staab, "The Consumption Dilemma of Digital Capitalism," *Transfer* 23, no. 3 (2017): 282, https://doi.org/10.1177/1024258917702830.

[81] Junic Kim and Hwanho Choi, "Value Co-Creation Through Social Media: A Case Study of a Start-Up Company," *Journal of Business Economics and Management* 20, no. 1 (2019): 9, https://doi.org/10.3846/jbem.2019.6262.

[82] Paul Belleflamme and Eric Toulemonde, "Tax Incidence on Competing Two-Sided Platforms: Lucky Break or Double Jeopardy," Working Paper (Munich: Center for Economic Studies and ifo Institute, 2016), 20, https://hdl.handle.net/10419/141859.

[83] Guttorm Schjelderup, Hans J Kind, and Marko Koethenbuerger, "Tax Responses in Platform Industries," *Oxford Economic Papers* 62, no. 4 (2010): 765–766, https://doi.org/10.1093/oep/gpq008.

[84] Martin Poniatowski et al., "Three Layers of Abstraction: A Conceptual Framework for Theorizing Digital Multi-Sided Platforms," *Information Systems and E-Business Management* 20, no. 2 (2022): 274, https://doi.org/10.1007/s10257-021-00513-8.

The second type of platform involves the formation of demand and supply with the help of the medium between the platform holder and the supplier. The offer can be formed directly between the platform holder and the consumer and indirectly through an intermediary. The functioning of this type of platform can create value in several forms at once, namely in the case of the provision of services or the sale of goods and the activity of customers on the platform in the case of the use of advertising.[85]

Ecosystem platforms, compared to platforms involving the cooperation of business entities, have a lower level of cooperation. The platform operator may set financial policies, limiting the freedom of suppliers. This form of cooperation may be prohibited due to the coordination of prices and the distribution of customers between the entities forming the offer.[86] This was the conclusion reached by the Court of Justice of the European Union in the *ETURAS* case,[87] where service providers coordinated their actions through a single platform. The only obstacle which prevented the responsibility of undertakings was the form of consent, which was not provided directly, and therefore, there was no explicit coordination of actions between the undertakings.

- *Effective use of information*. A different aspect that must be highlighted is the functionality of information and interaction with the user. While interacting with the Internet, the user forms inputs, which may be used to achieve the aim established by the provider and collect statistical information. For example, the frequency of clicks on search results may affect the order in which this result is demonstrated to the other users. Another example is CAPTCHA, which aims to prevent non-human access to inputs of information,[88] To pass the test, a person must match the image with a given object. In addition to receiving access to certain resources, a person contributes to the creation of a data inputs database, which can be used subsequently to train an artificial intelligence system. Subsequently, the owner of the system will be able to generate profit without having associated expenses connected to the system's training.[89]

Summarising the above, the development of the digital economy has consequences for creating new business models, which are often much more financially efficient than a classical model with physical elements. Considering the simplification of information flow and cooperation between business entities, new problems arise in the taxation of these subjects. Despite the

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[85] Boudreau and Andrei Hagiu, "Platform Rules: Multi-Sided Platforms as Regulators," in *Platforms, Markets and Innovation*, ed. Annabelle Gawer (Edward Elgar Publishing, 2010), 163, http://dx.doi.org/10.2139/ssrn.1269966.

[86] Andreas Hein et al., "Digital Platform Ecosystems," *Electronic Markets* 30, no. 1 (2020): 83, https://doi.org/10.1007/s12525-019-00377-4.

[87] Judgment of 21 January 2016, *'Eturas' UAB and Others v Lietuvos Respublikos konkurencijos taryba*, C-74/14 ECLI:EU:C:2016:42.

[88] "What Is CAPTCHA? - Google Workspace Admin Help," accessed 7 May 2024, https://support.google.com/a/answer/1217728?hl=en.

[89] Yennhi95zz, supra note, 5.

inevitable changes in taxation, the principles on which it will be made must remain the same, both for the physical economy and the digital one, because, in the opposite case, it can create an advantage for business representatives of one or another group. Thus, it is necessary to analyse the principles of taxation and their potential impact on the digital economy.

1.3. Analysis of the Ottawa Taxation Framework Conditions

Fundamental principles are "a general truth, constructed through a chain of reasoning, that forms the most important part of the foundation of a unique field of study from which theories and applied practices can be derived and verified in accordance with the current knowledge available to humanity."[90] An early categorisation of the principle of international taxation was done by Adam Smith in 1776, distinguishing proportionality, certainty, convenience and simplicity.[91] These were four main cornerstones, subsequently shaped by Kenndy and Seligman[92] and expanded the Carter Report by adding neutrality, accountability and transparency.[93] Nowadays, the principles of international taxation reached a consensus within the International Community in 1998, when a Report by the Committee on Fiscal Affairs, "A Borderless World: Realizing the Potential of Electronic Commerce,"[94] was prepared. The importance of the principles developed is also recognised by the OECD, identifying that one of the problems caused by the digitalisation of the economy is unpredictability for taxpayers connected with the allocation of profit between jurisdictions.[95] The Fiscal Committee identified such principles of the international taxation system:

- *Neutrality*. The concept of neutrality requires treating those subjects who are in the same economic position equally and have the potential to create revenue. Tex neutrality can refer to the tax system that avoids decision-making on subjective criteria.[96] It also stipulates that taxes should neither provide an advantage nor disadvantage directly or indirectly, as the main aim of

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[90] Musonda Kabinga, "Principles of Taxation," ed. Jörg Alt SJ and Kiprotich Tendet, 2016, 5, https://taxjustice-and-poverty.org/fileadmin/Dateien/Taxjustice_and_Poverty/Introduction/05_Principles.pdf.
[91] Jacob W Braestrup, "Simpler Taxes: A Guide to the Simplification of the British Tax System," Briefing paper (London: Adam Smith Institute, 2000), 14.
[92] Edwin Robert Anderson Seligman, *The Shifting and Incidence of Taxation*, 5th ed. ((New Yor: Columbia University Press, 1926), 169.
[93] Richard A Musgrave, "The Carter Commission Report," *The Canadian Journal of Economics / Revue Canadienne d'Economique* 1, no. 1 (1968): 171, https://doi.org/10.2307/133829.
[94] OECD, *supra note*:14.
[95] OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, 2013), 18, https://doi.org/10.1787/9789264202719-en.
[96] Douglas A Kahn, "The Two Faces of Tax Neutrality: Do They Interact or Are They Mutually Exclusive?" *Noethern Kentucky Law Review* 18 (1990): 14, https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1318&context=articles.

taxation is to receive needed revenue from the State's perspective.[97] In addition, decreasing tax incentives can broaden the tax base, which can lead to collecting more revenue with lower taxes. The neutrality of taxation shall be protected by law.[98] The OECD demonstrated an intention to apply this principle for taxation of the digital economy already in 2015.[99] A problematic aspect of this principle is the concept of similar economic circumstances, which is the basis for determining the equality of treatment. This principle shall be considered as important from the point of view of the analysis of the new proposals for the regulation of digital presence as, according to them, an additional burden of taxation is created only when a certain threshold of the entity's turnover is reached, which creates privileges for SMEs. Therefore, considering that there are, for example, two entities which operate actively engaged in providing services online, they will be treated differently depending on the annual turnover. If this situation is not approached in an equal way, this can only encourage aggressive tax planning and tax avoidance, given that the tax bases of two similar entities are not equal. Preferential treatment of the entity, for example, in case the different tax rates are applied to the taxpayers in the same circumstances, may give rise to distortion on the market and imply negative long-term consequences.[100] The relation between such regulation and the provision of State aid is also relevant to examine since a certain State can legitimately benefit from defragmented groups of entities.

- *Efficiency*. The principle of efficiency is revealed from the proportionality point of view, meaning that the procedures for tax collections should be as simple as possible for taxpayers who pay taxes, fees, and other payments. The OECD defines this principle as compliance costs for taxpayers and administrative expenses for the tax authorities that should be minimised as much as possible. It requires the development of clear rules for determining the digital presence and evaluating the intangible property and its contribution to profit formation. Because of this, the OECD announced the improvement of the Guidance on Transfer Pricing Aspects of Intangibles due to the requirements of the digital economy.[101] Some scientists consider this principle part of the principle of neutrality, given the influence of taxation on the implementation of business activities.[102] However, this principle shall be considered an independent requirement for

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[97] Paula Heliodoro, Vanda Martins, and Ricardo Moraes e Soares, "The Neutrality Principle and the Economic Efficiency of Tax Policy: An Exploratory Study of the Legal-Economic Approach," *Management and Administrative Professional Review* 10 (2023): 18523, https://doi.org/10.7769/gesec.v14i10.2715.

[98] Hanneke Preez and Madeleine Stiglingh, "Confirming the Fundamental Principles of Taxation Using Interactive Qualitative Analysis," *eJournal of Tax Research* 16, no. 1 (2018): 150 http://www.austlii.edu.au/au/journals/eJTR/2018/7.pdf.

[99] OECD, *supra note*, 9: 20.

[100] Jason Furman, "The Concept of Neutrality in Tax Policy," Testimony Before the U.S. Senate Committee on Finance Hearing on "Tax: Fundamentals in Advance of Reform," 2008, https://www.brookings.edu/wp-content/uploads/2016/06/0415_tax-_neutrality_furman-1.pdf.

[101] OECD, "Guidance on Transfer Pricing Aspects of Intangibles" (Paris: OECD Publishing, 2014), https://doi.org/10.1787/9789264219212-en.

[102] Lucas-Mas, *supra note*, 27: 31.

establishing a new model for taxation of the digital economy since creating a complex system of administration may encourage the outflow of capital from the jurisdictions. Simple tax rules also ensure predictability for business activity and certainty for taxpayers.[103] Some authors propose establishing the Tax Optimality Index to measure the efficiency of the tax system. This Index quantifies the distance of a given tax configuration from the optimal tax structure as the correlation between the potential maximum tax that can be collected and the distortion of the market.[104]

- *Certainty and simplicity*. The tax rules should be clear and straightforward to understand so taxpayers can anticipate the consequences before a transaction, including knowing when, where and how the tax should be accounted for.[105] This principle is revealed through the lens of the clarity of taxation. "The tax which each individual is bound to pay ought to be certain, and not arbitrary."[106] A predictable taxation system makes economic activity easier by calculating the potential tax liability and assessing the rationality of attracting or processing a resource in another jurisdiction.[107] However, simplicity as a requirement for the functioning of the tax system shall not be overdone to capture all the relevant profit and not to create situations of unequal treatment of taxpayers.[108]

The tax system, particularly the taxation of digital presence, must consider all circumstances and be predictable so as not to pose additional obstacles to cross-border commercial activity. This includes providing taxpayers with information on new changes in national and international taxation and avoiding temporary tax policies. On the other hand, tax system complexity is not detrimental to the market as long as it is necessary to achieve the proper functioning of the system.

- *Effectiveness and fairness*. Taxation should produce an appropriate amount of tax at the right time.[109] While the principles of predictability, neutrality and efficiency are to be measured objectively, this principle shall reflect the situations of taxpayers. Fairness can also be explained using vertical and horizontal systems of equity. The scope of vertical equality includes the measurement of expenditures, how tax decisions are made, how the tax authorities treat

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[103] Nihal Bayraktar, "Impact of Tax Simplification on Tax Efficiency," in *Advances in Cross-Section Data Methods in Applied Economic Research*, ed. Nicholas Tsounis and Aspasia Vlachvei, Springer Proceedings in Business and Economics (Cham: Springer International Publishing, 2020), 245, https://doi.org/10.1007/978-3-030-38253-7_16.
[104] Pascalis Raimondos-Møller and Alan D. Woodland, "Measuring Tax Efficiency: A Tax Optimality Index," Working paper (Frederiksberg: Copenhagen Business School (CBS), Department of Economics, 2006), 8, https://hdl.handle.net/10419/208480.
[105] OECD, *supra note*, 9: 20.
[106] Braestrup, *supra note*, 91: 16.
[107] Yair Holtzman, "Challenges in Achieving Transparency, Simplicity and Administering of the United States Tax Code," *Journal of Management Development* 26, no. 5 (2007): 422, https://doi.org/10.1108/02621710710748257.
[108] Samuel A Donaldson, "The Easy Case Against Tax Simplification," *Virginia Tax Review* 22, no. 645 (2003): 687, https://ssrn.com/abstract=755024.
[109] "Principles of Sound Tax Policy" (Tax Foundation), https://taxfoundation.org/taxedu/principles.

taxpayers and how the changes in the legislation are explained to taxpayers.[110] At the same time, the concept of horizontal equality includes equal treatment in equivalent circumstances.[111]

Roeme's view on the fairness of the tax system is that it guarantees equal opportunities to taxpayers.[112] This idea was further developed to divide the sources of inequalities into two groups. The first includes the individual characteristics for which a person shall not be held liable. Those require compensation to equalise the position, as positive discrimination requires intervention from a State. On the other hand, the second group involves the characteristics for which a person shall be liable since she/he chooses or controls them. For example, in the context of taxation, such can be referred to as the establishment of a private business, which shall be treated differently than a physical person.[113]

Some authors believe that the principle of fairness necessarily applies to the allocation of profit between the jurisdiction and the arm's length principle. In case the local tax authorities do not accept the allocated taxable income in their jurisdiction, it can encourage aggressive tax planning by an entity.[114] In addition, the principle of fairness is also relevant for determining the allocated profit between the jurisdictions, which uses the benefit principle to justify the attribution of profit to source States based on the place of profit generation. However, it is possible to find the contradictions to this rule even now. For example, while the profit generated in a source State in the context of a PE or subsidiary is taxed in that State, interest is deductible at the level of the taxes in the residence State.

- *Flexibility*. Taxation systems should be flexible and dynamic to keep pace with technological and commercial developments.[115] This principle provides for long-term planning of changes to legislation using stability and predictability. Tax authorities usually see flexibility as a potential risk to revenue, as it can be abused, for example, when taxes or incentives are directed to a certain category of taxpayers.[116] For this reason, governments establish integrity rules to protect revenue, such as the limitation of some form of entities to be publicly listed, the impossibility of selling a membership interest, and the allocation of loss rules.[117] Even in 1966, Smyth offered the

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[110] Ali Kazemi, "There Is More to Fairness in Taxation than Fair Taxes: Introducing a Multi-Faceted Fairness Framework of Taxation," in *Dynamics Within and Outside the Lab. Proceedings* (The 6h Nordic Conference on Group and Social Psychology, Lund, 2008), 148.
[111] Alharbi, *supra note*, 22: 16.
[112] John E Roemer and Alain Trannoy, "Chapter 4 - Equality of Opportunity," in *Handbook of Income Distribution*, ed. Anthony B Atkinson and Bourguignon Bourguignon, vol. 2 (Elsevier, 2015), 60, https://doi.org/10.1016/B978-0-444-59428-0.00005-9.
[113] Fleurbaey, *supra note*, 21: 16
[114] Stefan Greil, Christian Schwarz, and Stefan Stein, "Fairness and the Arm's Length Principle in a Digital Economy," *SSRN Electronic Journal*, 2018, 5, https://doi.org/10.2139/ssrn.3209205.
[115] Tax Foundation, *supra note*, 109.
[116] Brett Freudenberg and Bradley T Borden, "Contribution and Distribution Flexibility and Tax Pass-Through Entities," *Florida Tax Review* 23, no. 1 (2020): 36, https://doi.org/10.5744/ftr.2020.1006.
[117] *Ibid.*, 36.

concept of in-built flexibility of the tax system, which shall be defined taking into account the dynamic structure of the economic system.[118] Subsequent studies on this subject showed that flexibility of the tax system depends on tax reforms involving the change of the form of taxation, for example, shifts towards less progressive income taxes and greater use of indirect taxes, as well as experiencing rising mean incomes relative to tax thresholds.[119] Nowadays, the flexibility of the tax system is relevant to describe the adaptation of the international taxation system to the needs of the digital economy. As will be demonstrated, the current taxation system was not ready to capture the revenue created without physical elements, taking into account Article 5 of the OECD MTC. In addition, the principle of flexibility will be relevant not only for taxation of the digital economy but also for subsequent changes in the revenue-creating object, meaning that the new proposal shall not be exclusively focused on the digital economy but take into account the long-term perspective.

Summarising this Chapter, the revenue distribution system between the resident and source States was developed at the beginning of the last century. Based on these concepts, the system achieved such a level of functioning in allocating profit that it focuses exclusively on physical elements. However, the digitisation of the economy and immateriality as a feature of commercial relations demonstrate the inflexibility of those categories that were the basis of taxation.[120] This gave MNEs more freedom in the pricing of the transactions and made it more difficult for tax authorities to argue against profit allocation schemes since, in case of disagreement, the MNEs could use broader categories for aggressive tax planning.[121] However, the current taxation principles should be respected, as they apply not only to MNEs but also to individuals. Thus, the development and implementation of separate taxation principles may give rise to disrespect for the principles of equality or simplicity. As a result, current taxation rules shall be adapted to absorb the digital activity and ability of MNEs to avoid taxation. Therefore, it is necessary to determine the current threshold of the PE and define weaknesses in this concept.

[118] D. J. Smyth, "Built-in Flexibility of Taxation and Automatic Stabilization," *Journal of Political Economy* 74, no. 4 (1966): 400, https://doi.org/10.1086/259181.
[119] John Creedy and Norman Gemmell, "The Built-in Flexibility of Income and Consumption Taxes," *Journal of Economic Surveys* 16, no. 4 (2002): 519, https://doi.org/10.1111/1467-6419.00176.
[120] Harpaz, *supra note*, 51: 99.
[121] Peter Mullins, "Taxing Developing Asia's Digital Economy" (ADB, 2022), 10, https://www.adb.org/sites/default/files/institutional-document/782851/ado2022bp-taxing-developing-asia-digital-economy.pdf.

CHAPTER 2. CURRENT REGULATION OF THE CONCEPT OF PERMANENT ESTABLISHMENT AND RULES OF ATTRIBUTION OF PROFIT

While Chapter 1 is devoted to the basic principles of international taxation and social changes due to the digitalisation of relations, Chapter 2 is dedicated to the analysis of the concept of PE as a threshold enabling source taxation and the rules of attribution of profit to it. The first part describes the elements and threshold requirements for reaching a PE, and the second part focuses on the particular problems of PE functioning, which have been identified as causing the majority of cases of tax avoidance. The last part explains the rules for the attribution of profit to a PE.

2.1. The Definition and Types of Permanent Establishment

A non-resident may conduct commercial activity in a foreign jurisdiction through a subsidiary or PE.[122] The main difference lies in terms of the separation of the legal personality from the main entity. While a branch is a separate legal entity, a PE is a continuation of a non-resident company.[123] Such difference is crucial with regard to taxation of economic activity. A State obtains the right to impose taxes on a branch since it performs economic activity in the State of incorporation. However, the same solution is not applicable to a PE since the activities are performed on behalf of a non-resident entity. The taxation rights of a source State are limited by the principle of territoriality[124] and will be obtained if the existence of a PE is confirmed and it is possible to attribute profit to it.

The relevance of the analysis of the threshold of PE is explained by the fact that with the digitalisation of economic activity, the generation of revenue becomes possible without the creation of a separate legal entity or reaching the level of a PE, leaving a source State without the possibility to obtain part of the revenue created in its territory.[125] This situation occurred in *Amazon* case, where the MNE attributed profit obtained from the performance of economic activity in the UK's digital space to the entity established in Ireland.[126] The treatment of such transactions falls

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[122] A.C.G.A.C. de Graaf, P. Kavelaars, and A.J.A. Stevens, *Internationaal Belastingrecht*, 2nd ed (Deventer: Kluwer, 2008), 39.
[123] Faúndez Ugalde, "Control of Expenses Computed by Permanent Establishments under the OECD Model Agreement," no. 30 (2010): 72, https://www.ciat.org/Biblioteca/Revista/Revista_30/Ingles/2010_TR30_faundez.pdf.
[124] David W Williams, *Trends in International Taxation* (Amsterdam: IBFD Publications, 1991), 101, http://catalog.hathitrust.org/api/volumes/oclc/25170220.html.
[125] European Parliament, "Taxing the Digital Economy: New Developments and the Way Forward" (European Parliamentary Research Service, 2021), 2, https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698761/EPRS_BRI(2021)698761_EN.pdf.
[126] Public Accounts Committee, supra note, 73.

within the discretion of the source State and might be assessed as valid tax planning or tax avoidance. For the purpose of the thesis, the concept of PE laid down in the OECD MTC will be the primary object of analysis. However, the rules for PE can also be found in other UN Model Tax Convention (hereinafter – UN MTC), US MTC and national legislations, which will be applicable if no bilateral or multilateral tax agreements exist between source and residence States.

The concept of PE relates to the concept of source, making it possible to determine the jurisdiction that obtains the rights of a source State in case of reaching the threshold.[127] A PE also determines the availability of the rights to exercise jurisdiction over the non-residence entity.[128] To attribute the profit generated in the digital or physical space of the source State to a PE, the first step is to determine the existence of such a PE. This step is also referred to as the level of applicability.[129]

Article 5(1) of the OECD MTC defines PE as a fixed place of business through which an enterprise's business is wholly or partly carried on.[130]

Temporal criterion. The major criterion implied in the concept is the consistency and timely nature of commercial activity through PE.[131] Since it is not addressed in the definition, it cannot be attributed to the requirement established by the OECD MTC. However, national legislation is free to determine the scope of temporal criterion necessary for the creation of the PE. For example, a hotel room that was temporarily used for meetings to discuss market policy for less than three months cannot be considered a PE.[132] At the same time, a permanent Formula One racing circuit that is used for a limited amount of time during a year may be recognised as a PE by tax authorities.[133] In addition, some authors support the introduction of the rules of thumb, which establishes that the existence of a PE will not be assumed if the activities are performed for less than six months.[134]

However, some temporal requirements are laid down with regard to specific types of commercial activity. According to Article 5(3) of the OECD MTC, "a building site or construction or installation project constitutes a PE only if it lasts for more than twelve months." The special character and non-application of this criterion to the general definition of PE is also evident from

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[127] Atanasov, *supra note*, 6: 14.
[128] OECD, *supra note*, 46: C(5)-1.
[129] Michael Lang, Alfred Storck, and Raffaele Petruzzi, *Attribution of Profits to Permanent Establishments*, 1st ed., vol. 118, Series on International Tax Law (Linde Verlag, 2020), 25.
[130] OECD, *supra note*, 36: Article 5(1).
[131] Zaleha Othman and Mustafa Mohd Hanefah, "Taxation, E-Commernce and Determination of Permanent Establishment," *Malaysian Accounting Review* 5, no. 2 (2006): 4.
[132] "Kunstogenarrest," Supreme Court of the Netherlands, 1955, https://www.ndfr.nl/content/ECLI_NL_HR_1955_AY4120.
[133] "Formula One World Championship LTD v. Commissioner of Income Tax. International Taxation - 3, Delhi & Anr.", 2017, https://tpcases.com/india-vs-formula-one-world-championship-ltd-april-2017-indias-supreme-court/.
[134] Ditz, *supra note*, 20: 560.

the structure of Article 5 of the OECD MTC, meaning that a twelve-month period is applicable only to the activity specifically referred to. Therefore, it is up to the discretion of tax authorities to lay down the rules with regard to the period of business activity necessary for the creation of PE in a source State.

Place of business. Article 5 of the OECD MTC is silent on the definition of the place of business, which raises the question, for example, is the location of the server or storage of the goods without exploitation enough to reach the PE threshold? The answer to this question is possible to extract from Article 7 of the OECD MTC, which establishes rules for the attribution of PE. However, the attribution of profit to a PE is possible only if the threshold is reached, meaning that it would be possible only by adopting a broad interpretation of the OECD MTC. In addition, in answering this question, one shall consider the position of tax authorities concerning tax planning. Therefore, the place of business is to be understood as facilities, premises, machinery, equipment or material used to perform the activities of an entity.[135] In addition, the place of business does not necessarily have to be located in the facilities of a particular company. It is possible for it to be located in the facilities of another business.[136] On the other hand, a website without any physical presence in a State cannot constitute a PE.[137]

Fixed. Another element of the concept of PE is the criterion *fixed* used with the conjugation of the place of business. The criterion is applied to determine the geographic location of the place of economic activity and does not require the object to be physically attached to the land but only to be located within the fiscal jurisdiction of a State.[138] The level of consistency is also present since the constant movement of the economic activity in the provision of vehicle repair services on roads between States shall not, itself, grant the right to tax such profit to a source State. In addition, a fixed place of business does not require human presence for the creation of a PE,[139] but only a certain *situs*.[140]

Through which business is carried on. Article 5 of the OECD MTC also requires a necessary link between the generation of profit and the creation of PE.[141] Since Articles 5 and 7 of

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[135] Montserrat Hermosín Álvarez, "Permanent Establishment. The Crisis of the Article 5 OECD MC in the Digital Economy," *Crónica Tributaria* 180, no. 3 (2021): 106, https://doi.org/10.47092/CT.21.3.4.
[136] João Sérgio Ribeiro, "Outline of Article 5 of the OECD Model Convention," *Jurisprudencija* 1, no. 115 (2009): 298, https://ojs.mruni.eu/ojs/jurisprudence/article/view/1588/1527.
[137] Othman, *supra note*, 131: 5.
[138] OECD, *supra note*, 46: C(5)-10.
[139] Jacques Sasseville, Arvid A Skaar, and International Fiscal Association, *Is There a Permanent Establishment?* vol. 94a, Cahiers De Droit Fiscal International (The Hague: Sdu Uitgevers, 2009), 24.
[140] Cidália M Lopes and António C Santos Santos, "Tax Sovereignty, Tax Competition and the Base Erosion and Profit Shifting Concept of Permanent Establishment", EC Tax Review 25, no. 5 & 6 (2016): 302, http://dx.doi.org/10.54648/ECTA2016030.
[141] Ksenia J Levouchkina, "Relevance of Permanent Establishment for the Taxation of Business Profit and Business Property," in *Permanent Establishments in International Tax Law*, by Hans-Jörgen Aigner and Mario Züger, vol. 29 (Linde, 2003), 20-21.

the OECD MTC divide the question of the creation of a PE and attribution of profit to it into different stages, the existence of a PE does not, *per se*, give rise to a source State to tax the profit, meaning, that the factual generation of profit is not a necessary condition for the creation of PE.[142] Only the ability of the assets or source location is enough to reach the threshold to satisfy the requirement described above. The test applicable between profit generation and PE is that the facilities should be at the disposal.[143] For example, the place of business shall not be considered at the disposal if a subcontractor simply performs work under the contract and has no right to access any fixed place.

However, with the digitalisation of business relations, the current definition of the PE showed its inefficiency since it is based on the physical presence element. While the conduct of business activity and generation of profit is possible without a physical presence in a State, the MNEs involved in digital business could avoid the creation of PE under Article 5 of the OECD MTC.[144]

The form of a PE described in Article 5(1) of the OECD MTC is the most commonly accepted form of continuation of the main entity. However, the OECD MTC is not the only model tax convention that establishes the rules for the functioning of the PE. The UN MTC allows capital-importing States to retain more taxing rights, while the OECD MTC gives more rights to developed countries.[145] The US, incorporating the rules for benefit entitlements, ensures control over the treaty framework adopted by the United States Model – Tax Treaty, which is usually concluded only with certain jurisdictions.[146] In addition, the development of business relations and the practice of taxation avoidance showed the need to limit the PE threshold.[147]

Dependant agent permanent establishment. Article 5(5) of the OECD MTC provides an exception to the general rule of PE, which is usually distinguished in doctrine as a separate type of PE.[148] It establishes that where a person is acting in a State on behalf of an entity and, in doing so, habitually concludes contracts or habitually plays the principal role leading to the conclusion

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[142] Mandy Witt, "Requirements for Assuming a Permanent Establishment under Art. 5 OECD Model Tax Convention: In Accordance with the German Federal Fiscal Court's Considering a Locker as a Fixed Place of Business," *Science International Empirical Review* 1, no. 1 (2021): 118, https://doi.org/10.52514/sier.v1i1.8.
[143] Sérgio, *supra note*, 136: 299.
[144] Mzwandile Ngidi, "Determining Permanent Establishment" in the Digital Economy Epoch: A Case for South Africa', *OBITER* 43, no. 3 (2022): 514, https://doi.org/10.17159/obiter.v43i3.14882.
[145] Veronika Daurer and Richard Krever, "Choosing between the UN and OECD Tax Policy Models: An African Case Study" (Italy: Robert Schuman Centre for Advanced Studies, 2012), 1.
[146] "United States Model Income Tax Convention," 2016, Article 4(3), https://home.treasury.gov/system/files/131/Treaty-US-Model-2016_1.pdf.
[147] Michael Lennard, "The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments," *Asia-Pacific Tax Bulletin* 15, no. 1 (2009): 5, https://doi.org/10.59403/2ds8pmt.
[148] Tommy Yee and Yuan Yong S, "Necessity of the Dependent Agent Permanent Establishment" (SMU-CET, 2019), 9, https://www.taxacademy.sg/files/research-papers/paper_tommy%20and%20sing%20yuan_final.pdf.

of contracts, and these contracts are in the name of an entity or for transfer of the ownership or granting the right to use or for the provision of services by the entity, this activity shall constitute the PE of the entity concerning the activities performed by the agent.[149] The main limitation of the dependant agent permanent establishment (hereinafter - DAPE) is the exhaustive list of activities attributed to the main entity. Agency dealings are not limited to the physical person, and legal entities can also be considered agents of another legal person, giving rise to the problem of separating the activities of the entity in its own name from those of the entity as a PE.[150] Since Article 5(5) of the OECD MTC establishes the result of an agent's activities, namely the conclusion of agreements, mere negotiation on behalf of the entity is not enough to give rise to the existence of a PE.[151] Moreover, for natural persons, the place of residence, employment with the main company, and maintenance of the permanent place of business are irrelevant.[152] However, in the case of a legal entity, there shall be a level of separation of legal personalities to establish the relationship of dependence. For this, it is defined that a person is considered to be an agent if the undertaking taken by him directly or indirectly affects the main entity.

Some important clarifications to this concept have been highlighted in national practice. In the *Google Ireland v. France* case, the Paris Court of Appeal emphasised that an essential element for determining the existence of a DAPE is the scope of the powers. The court ruled that Google France could not be recognised as a DAPE of Google Ireland, as the former was not entitled to enter into contracts favouring the latter.[153] In addition, a lower threshold for the existence of a DAPE is established by the UN MTC, Article 5(5)(b), which states that a person is considered to be an agent of the main entity if "the person does not habitually conclude contracts nor plays the principal role leading to the conclusion of such contracts, but habitually maintains in that State a stock of goods or merchandise from which that person regularly delivers goods or merchandise on behalf of the enterprise."[154]

Service permanent establishment. The OECD MTC still does not explicitly recognise this form of PE. However, the Commentaries to Article 5 of the OECD MTC establish that such service activities may be taxed by the source State without establishing a PE if there is a mutual agreement

[149] OECD, *supra note*, 36: Article 5(5).
[150] Leonardo F M Castro, "Problems Involving Permanent Establishments: Overview of Relevant Issues in Today's International Economy," *The Global Business Law Review* 2, no. 2 (2012): 138, https://engagedscholarship.csuohio.edu/gblr/vol2/iss2/3.
[151] *Ibid.*, 139.
[152] Reimer, *supra note*, 18: 102.
[153] 17PA03065, No. 17 (Cour administrative d'appel de Paris 2019), https://www.legifrance.gouv.fr/ceta/id/CETATEXT000038420177/.
[154] OECD, *supra note*, 36: Article 5(5).

between the jurisdictions and there is a significant risk of aggressive tax planning due to the absence of a physical element.[155]

On the contrary, the United Nations (hereinafter – UN) consistently incorporated the clause of service permanent establishment in 1979, 2001, 2011 and 2017 Model Tax Convention.[156] A service permanent establishment does not require a fixed place of business and covers furnishing of and consultancy services by a person, not limited to an employee, for at least 183 days in any 12-month period.[157] It shall be noted that the threshold for service permanent establishment is relatively low, which poses a risk that some activities of taxpayers might be caught without the intention to engage in business activity in a particular jurisdiction since this PE does not take into account the number of contracts, the place of the user of the service. The application of service permanent establishment may result in a complex administrative burden for taxpayers since Article 5(5) of the UN MTC is also applicable to the employees of the main entity, meaning that if an employee facilitates the provision of the services from a fixed place of business reaching the threshold of a PE in another State physically located in that State the same revenue may be captured by both general forms of PE and service permanent establishment.[158]

Building site permanent establishment. Lastly, Article 5(3) of the OECD MTC establishes that a building site or construction or installation project constitutes a PE only if it lasts more than twelve months. The building site or constriction is defined by the commentaries to include a broad spectrum of construction activities, such as roads, bridges, pipelines, dredging, etc. In addition, the term installation project is not restricted to the installation of equipment on the construction site by the same entity and might constitute a PE if it lasts for more than twelve months. Special consideration is also given to the planning or supervision activities which might create PE in case of satisfaction of a temporal criterion.[159]

The OECD recognised the abuse connected with the application of 12 months criterion for the existence of this type of PE by splitting up the contracts between contractors and sub-contractors, each of which lasts for less than the period established, disabling tax authorities to attribute the activities to one specific entity which prevented the existence of PE. To tackle such abuses, the OECD recommended applying national legislative or judicial anti-avoidance rules and anti-abuse rules of Article 29(9) of the OECD MTC. This demonstrates that the definition of building site permanent establishment itself is not able to cope with associated abuses.

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[155] OECD, *supra note*, 46: C(5)-51.

[156] The UN published 2011 update of the UN Model on double taxation between developed and developing countries on 15 March 2012. The 2011 update replaced the 1999 version of the Model Convention, published in 2001.

[157] "United Nations Model Double Taxation Convention between Developed and Developing Countries" (United Nations, 2017), Article 5(3), https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf.

[158] Castro, *supra note*, 150: 149.

[159] OECD, *supra note*, 46: C(5)-20.

On the other hand, Article 5(3) of the UN MTC established 6 months temporal criterion. While no evidence of rationale for introducing such an approach is to be found in the commentaries, this implies a stricter approach to the definition of a building site PE, possibly making it less financially rational and reporting burdensome to split construction agreements.[160]

2.2. Weaknesses of the Current Definition of Permanent Establishment

Having analysed the current regulation of a PE, its forms and the rules for attribution of profit, this part examines the elements of a PE, which commonly became the object of tax avoidance.

2.2.1. Commissionaire Arrangements

As discussed in Section 2.1.1, Article 5.5 of the OECD MTC establishes an exception to the general definition of a PE; the main entity will have a DAPE in a State, where a person acts on behalf of that entity, and the dealing results in property rights for the entity. Until 2017, the OECD MTC also established the dependence on the agent's action for assuming the existence of a PE, meaning that if an agent was formally independent of the main entity, the activity performed could not constitute a DAPE.[161] Now, the level of affiliation is determined by means of Article 5(8) of the OECD MTC, which establishes that if a person or entity is under factual control of another entity or possesses directly or indirectly more than 50% of beneficial interest, such entities or persons shall be considered as closely related.[162] In addition, changes were also introduced with regard to the activity of a main entity and an agent. It is possible to determine the existence of a DAPE if the activity of an agent facilitates the exercise of business activity.[163]

Even with the introduction of such changes, this approach is limited, especially with regard to the determination of closely related entities by the administrative cooperation between tax authorities.[164] This situation may be particularly evident if coupled with the provision of aid to an entity in a State with a wide net of DTA. For example, although Article 5(6) of the OECD MTC establishes that an independent agent will be considered a DAPE in case of exclusive or almost exclusive acting on behalf of one or more entities,[165] the level of affiliation between the entities

[160] UN, *supra note*, 157: 161.
[161] OECD, *supra note*, 171: 13.
[162] OECD, *supra note*, 36: Article 5(8).
[163] Álvarez, supra note, 135: 110.
[164] OECD, *supra note*, 175: 247.
[165] OECD, *supra note*, 36: Article 5(6).

will be measured in accordance with Article 5(8) of the OECD MTC. Given that the rules for affiliation are focused on the concept of the ultimate beneficial owner, nothing prevents the MNEs from broadening the structure of the group to create multiple and unconnected holding entities, lowering the level of affiliation with a PE. Some authors refer to this situation as low-risk distributors or flash titles.[166]

The same is applicable in the case of cooperation between competitors with the aim to lower the level of control under Article 5(8) of the OECD MTC. In this situation, from the perspective of legal positivism, the activity of independent agents will not constitute a PE. The same applies in the case of branching of the MNEs between jurisdictions with an ineffective level of administrative cooperation since the tax authorities will not be able to define an agent's indirect control level.

2.2.2. Ancillary or Preparatory Activities

In addition, Article 5.4 of the OECD MTC provides an exhaustive list of ancillary and preparatory activities, which shall not be considered to constitute PE as such. Those include the use of facilities solely for the purpose of storage, display or delivery of goods, maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of storage, display delivery or processing by another enterprise, fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information.[167]

The decisive criterion for distinguishing ancillary and preparatory activities is whether the activity forms "an essential and significant part of the activity of the enterprise as a whole."[168] In this regard, the Report on Action 7 also clarifies that the activity has a preparatory character if it is carried out in contemplation with the main activity, while the ancillary character has an activity that is carried out to support, without being part of the activity of an entity.[169] However, if such activity is performed in a fixed place of business, it can be attributed to the existing PE. The main problem with the application of this exception is the risk of fragmentation of the operation of the main entity, which would separately fall under the concept of ancillary or preparatory activities.[170] However, the implementation of such a strategy was limited by the introduction of changes to

[166] Maarten F Wilde, "Lowering the Permanent Establishment Threshold via the Anti-BEPS Convention: Much Ado about Nothing?" *Intertax* 45, no. 8 & 9 (2017): 4.
[167] OECD, *supra note*, 36: Article 5(4).
[168] Eva Escribano, "The Arrival Of The New Beps Pe Clause In Actual Tax Treaties Via The Mli: Impact, Risks And Need For Further Regulatory Changes (Particular Focus On Spain)," *Intertax* 51, no. 5 (2023): 5, https://doi.org/10.54648/TAXI2023034.
[169] OECD, *supra note*, 171: 31.
[170] Maarten F Wilde, "Lowering the Permanent Establishment Threshold via the Anti-BEPS Convention: Much Ado about Nothing?" *Intertax* 45, no. 8 & 9 (2017): 5.

Article 5 of the OECD MTC by the Report on Action 7, establishing that the activities will not constitute ancillary or preparatory activities if the same or closely related entities in the same or another place in the same State perform the activities which, in conjugation, would constitute a PE.[171]

However, these amendments do not solve the same problems that are applicable to the DAPE. Since Article 5(4)(1) of the OECD MTC takes into account the fragmentation of activities in one State, nothing prevents MNEs from separating the main activity into different States or reallocating the existing fixed places of businesses covered by this exception into another State.[172] This becomes even easier to implement since more activities lose physical elements and can be fulfilled remotely. In addition, the exception of ancillary and preparatory activities is also applicable to DAPE, and in combination with such, MNEs would be able to avoid taxation even if they are involved in an activity with a physical element.

2.3. Rules for Attribution of Profit to a Permanent Establishment

Once the existence of the permanent establishment is confirmed, the next step to grant a source State taxing rights over the commercial activity of a non-resident is the attribution of profit to the permanent establishment, referred to as the level of application.[173]

2.3.1. The Direct Approach

Article 7(1) of the OECD MTC establishes that the profit of an entity or PE in a State shall only be taxed in that State unless the entity carries on business through a PE.[174] This rule represents a generally accepted principle of taxation.[175] Article 7(2) clarifies the attribution of profit to a PE and operates the assumption that the amount attributed shall be considered the profit that a PE is expected to make if it were a separate and independent enterprise. Thus, the amount of profit attributed to the PE shall be defined by considering the functions performed, assets used, and risks assumed by the enterprise through the PE.[176] This method for attribution of profit is

[171] OECD, *supra note*, 36: Article 5(4)(1).
[172] Wilde, *op. cit*., 5.
[173] Lang, *supra note*, 129: 29.
[174] Hentschel, *supra note*, 17: 107.
[175] Susan C Morse, "Value Creation: A Standard in Search of a Process," *Bulletin for International Taxation* 72, no. 4/5 (2018): 198, https://doi.org/10.59403/3dxa2wh.
[176] OECD, *supra note*, 36: Article 7(2).

referred to as the separate entity approach,[177] is authorised by the OECD[178] and requires the determination of accordance of a PE transaction to the arm's length principle.[179] This means that a PE may be profitable despite the fact that the main entity may incur losses during the financial year. Most authors agree that this method of profit allocation requires separate accounting for the main entity and a PE.[180] Even though the application of this method seems straightforward, involving the definition of arm's length transactions conducted via a PE and functional and factual analysis, it is not possible to determine the whole transactions with a PE.[181]

In addition, the consistency of this method for attribution of profit to PE allowed the development of the practice of advance pricing agreements between tax authorities and taxpayers under which tax authorities accept the selection of methods, comparable, appropriate assessment, etc., for certain transactions.[182] The primary purpose of such an agreement is to ensure tax certainty and predictability for taxpayers. On the other hand, the advance pricing agreement may include the number of tax advantages covered by the confidentiality, which may give rise to the question of equal treatment of taxpayers.

However, the primary criticism of this method relates to the assumption of the existence of an entity with a separate legal personality. Rosenbloom describes this situation as the need to answer the question, "If you had a brother, would he like cheese?"[183] This means that without real economic transactions, it is not possible to predict the allocation of functions between the main entity and a PE. In addition, the attribution of profits depends on the location of the critical decision-making powers in the entity's context.[184]

2.3.1.1. Attribution of Significant People Functions

With the introduction of the concept of significant people functions, the attribution of profit to a PE is possible only with the presence of employee or physical persons in the State of

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[177] Charles Edward Andrew Lincoln IV, "Approaches to Attribution of Profits in International Corporate Permanent Establishmentss Taxable Separate Entities," in *The Myth of Separate Enterprises in International Taxation: Approaches to Attribution of Profits to Permanent Estbalishments* (Trinity Law Review, 2017), 5, https://www.ssrn.com/abstract=2919387.
[178] Philip Baker et al., *The Attribution of Profits to Permanent Establishments*, vol. 91B, Cahiers De Droit Fiscal International (Amersfoort: Sdu Fiscale & Financiële Uitgevers, 2006), 25, https://www.fieldtax.com/wp-content/uploads/2015/09/Attribution-of-Profits-to-Permanent-Establishments.pdf.
[179] OECD, *supra note*, 36: Article 7(1).
[180] Reimer, *supra note*, 18: 110.
[181] Lincoln IV, *op. cit*., 14.
[182] OECD, "Bilateral Advance Pricing Arrangement Manual" (Paris: OECD Publishing, 2022), 14, https://doi.org/10.1787/4aa570e1-en.
[183] David H Rosenbloom, "Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt," *The Sydney Law Review* 26, no. 1 (2003): 989, https://www.caplindrysdale.com/media/publication/150147.
[184] Hentschel, *supra note*, 17: 170.

location of a PE, since without them, the functional and factual analysis does not allow to attribute significant function which would provide the possibility to generate profit.[185] This is explained by the fact that a PE cannot obtain legal ownership over assets or assume risks.[186] Although such functions are identified in the Transfer Pricing Guidelines, the same logic applies to the attribution of a profit to a PE under a direct approach because of a presumption of a separate legal personality.

It should be noted that the OECD separates the functions of ancillary or support and significant people.[187] This distinction is not relevant for the determination of the existence of a PE but for the identification of the transaction or functions which may create the value. Respectively, significant people function attributed a PE creates value and gives rise to a source State's rights to tax such value. The OECD does not provide the criteria for identifying significant people's functions. However, some authors state that function can constitute significant people only if the personnel at the location of a PE has the capabilities, knowledge, or skills to perform certain functions, the competence to assume responsibility, and some level of control over assumed risks.[188] Even though significant people functions are identified, a taxpayer has to attribute specific functions to a person to price the transaction. The OECD provides a non-exhaustive list of such functions as design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management.[189] It is the economic significance of those functions in terms of their frequency, nature, and value to the transaction that is relevant for value creation.[190]

The OECD does not provide clarification on specific situations which may arise with regard to the pricing of transactions and identification of function, for example, in case of overlap of function between two PE of one main entity, separation of a value created between a PE and a main entity and functions appeared with the digitalisation of international commerce. Moreover, prior to pricing transactions with other entities, there is a need to identify the transaction of a PE with the main company.[191]

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[185] OECD, "Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7," 2018, 12, http://www.oecd.org/tax/beps/additional-guidance-attribution-of-profits-to-a-permanent-establishment-under-beps-action7.htm.
[186] Hentschel, *supra note*, 17: 121.
[187] Centre for Tax Policy and Administration, "Report on the Attribution of Profit to Permanent Establishment" (OECD, 2010), para. 62, https://www.financnisprava.cz/assets/cs/prilohy/ms-prime-dane/45689524.pdf.
[188] Sophie Margerie, *Gewinnermittlung und Gewinnabgrenzung bei Betriebsstätten: Eine Analyse des AOA und seiner Umsetzung in nationales deutsches Steuerrecht*, 1st ed. (Lohmar: Technische Universität Darmstadt, 2016), 112.
[189] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations: 2010* (Paris: OECD Publishing, 2010), 45, https://doi.org/10.1787/tpg-2010-en; OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022* (Paris: OECD Publishing, 2022), 47, https://doi.org/10.1787/0e655865-en. The list of functions was deleted from the 2022 Guidelines.
[190] *Ibid.*, 46;
[191] Centre for Tax Policy and Administration, *supra note*, 173: 33.

2.3.1.2. Attribution of Tangibles Assets

The attribution of tangible assets to a PE, in addition to the functional and factual analysis, may be based on the place of use of assets.[192] While it is not possible to attribute the whole range of property rights, especially with objects which require registration of rights since of no separate legal personality exists, it is possible to identify functions performed with regard to a specific asset, which may add value created to significant functions performed.[193] Examples of such attribution of profit may be the use of rented, leased property in the location of a PE in the name of the main entity.[194] However, for the purpose of profit attribution, there is another presumption of ownership or lessees of tangible property if it is used exclusively in the location of a PE.[195]

However, if it is impossible to attribute the profit generated from the use of assets, for example, in case of shared development or use of such assets by the main entity and PE, then the attribution shall be performed proportionally, taking into account the costs and functions contributed to revenue generation.

2.3.1.3. Attribution of Intangible Assets

In addition to tangible property, a PE may operate on intangible property. This category of assets has become problematic for attribution of profit in international taxation since even the OECD recognised that the use of intangibles to avoid taxation has become widespread by reallocating the title to the property to specific jurisdictions which allow attribution of functions to the entity while the revenue may be received in another.[196]

The primary issue that could arise with the valuation of intangibles is the definition. National legislation may establish different scopes, which may lead to hybrid mismatches. To address this, Chapter VI of the OECD Transfer Pricing Guidelines establishes an autonomous definition of intangible assets as follows: "something that is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances."[197] The non-exhaustive list of intangible property comprises patents, trade secrets, trade names, know-how, licenses, brands, exclusive rights provided for in a

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[192] *Ibid.*, 57
[193] *Ibid.*
[194] Margerie, *supra note*, 174: 122.
[195] Centre for Tax Policy and Administration, *supra note*, 173: 75.
[196] OECD, *supra note*, 9: 373.
[197] OECD, *supra note*, 175: 247.

contract with a State, and similar rights.[198] Notably, while goodwill and ongoing concern are discussed as possible examples of intangible assets, they were not included in the list. However, there is no difference in valuation criteria depending on the type of assets, so it is not relevant to define each type of intangible asset included.[199]

Since the OECD adopted the implied criterion of exclusiveness or uniqueness to determine intangible assets, not all objects, even those included in the list, can constitute such property or lose such character due to the loss of uniqueness. It means that even if the definition recognises the object as an intangible asset, it might not receive attributed revenue; for example, widespread use of the object precludes the attribution of functions to it.[200] The situation may be the opposite when the object gains uniqueness although it is not generally recognised as the object of intellectual property, such as exclusive rights under the contract with a State and licences.

Contrary to the assessment of function performed with tangible assets, the place where the object is used is irrelevant for the valuation of intangible property because of the possibility of use in different jurisdictions.[201] The OECD establishes specific functions performed with intangible assets that give rise to profit attribution, namely development, enhancement, maintenance, protection, and exploitation. This implies that only an entity or a PE performing the range of functions mentioned, providing all the assets and assuming the risks, obtains the right to a full return. On the other hand, other entities and PE receive a return or attribution of a portion only if they perform the functions by the arm's length principle. The Guideline establishes a compensatory form of profit allocation for bearing the risks associated with performing the object's functions.[202]

Comparing the list of functions adopted by the OECD, the UN established an additional function, such as the acquisition of intangibles.[203] The logic of including such a function is that an entity may develop the intangible through self-development. This peculiarity poses no difference with regard to the practical assessment of intangible assets since the OECD includes the acquisition of the function of development. However, this may complicate the administrative burden since the taxpayers have to differentiate the functions for profit attribution.

In addition, the OECD recognises the existence of unique practical situations when it is hard to determine the price of a particular function. This led to the adoption of additional Guidance

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[198] *Ibid.*, 250-255.
[199] Hentschel, *supra note*, 17: 132.
[200] OECD, *supra note*, 175: 250.
[201] Richard Collier and Joseph L Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS* (Oxford University Press, 2017), para. 6.53, https://olrl.ouplaw.com/display/10.1093/law/9780198802914.001.0001/law-9780198802914.
[202] OECD, *supra note*, 175: 255.
[203] Department of Economic and Social Affairs and Financing for Sustainable Development Office, "United Nations Practical Manual on Tranfer Pricing for Developing Countries 2021" (New York: United Nations, 2021).

for Tax Administration on the Application of the Approach to Hard-to-Value Intangibles under Action 8. Such a situation may involve when no comparables exist, and during the time of conclusion of an agreement, the profit was expected to arise from tangible property or the assumption made while the valuation of an intangible asset is too uncertain.[204] Some authors provide examples of when it is hard to conduct pricing. The object shall be considered to be hard-to-value intangibles when it:

- Was only partially developed at the time of the transfer;
- Was not expected to be exploited commercially until several years after the transaction;
- Is integral to the development or enhancement of other hard-to-value;
- Is exploited in a novel manner, making reliable projections from past developments unavailable;
- Is being transferred for a lump-sum payment;
- Is used and/or developed under a cost contribution or cost-sharing arrangement.[205]

The practical impossibility of assessment of intangibles relates to the imbalance of information between taxpayers and tax authorities until the *ex-post* outcomes of the transaction are known. Moreover, the general approach for assessing intangible assets requires authorities to possess *ex-ante* information, for example, on the development of a particular object. That is the reason why the Guideline allows tax authorities to rely fully on *ex-post* outcomes as the resumptive evidence to assess whether the pricing is in accordance with the arm's length principle. However, this approach has its disadvantages, since if the owner of an asset was changed a few times subsequently, tax authorities will take into account only the last owner.[206] In this case, the taxpayer will be burdened to prove the *ex-ante* chain of ownership.

2.3.2. The Indirect Approach

The second method for profit attribution to a PE is indirect. The difference between this and direct methods is that the second method does not create a presumption of a separate legal personality of a PE.

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[204] OECD, "Guidance for Tax Administrations on the Application of the Approach to Hard-to Value Intangibles - BEPS Actions 8-10." G20 Base Erosion and Profit Shifting Project (Paris: OECD, 2018), para. 18.

[205] Reyhaneh Safaei, "Transfer Pricing Rules for Intangibles: Implementation and Practical Challenges," Working Paper (TAF, 2022), 16, https://en.wiwi.uni-paderborn.de/fileadmin-wiwi/cetar/TAF_Working_Paper_Series/TAF_WP_079_Safaei2022.pdf.

[206] B Konings and D Morren, "Hard-to-Value Intangibles: How Hard Can It Be?" *International Transfer Pricing Journal* 28, no. 1 (2021), https://doi.org/10.59403/2s0k8r6.

The mechanisms of this approach predict the calculation of the total profit of an entity and its proportional allocation between its parts, including PE.[207] To allocate the profit to a PE, the formula of contribution to generating profit for each part of the main entity shall be created, either in coordination with tax authorities, which will ensure predictability, or by the taxpayer independently. It might include premium, cash-flow, sales, assets, turnover, capital and other criteria or their combination.[208] The main disadvantage of this method is the accuracy of calculation, meaning that profit can be allocated to a PE only if the main entity receives profit, while the direct method ensures more flexibility. Consequently, under the indirect method, if the entity is profitable only in one jurisdiction, a source State might not receive a portion of revenue since it will be decreased by global losses. Additionally, this method does not require separate accounting for a PE, and the question of dealing between separate parts of the main entity does not arise.[209] Moreover, a PE is not involved in economic activity with other entities. Therefore, the rules for transfer pricing are irrelevant to this method.

However, the main problem with this method is the creation of a formula since it serves the role of the transfer pricing rules and, consequently, the mean for allocation of profit between source and resident States. Given that accounting differs significantly between entities and jurisdictions, the maximum level of standardisation that could be achieved is at the level of industries. For example, while turnover is more common within the entities involved in manufacturing goods or providing such with high profit, the profit derivation from capital is more appropriate in financial institutions. Even if this level of harmonisation is reached, the conjugation of two functions, such as allocation of the profit within the parts of an entity and between jurisdictions in accordance with the arm's length principle, is high to reach. That is the logic of why the indirect method for profit attribution was abandoned by the OECD in 2010.[210]

In conclusion to this Chapter, the concept of a PE is strictly tied to a physical element, while the attribution of profit may involve the assessment transaction with the non-physical object. In addition, multiple exceptions to a PE under Article 5 of the OECD MTC and their combination allow MNEs to avoid the threshold of the PE even if they involve activities with physical elements. As a result, MNEs are able to avoid taxation in the source State. In addition to this, the effective application of the concept of PE is conditional upon the communication between tax authorities. Therefore, it is relevant to examine the proposed changes in international taxation for both the replacements of the concept of PE and its adjustment to the requirements of the digital economy.

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[207] Hentschel, *supra note*, 17: 110.
[208] Baker, *supra note*, 164: 30.
[209] Hentschel, *supra note*, 17: 110.
[210] OECD, *supra note*, 46: C(7)-17.

CHAPTER 3. PROPOSALS FOR NEW METHODS OF TAXATION OF CROSS-BORDER COMMERCIAL DIGITAL ACTIVITY

Having revised the concept of PE and the last changes to expand the threshold, Chapter 3 analyses new methods proposed and implemented to tax the digital economy. Part 1 is devoted to the overview of Pilar 1, particularly Amount A and Amount B. Part 2 is dedicated to the Digital Service Tax (hereinafter – DST Proposal) and Significant Digital Presence (hereinafter – SDP Proposal) Proposals of the EU and the reasons for its failure. Part 3 analyses the unilateral methods of taxation implemented by States, and the last part considers the implementation of withholding tax.

3.1. Pillar One Proposal

Pillar One proposal by the OECD aims to achieve a consensus-based solution to the reallocation of profit between source and residence States and tackle the problem of non-physical commercial activity. It comprises two components, namely Amoun A and Amount B. While the former employs the residual split of MNEs' profit operating in source States by means of sourcing rules in case the activity of such MNEs exceeds the established local threshold, the latter establishes the streamlined pricing approach of eligible marketing and distribution activities to simplify the reporting obligations of taxpayers. The result of work on Amoun A resulted in approval by the Framework's Task Force on the Digital Economy of the release of the Multilateral Convention to Implement Amount A of Pillar One in 2023. It represents the agreement between over 135 jurisdictions. On the moment of April 2024, it is still not open to signature.[211] On the other hand, the OECD published the Amount B report in February 2024 with the sole discretion of each State to implement it.

3.1.1. Assessment of the Multilateral Convention to Implement Amount A of Pillar One

As a preliminary point, according to the OECD, the operation of the Multilateral Convention to Implement Amount A of Pillar One (hereinafter – MLC) would cover 54.1% of the residual profit of digital businesses of various kinds, as well as other sectors such as pharmaceuticals and consumer goods, real estate.[212] This means that the aim of MLC is not only

[211] "International Tax Reform: Multilateral Convention to Implement Amount A of Pillar One - OECD," accessed 5 May 2024, https://www.oecd.org/tax/beps/multilateral-convention-to-implement-amount-a-of-pillar-one.htm.
[212] Pierce O'Reilly et al., "Update to the Economic Impact Assessment of Pillar One: OECD/G20 Base Erosion and Profit Shifting Project," OECD Taxation Working Papers, vol. 66, OECD Taxation Working Papers (Paris, 2023), 23.

to tackle the problems of taxation of the new models of revenue generation but also to establish a new method for the allocation of profit between source and resident States without the need to modify existing bilateral treaties. Since the MLC overrides Articles 5, 7, and 9 of DTAs, the relevance of this thesis is explained by the abolition of the PE.[213] It should also be mentioned that the scope of MLC was expanded to reach a consensus with the United States of America (hereinafter – US).[214] Otherwise, the taxed revenue of the US-based MNEs would be disproportionate.

As discussed previously, the concept of PE showed its inefficiency in the taxation of the digital economy.[215] Considering the solution proposed unilaterally and in cooperation, the International Community has only two optimal models, which have the potential to be successful for the future development of international taxation. The first option is the ratification of the MLC by a significant number of States to harmonise international taxation. This will abolish the rules for transfer pricing covered by the DTA. However, since 45% of the 69 MNEs covered by the MLC are established in the US, the probability of global support is low.[216] In addition, the ratification of the MLC does not prevent non-contracting States from abolishing or establishing digital service taxes (hereinafter – DST) as it is left to the freedom of States. On the other hand, the second option is the imposition of the DSTs, which has its immediate drawback of lack of coordination of the regulation, decreasing certainty for taxpayers.

The MLC will enter into force by the decision of the Contracting States after 30 States have joined it and 600 points have been collected pursuant to Annex I of the MLC.[217] Analysis of the points allocated also shows that the success depends largely on the US, as without its support, the MLC will not enter into force.

The MLC is applicable to MNEs with more than EUR 20 million in revenue and profitability of at least 10 per cent in two of the past four years and on average over the last five years.[218] However, even if the MNE[219] does not meet the thresholds of Article 3 of the MLC as a

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[213] Avi-Yonah, *supra note*, 24: 1.
[214] “Re-Born in the USA: Will the OECD Tax Plans Now Be Made in America? - Macfarlanes,” accessed 5 May 2024, https://www.macfarlanes.com/what-we-think/in-depth/2021/re-born-in-the-usa-will-the-oecd-tax-plans-now-be-made-in-america.
[215] Selçuk İpek and Adnan Gercek, *Current Perspectives in Public Finance* (Berlin: CPI books GmbH, Leck, 2019), 15.
[216] Daniel Bunn, “The OECD’s Pillar One Project and the Future of Digital Services Taxes”, Testimony before the U.S. House Ways & Means, Subcommittee on Tax (Tax Foundation, 2024), 7, https://gop-waysandmeans.house.gov/wp-content/uploads/2024/03/Bunn-Testimony.pdf.
[217] “The Multilateral Convention to Implement Amount A of Pillar One”, *OECD*, 2023 Annex I.
[218] “Explanatory Statement to the Multilateral Convention to Implement Amount A of Pillar One” (OECD, 2023), 41, https://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf.
[219] The MLC employs the wording “group.” For the purpose of consistency of this work such concept will be referred to as “MNE.”

whole, it might be applicable to the disclosed segments of the MNE, such as regulated financial institutions and qualifying extractives, if such segments satisfy the requirements of Article 3 of the MLC on a standalone basis.[220] However, it excludes application MNEs which generate at least 90% of profit from one jurisdiction and not more than 5% from other jurisdictions.

The MLC is not conditional upon any physical connection in a source State, which increases effectiveness compared to the PE. However, it establishes a revenue criterion, which might motivate MNEs to increase expenses or losses artificially.[221] On the other hand, this criterion relieves MNEs of having no revenue during a prolonged period of administrative burden.

The MLC also establishes the autonomous concept of the source State. It is a determination tied to the economic activity of the MNE in a particular jurisdiction. Article 7 of the MLC determines that such jurisdictions shall be treated as a source State:

- The jurisdiction of the delivery of finished goods in case of the contract for the sale of finished goods;
- The jurisdiction of the use of service in case of provision of digital content;
- The jurisdiction of delivery of the finished goods containing the components to the final customers in case of sale to a business customer of components;
- The jurisdiction of performance of service in case of provision of location-specific service;
- The jurisdiction of the location of the viewer of advertisement in case of provision of advertising services;
- The jurisdiction of the location of the user in case of licensing, sale or other alienation of user data;
- The jurisdiction of the location of immovable property in case of alienation of immovable property;
- In case of diversity of jurisdiction, the jurisdiction that made or funded grants, subsidies, or refundable credit, or equally each jurisdiction, provided funds if it is not possible to determine each jurisdiction's share.[222]

[220] Graeme S. Cooper, "Building on the Rubble of Pillar One," *Bulletin for International Taxation* 75, no. 11 (2021): 538, https://doi.org/10.59403/q2700q.
[221] Petr Janský and Miroslav Palanský, "Estimating the Scale of Profit Shifting and Tax Revenue Losses Related to Foreign Direct Investment," *International Tax and Public Finance* 26, no. 5 (2019): 1051, https://doi.org/10.1007/s10797-019-09547-8.
[222] OECD, *supra note*, 217: Article 7.

The methods for determination of source States leave MNEs fewer options with regard to attribution of profit to a particular jurisdiction, meaning that the rules for transfer pricing will become irrelevant in the case of economic activity in the jurisdiction that adopted the MLC.[223]

It is also essential to notice that the methods described in Article 7 of the MLC are not only beneficial to third States, but they also equalise the relation with resident States, as they provide a division of revenue obtained from a transaction in case it is not possible to define the jurisdiction, which mainly contributed to the generation of revenue.[224] In such a way, the revenue derived from the provision of online intermediation services that facilitate the sale or purchase of tangible goods and digital content shall be considered as arising 50% from the jurisdiction in which the purchaser of such service is located and 50% from the jurisdiction where the seller is located. The same approach applies to the provision of services that facilitate the sale or purchase of location-specific services and the provision of cargo transport services with attribution to profit equally to the jurisdictions of uploading and unloading cargo.[225]

The impact of Article 7 of the MLC is of particular importance since it replaces the application of the concept of PE,[226] eliminating the possibility of avoiding the existence of PE, as was demonstrated in Chapters 1 and 2. In particular, the Committee of Public Accounts in the UK in 2013 criticised the provision of advertisement services by Google Ireland, which, under the appliable rules, attributed revenue to Ireland since Google Ireland was the owner of the intellectual property rights and the threshold for the existence for PE was not reached.[227] Considering Article 7 of the MLC, such a situation would not even be in question since the users of services are located in the territory of the UK.

However, even if a State is considered to be a source State within the meaning of Article 7 of the MLC, it obtains the right to impose taxes only if the revenue of the covered MNEs arising out from that jurisdiction is equal to or more than EUR 1 million or EUR 250 000 in case a GDP of that State is less than EUR 40 billion.

To determine the portion of the Amount A Profit of a covered MNE, each source State has first to determine the Amount A Profit of an MNE, which is defined by Article 2(d) of the MLC:[228]

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[223] Stefan Greil and Thomas Eisgruber, "Taxing the Digital Economy: A Case Study on the Unified Approach," *Intertax* 49, no. 1 (2021): 54, https://doi.org/10.54648/taxi2021006.
[224] Richard Collier, Michael P Devereux, and John Vella, "Comparing Proposals to Tax Some Profit in the Market Country," *World Tax Journal* 13, no. 3 (2021): 407, https://doi.org/10.59403/vj9y4k, https://doi.org/10.59403/vj9y4k.
[225] OECD, *supra note*, 218: 79.
[226] Murray Clayson and Brin Rajathurai, "Unify and Conquer: The OECD's "Unified Approach" to Pillar One", *Tax Journal*, 2019, 11, https://doi.org/10.2307/2017196.
[227] "Tax Avoidance – Google" (London: House of Commons: Committee of Public Accounts, 2013), 8, https://publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf.
[228] OECD, *supra note*, 217: Article 2(d).

$$Amount\ A\ Profit = (10\%\ x\ Adjusted\ Revenue - Adjusted\ Profit\ Before\ Tax)\ x\ 25\%$$

Formula No. 1

After a source State shall define the portion of the Amount A Profit on which it will retain the right to impose taxes under Article 5(1) of the MLC:[229]

$$Portion\ of\ Amount\ A = \frac{Amount\ A\ Profit\ x\ Adjusted\ Revenue\ derived\ from\ the\ source\ State}{Adjusted\ Revenue\ of\ the\ MNE}$$

Formula No. 2

By means of the last formula, the MLC ensures the equality of all source States in which the covered MNE operates and reaches the nexus. Moreover, Article 6(2) of the MLC additionally protects the portion of the Amount I Profit of the covered MNE from double counting by a source State by introducing the Marketing and Distribution Safe Harbour Adjustment.[230] This situation may occur when a source State includes the relevant marketing and distribution profits in calculations for the purpose of both Amount A Profit under the MLC and existing profit allocation rules based on DTA.[231] It applies when the ratio of Jurisdictional Depreciation and Payroll to the Adjusted Revenues sources to the Jurisdiction under Article 6 is less than 75% of the ratio of the sum of the accounting depreciation and accounting payroll Under Annex B Section 5 of the MLC. The result of the application of the Marketing and Distribution Sage Harbour Adjustment is that such profits are capped from inclusion into Amount A Profit.[232]

As demonstrated by Articles 2-8 of the MLC, the concept of PE and the question of attribution of profit to PE are replaced. It is based on the mechanisms of the residual profit allocation, which has two main peculiarities.[233] Firstly, as was already stated, the arm's length principle is no longer applicable, but attribution is to be performed on global profitability and the origin of such profit.[234] Secondly, it allows States where the profit was generated to obtain part of the revenue that it would not obtain without the functioning of the Residual Profit Allocation Mechanism. Therefore, comparing the methods that give the right to source States to impose a tax

[229] OECD, *supra note*, 217: Article 5(1).
[230] OECD, *supra note*, 218: 245.
[231] Vikram Chand and Camille Vilaseca, "Pillar I: The Marketing and Distribution Safe Harbour (MDSH) as Applicable to Licensed Manufacturers and Centralized Business Models: Does It Fulfil Its Policy Objective?" *Intertax* 51, no. 8 & 9 (2023), 5, https://serval.unil.ch/resource/serval:BIB_EFCAE56EF051.P001/REF.pdf.
[232] *Ibid.*, 7.
[233] Sebastian Beer, Ruud De Mooij, Shafik Hebous, Keen Michael, et al., "Exploring Residual Profit Allocation" (International Monetary Fund, 2020), 22, https://www.imf.org/en/Publications/WP/Issues/2020/02/28/Exploring-Residual-Profit-Allocation-48998.
[234] *Ibid.*, 5.

on MNEs that operate in that State without physical presence, the MLC seems to be more efficient. However, considering Pillar One Amount A as a solution for digital economy taxation, the conclusion is not that straightforward.

The major criticism of the MLC lies within the threshold for application. As was mentioned, only 69 MNEs will be covered by the MLC, from which only 7 MNEs are involved in selling automated digital services,[235] and only 30 automated digital services and CFB MNEs[236] meet the revenue and profitability thresholds under Article 3 of the MLC. The result of the application of such a high threshold is that such MNEs as Amazon, having 8.2% and 7.8% profitability in 2021 and 2023, respectively,[237] and Dell, with revenue over USD 100 billion and profitability of 2.4% in 2022, will not be covered. One could invoke the reduction of the threshold pursuant to Article 3(9) of the MLC, however, it relates only to Adjusted Revenues, which will be EUR 10 billion seven years after the entry into force of the MLC,[238] which will still leave MNEs with the possibility of artificially increasing expenses or losses. Initially, the profitability threshold should have been determined separately for different business lines and regions.[239] This segmentation would not only ensure the flexibility of the threshold but also underline the proportionality between States at different stages of economic development regarding the treatment of losses sustained by MNEs.[240] However, this approach did not receive enough attention, and it should have been applied in "exceptional circumstances."[241]

Another problem with the applicability of the MLC is connected with the existing accounting methods. Its application is based on the Acceptable Financial Accounting Standards, which includes International Financial Reporting Standards and generally accepted accounting principles for a limited number of jurisdictions.[242] IFRS 15 establishes the five-step test for identification of revenue from contracts with customers, which includes identification of the agreement, determination of commitments, establishment of the price of the agreement, allocation of the price to the commitments of the performance and identification of the revenue generated by

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[235] Barake, *supra note*, 23: 7.

[236] OECD, "Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS" (Paris: OECD, 2020), 19.

[237] "Amazon's Profit Margin Nears Record High after CEO Jassy's Cost Cuts", 2023, https://www.cnbc.com/2023/10/26/amazons-profit-margin-nears-record-high-after-ceo-jassys-cost-cuts.html.

[238] OECD, *supra note*, 217: Articles 3(9) and 43.

[239] OECD, "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy." OECD/G20 Inclusive Framework on BEPS, (Paris: OECD, 2020), 14, http://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf.

[240] *Ibid*., 22.

[241] *Ibid*., 2.

[242] OECD, "Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy" OECD/G20 Base Erosion and Profit Shifting Project' (Paris: OECD, 2022), 23.

the performance.[243] The MNEs bear the burden of identifying the generated revenue. The margin of discretion exists with regard to the timing of the determination of transactional price in case the price depends on future events.[244] That is probably the reason for the exclusion of derivatives and regulated financial institutions from the scope of the MLC.[245] In addition, IFRS 15 requires separate identification of obligations in case of complex agreements,[246] while the combination or disjunction may generate different revenue.[247] This discretionary decision-making power inherent in the accounting standards may allow the reporting of a lower amount of revenues and fall out of the threshold for applicability of the MLC.[248]

Despite criticism of Amount A Pillar One, the main question is of the result of the operation of the MLC. As demonstrated by the impact assessment produced by the OECD, the total amount of residual profit allocated would reach USD 113.5 billion in 2020.[249] This is consistent with assessments conducted by Barake and Pouhaër, according to which the revenue caught by the MLC would reach EUR 94.4 billion.[250] After calculation of the CIT rates of the States affected, elimination of double taxation and gross losses, MLC increases global CIT revenues by an average of USD 9.8 – 22.6 billion in the period of 2017-201 and USD 17.4 – 31.7 billion in 2021 by means of reallocation of the taxation right from the jurisdiction with lower rates to higher.[251]

However, the proportion of allocation of State-by-State revenue is more evident when considering the final goal. A. Barake and Pouhaër concluded that the US, China and Germany would obtain 74% of total revenue. Generally, the developed States will be able to collect over 77% of the net revenue, with G7 itself obtaining 71% of the total gains, considering that China is a developing State, according to the UN classification, itself collects 23% of the revenue reallocated by the MLC.[252] The only progressive result that the operation of the MLC will reach

[243] "International Financial Reporting Standard 15 Revenue from Contracts with Customers (IFRS 15)" (IFRS Foundation, 2016), A761–67.
[244] David Baur, Lüpold Patrick, and Christian Witte, "Ermessensspielräume Im Umgang Mit IFRS 15," *Zeitschrift Für Internationale Rechnungslegung* 9, no. 12 (2014): 469.
[245] OECD, *supra note*, 217: Article 2(j)(i).
[246] Eva Eberhartinger and Georg Winkler, "Pillar Two and the Accounting Standards," *Intertax* 51, no. 2 (2023): 146, https://doi.org/10.54648/TAXI2023010.
[247] Megumi Makino, Jelena Voilo, and Rachel Knubley, "Post-Implementation Review of IFRS 15 | Identifying Performance Obligations in a Contract" (IFRS Accounting, 2024), 5, https://www.ifrs.org/content/dam/ifrs/meetings/2024/february/iasb/ap6a-ifrs-15-pir-identifying-performance-obligations-in-a-contract.pdf.
[248] Eberhartinger and Winkler, supra note, 246: 136. The authors analyse the accounting standards problems in the context of Pillar Two. However, the same standards are applicable to Amount A Pillar One potentially giving rise to the same problems under the current object of analysis.
[249] O'Reilly, *supra note*, 213: 23.
[250] Barake, *supra note*, 23: 12.
[251] O'Reilly, *supra note*, 213: 39.
[252] Barake, *supra note*, 23: 13.

is a significant loss of taxation rights by tax heavens of 200%.[253] This is explained by the low tax rates established and the low factual operation of shell companies in those jurisdictions. Thus, it shall be concluded that although the primary aim was to find a new way to tax the digital economy, which was caused partly by the weaknesses of the concept of a PE, the factual result that the implementation of MLC is a reallocation of profit from jurisdictions with lower tax rates.

3.1.2. Assessment of Amoun B Pillar One

Preliminary, there is a need to address the question of why the MLC is coupled with Amount B, meaning that they are not able to address the problems of taxation of the digital economy on a self-standing basis. And the major peculiarity of the application of the MLC, as was already described, is its scope, targeting major market participants. This implies that routine commercial activity would be left untouched by the MLC, which could create motivation to create complex corporate structures by MNEs to avoid attribution of residual profit to the group, hence, making it impossible to apply the MLC.

Amoun B Pillar One aims to simplify the transfer pricing rules for tax administrations, reduce taxpayer compliance costs, enhance tax certainty, and eliminate controversies between tax administrations and taxpayers.[254] The relevance of examining Amount B Pillar One is explained by the fact that it changes transfer pricing rules, which apply to the question of attribution of PE under Article 7 of the OECD MTC, establishing that the profit attributed to the PE shall correspond to the arm's length principle.[255] Amount B Pillar One offers a "simplified and streamlined approach" to baseline marketing and distribution activities. The scope covers sell-purchase marketing and distribution transactions where the distributor purchases goods from one or more associated enterprises and sales agencies, as well as commissionaire transactions where the sales agent or commissionaire contributes to one or more associated enterprises' wholesale distribution of goods to unrelated parties.[256] The categorisation of transactions is to be performed on the basis of the principle of substance over form, meaning that there will be a need to assess the assets used, risks assumed by the parties, and functions to be performed.[257] Pillar One Amount B excludes two-sided transfer pricing methods from its scope and establishes that for the transaction to fall within

[253] Barake, *supra note*, 23: 13.
[254] OECD, *supra note*, 237: 160.
[255] OECD, *supra note*, 36: Article 7.
[256] OECD, "Pillar One - Amount B: Inclusive Framework on BEPS." OECD/G20 Base Erosion and Profit Shifting Project." (Paris: OECD, 2024), 17, https://doi.org/10.1787/21ea168b-en.
[257] Vita Apriliasari, "OECD/G20 Two-Pillar Solution: Does It Promote Inter-Nation Equity?" *Indonesian Tax Review* 6, no. 2 (2022): 347, https://doi.org/10.31092/jpi.v6i2.1826.

the scope of a simplified and streamlined approach, it shall have the criteria that can be reliably priced using a one-sided method approach.[258]

In addition, the scope of the simplified and streamlined approach is further limited by quantitative criterion; in particular, it will be applicable if the entity incurs operating expenses between 3% and the upper bound between 20% and 30% of the annual net revenues. The upper bond aims to exclude transactions with high operational expenses, which may indicate the performance of additional functions and thus may make the application of a particular pricing method ineffective.[259] Moreover, as expenses and revenue may vary, the bound shall be defined using a three-year weighted average ratio to stabilise the application of the criterion.[260]

The differentiation between a distribution and non-distribution activities shall be performed according to objective measurement. For this, non-distribution activities shall include manufacturing, research, development, procurement, and financing. However, in case the transaction unites distribution and non-distribution activities in a manner that does not allow the definition of the share of distribution activities, such as a transaction including both provision of goods and financing to the consumer, it will be eligible to be priced under the simplified and streamlined approach. This is due to the impossibility of defining the operation expenses and revenue from different transaction elements.[261]

Once it is defined that the transaction falls under the scope of the simplified and streamlined approach, the next step is to determine whether the transaction is in accordance with the arm's length principle. According to the OECD, the transactional net margin method is the most appropriate because of the economically relevant characteristics of in-scope transactions and the information available on comparable transactions. The OECD also recognises instances when the application of the comparable uncontrolled price method will be more suitable depending on the availability of the internal comparable.[262]

The heart of the Amount B Pillar One goes to the pricing matrix, which allows source States to receive returns on the marketing and distribution activities. The pricing matrix is based on a set of criteria: net operating asset intensity, operating expense intensity and industry grouping.[263] The return rate is defined starting with the identification of the applicable industry group, which the OECD defines as the segmentation of the distribution activities between different

[258] OECD, "Public Consultation Document: Pillar One – Amount B." OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. (Paris: OECD, 2023), 13.
[259] *Ibid*., 20.
[260] OECD, *op. cit*., 17.
[261] OECD, *op. cit*., 23.
[262] OECD, *supra note*, 256: 17.
[263] Wilde, *supra note*, 203: 4.

industries.[264] If the secondary industry group obtained more than 20% of sales, a weighted average return should be calculated, applying different return rates. Then, the tax administrator and the taxpayer shall determine the net operating asset intensity and operating expense intensity based on fixed assets, working capital, net operating assets, sales, and operating expenses. This will allow to identify the appropriate return rate varying from 1.5% to 5.5%.

However, there are some general critics of Amount B Pillar One about its practical effect and the narrow scope since the analysis indicates that it does not cover a broad group of intra-group transactions and the inclusion of the agent and commissionaires to the definition of the distributor might not ensure legal certainty since their status depends on the functions performed. Thus, this leads to the application of Amount B Pillar One on accounting data outside of the MNEs' financial statements.[265]

Since Amount B Pillar One aims to simplify the rules for determining arm's length transactions for marking and distribution activities, the expected result is the improvement of the administrative system of taxation and reduction of the administrative burden on taxpayers.[266] However, the administrative design of Amount B Pillar One is quite complex since it entails the conjunction of public unitality rate-of-return regulations and cap-and-collar mechanisms policies, involving fixed rates of return for baseline distribution and marketing activities and two caps and collars, a margin of 0.5% around the fixed rate of return.[267] Some authors suggest that Amount B Pillar One shall function as a reference pricing policy, giving taxpayers the right to follow the approach offered. To achieve this, both the State and taxpayer shall have the right to apply the simplified and streamlined approach. In addition, the pricing matrix shall only serve as an example for States to which the performance of their benchmarking is financially burdensome.[268] In addition, Amoun B Pillar One does not, itself, solve the underlying problem of taxation in the era of digitalisation, which is the avoidance of the threshold of the PE. The potential result of the simplified and streamlined approach, in the context of a PE, will be focused only on the rules for attribution of profit.[269] Therefore, Amount B Pillar One is insufficient to tackle the consequences of the digitalisation of international commerce in taxation.

[264] OECD, *supra note*, 256: 13.
[265] Francesco Saverio Scandone, "Let It (Amount) B", *International Transfer Pricing Journal* 30, no. 2 (2023): 5, https://doi.org/10.59403/sb1en2.
[266] Aitor Navarro, "The Allocation of Taxing Rights under Pillar One of the OECD Proposal", in *The Oxford Handbook of International Tax Law*, ed. Florian Haase and Georg Kofler (Oxford University Press, 2023), 957, https://doi.org/10.1093/oxfordhb/9780192897688.013.56.
[267] Lorraine Eden, "Pillar 1 Amount B: Simplifying the Arm's-Length Principle for Baseline Distribution Activities", *Tax Notes International* 112, no. 2 (2023): 187.
[268] Eden, *supra note*, 267: 270.
[269] OECD, *supra note*, 259: 1.

3.2. Proposals by the European Union

In the EU, the discussion of the impact of digitalisation on taxation of the digital economy started in 2002, with the question of the impact of electronic commerce on value-added taxes.[270] A possible solution was then proposed, based on the principle of destination, treating import operations as creating domestic value.[271] However, the discussions did not result in any substantive proposal. On the other hand, the development of digitalisation and establishment of the Action Plan on Base Erosion and Profit Shifting in 2013 by the OECD showed evidence of the need to adopt the taxation system to meet the requirements of digitalisation.

This resulted in two proposals, namely, a Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services and a Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence in 2018.

3.2.1. Proposal for Digital Services Tax Directive

The DST Proposal offered the establishment of a 3% DST on revenues obtained from placing on a digital interface or advertising targeted at users of that interface, making available to users of a multi-sided digital interface which to find other users, interact with them and the transmission of data collected about users and generated from users' activities on digital interfaces. The qualifying entities shall have worldwide revenues of EUR 750 million and the total taxable revenues obtained within the EU of EUR 50 million.[272] The exceptions to the tax base are the provision of advertisement services where the platform owner is not responsible for placing advertisements, digital interfaces with the sole purpose of supplying digital content, communication, or payment services to users, and services provided through digital interfaces consisting of video, audio, or text, as it is not possible to define where the value is created clearly.[273] The general rules for the place where value is created shall be deemed the State where the user of services is located.[274] However, on 12 March 2019, the Economic and Financial Affairs

[270] Charles E. McLure Jr, "EU and US Sales Taxes in the Digital Age: A Comparative Analysis," *IBFD* 56, no. 4 (2002): 135.
[271] *Ibid*., 135.
[272] European Commission, "Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services" (Brussels: European Commission, 2018), 10.
[273] Gary Clyde Hufbauer and Zhiyao Lu, "The European Union's Proposed Digital Services Tax: A De Facto Tariff", *Peterson Institute for International Economics.* 18, no. 15 (2018): 7, https://www.piie.com/sites/default/files/documents/pb18-15.pdf.
[274] European Commission, op.cit, 10.

Council could not reach an agreement on the sales tax with a scope limited to digital advertising services.[275] After this, the proposal did not find much support "for political reasons as a matter of principle, irrespective of the technical adaptations made to the text."[276]

3.2.2. Proposal for Significant Digital Presence Directive

However, despite the DST Proposal, as a short-term solution, did not succeed, the original intention to adopt the system of taxation was under the SDP Proposal, which offered the expansion of the threshold of PE. It shall be considered to exist in the Member State where the "business carried on through it consists wholly or partly of the supply of digital services through a digital interface" and satisfies at least one criterion:

- The number of users of digital services in that Member State is more than 100 thousand;
- The number of business contracts for the supply of digital service in that MS exceeds 100 thousand; and
- The total revenue obtained from that Member State resulting from the supply of digital services is more than EUR 7 million.

The attribution of profit is based on the classic rules for attribution of profit to the PE with the arm's length principle, considering the functions performed, assets used and risks assumed through the digital interface. However, since the expansion of the scope of a PE covered economic activity through physical presence, special attention should have been given to the use of intangible property, which could be attributed to the PE on the analysis of the functions performed, namely DEMPE.[277] However, after the adoption of changes by the European Parliament enhancing the exchange of information between the taxpayers and relevant authorities and introducing the obligation of the European Commission to issue guidance for the assessment of digital presence,[278] the negotiations on the SDP proposal stopped after 30 July 2018, when the EU admitted that the unilateral change of the nexus of PE would increase the complexity of the international tax system

[275] "Proposal for a Directive on the Common System of a Digital Services Tax on Revenue Resulting from the Provision of Certain Digital Services - Q1 2018," Legislative Train (European Parliament, 2024), 2.
[276] Presidency of the Council of the European Union (Brussels: Council of the European Union, 2018), 2, https://data.consilium.europa.eu/doc/document/ST-14885-2018-INIT/EN/pdf.
[277] Julian Bach, "International Taxation of Digital Economies: Impact of Digital Business Models on Existing Conventional International Taxation Approaches," Working Paper (Vienna: Stanford-Vienna TTLF, 2020), 31, https://law.stanford.edu/wp-content/uploads/2020/08/bach_wp60.pdf.
[278] "European Parliament Legislative Resolution of 13 December 2018 on the Proposal for a Council Directive Laying down Rules Relating to the Corporate Taxation of a Significant Digital Presence," Pub. L. No. P8_TA(2018)0524 (2018), 13, https://www.europarl.europa.eu/RegData/seance_pleniere/textes_adoptes/definitif/2018/12-13/0524/P8_TA(2018)0524_EN.pdf.

and uncertainty for investors.[279] Thus, the EU shifted its focus from introducing unilateral initiatives to finding a solution at the universal level under the auspice of the OECD.

The DST and SDP Proposals were the solutions to the emergency to prevent the adoption of divergent unilateral actions at the national level by Member States.[280] By abandoning both temporary and permanent solutions for taxation of the digital economy, the EU opened the door for introducing DST by MS[281] until a joint statement from the UK, Australia, France, Italy, Spain and the US on a transitional approach to existing unilateral measures before Pillar One is in effect, agreeing that the excess revenue obtained through national DST will be credited against the corporate income tax associated with Amount A Pillar One.[282] However, the interim period ended on 31 December 2023, and the MLC is still not open for signature, giving States the freedom to establish domestic approaches to taxing the digital economy.

3.3. National Measures Implemented

As of 21 February 2024, the approach for introducing DSTs in Europe differs significantly. Spain, France, the UK, and Austria successfully implemented the DST but repealed it until the implementation of Amount A Pillar One. Portugal, Poland, and Hungary operate DSTs without stay. Slovakia expanded the concept of PE.[283] In addition, States such as Latvia, the Check Republic, the Netherlands, Belgium, Norway, and Slovenia are considering implementing DSTs.[284]

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[279] Council of the European Union, *supra note*, 16: 9.
[280] European Commission, *supra note*, 273: 5.
[281] Francesca Gastaldi and Alberto Zanardi, "The Digital Services Tax: EU Harmonisation and Unilateral Measures" (XXI Banca d'Italia Workshop on Public Finance - Frontiers of taxation and taxation across frontiers, Rome, 2019), 4–5.
[282] "Joint Statement from the United Kingdom, Austria, France, Italy, Spain and the United States Regarding a Compromise on a Transitional Approach to Existing Unilateral Measures during the Interim Period before Pillar 1 Is in Effect" (HM Treasury, 2021), 1, https://assets.publishing.service.gov.uk/media/617168f8e90e07198334647c/Joint_statement.pdf.
[283] Stefanie Geringer, "National Digital Taxes – Lessons from Europe," *South African Journal of Accounting Research* 35, no. 1 (2021): 10, https://doi.org/10.1080/10291954.2020.1727083.
[284] Bunn, *supra note*, 217: 10.

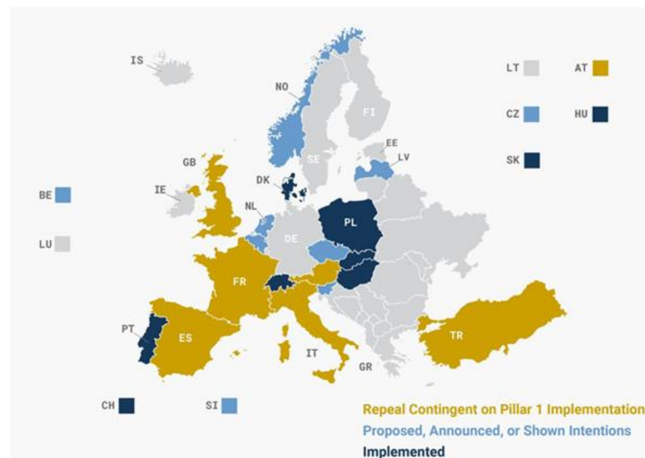

Table No. 1. States in Europe which implemented national measures[285]

The structure of the digital services tax generally comprises the selective revenue derived from levied on the user's interactions, such as online advertisement, sale of user-collected data, and user interactions. The losses incurred in the given financial year are not considered for identification of the applicability of DST in contrast to the CIT, the tax base of which is calculated as revenue minus expenditures.[286] The DST is a tax on intermediate services in the supply chain. Some authors categorise taxes on digital services as pure DSTs, including intermediary digital services in the chain, digital advertising services and unilateral adjustment to the PE.[287]

However, expanding the scope of the PE is not an imposition of a tax on digital services. Secondly, the division of the taxes covering the same nature of profit generation with the administration mechanism based on the tax base is not enough to conclude the existence of a separate tax. Moreover, the question of types of taxes will be unanswered if the scope of one tax will cover two tax bases and if the operations with advertisement go beyond the existing tax.

The average tax rate imposed by DST varies between 1.5% and 5%, excluding Turkey and Hungary, which established a 7.5% tax rate.[288] The nexus comprises the global turnover at the MNE's level and the threshold of revenue obtained in a particular jurisdiction. A global revenue threshold of EUR 750 million is established in Italy, Spain, Austria, and France, while the market threshold varies between EUR 25 million in Austria, France, and EUR 3 million in Spain.[289]

[285] Bunn, *supra note*, 217: 3.
[286] Sean Lowry, "Digital Services Taxes (DSTs): Policy and Economic Analysis" (Congressional Research Service, 2019), 2, https://sgp.fas.org/crs/misc/R45532.pdf.
[287] Geringer, *supra note*, 283: 2.
[288] Ana Cebreiro-Gomez et al., "Digital Services Tax: Country Practice and Technical Challenges" (Washington: World Bank, 2021), 19, https://doi.org/10.1596/36840.
[289] Harpaz, *supra note*, 51: 25.

State	Global Revenue Threshold	Jurisdictional threshold	Rate
Austria	EUR 750	EUR 25	5%
Belgium	EUR 750	EUR 25	3%
Denmark		DKK 15	2%
Italy	EUR 750	EUR 5.5	3%
France	EUR 750	EUR 25	3%
Spain	EUR 750	EUR 3	3%
UK	GBD 500	GBD 25	2%
Switzerland		CHF 2.5	4%
Hungary		HUF 100	7.5%
Turkey	EUR 750 million	TRY 20 million	7.5%
Poland	EUR 750	EUR 3	1.5%
Czeck Republic	EUR 750	CZK 100	
Canada	CAD 1 billion	CAD 40	3%

Table 2. States in Europe which established DST

For the purpose of this thesis, the unilateral models of taxation of the digital economy in Italy and Slovakia will be analysed as the model example of functioning of DST and rare example of expansion of the scope of PE, respectively.

3.3.1. The Model of Digital Service Tax Introduced by the Italian Republic

Italy implemented DST on 27 December 2019, the tax base of which includes digital advertisement services, digital interface services, and data transmission. It is applicable if the user of a taxable service is located in the State's territory.

The applicability is conditional upon the thresholds at both the universal and national levels. The global revenue threshold is established at EUR 750 million, and the revenue generated in Italy is EUR 5.5 million.[290] Interestingly, the scope of the DST in Italy is significantly expanded by not establishing the limitation for the profit to derive from the covered transactions for the global turnover threshold. The services covered reflect the idea of the DST Proposal by the EU.[291] However, the scope of exclusion from the tax base is broader and includes:

- the provision of goods or services directly between users in the context of a digital intermediation service;
- the supply of goods or services ordered online via the website of the supplier of such goods or services, where the supplier does not act as an intermediary;
- making available a digital interface where the sole purpose is to supply digital content to users to supply communication services to users, or supply payment services to users;
- financial services-related activities; and

[290] "Bilancio di Previsione Dello Stato per l'anno Finanziario 2020 e Bilancio Pluriennale per Il Triennio 2020-2022," 160 19G00165 § (2019), para. 47, https://www.gazzettaufficiale.it/eli/gu/2019/12/30/304/so/45/sg/pdf.
[291] *Ibid.*, Article 37.

- activities relating to the exchange of electricity, gas, environmental certificates and fuel.[292]

The revenue from the generated transactions is to be regarded as generated in the territory of Italy when a user of such services is located in Italy. In the case of targeted advertisement, the tax employed the physical criterion of connection, meaning that if the advertisement is demonstrated on devices providing access to a digital interface located in Italy, then the revenue generated from such interaction between the user and advertisement shall be deemed to be generated in the territory of Italy. However, the approach is much broader in the case of the use of a multi-sided platform. A user is located in the State if she/he uses devices in the State's territory to access multisided platforms and concludes a transaction on that interface.[293] In addition to this rule, Italian national legislation also establishes safe harbour in the form of a definition of a device's location using the Internet Protocol to minimise the risks of the avoidance of the digital presence in the State. The tax rate of 3% applies to all the covered transactions.

However, this form of digital services tax is open to criticism; it neither cannot be classified as income tax as it applies to gross revenue, and it is not consumption tax because the tax base does not include the last point of sale to the end user.[294] Some authors include DST in the sub-category of the consumption tax based on the turnover criterion for applicability.[295] The problem with categorising of DST is that it is too broad and does not explain the essence of the tax since it represents just a different side of the business activity. Consumption taxes are taxing systems where the taxpayers are taxed based on how much they consume and not on how much they earn.[296] On the other hand, turnover taxes, including DST, have recently become the object of discussion because of the increase in the consumption chains. Since the DST is based on the income obtained rather than revenue from the transaction, the total tax paid will be increased since it will pass through several companies.[297]

Moreover, in responding to the argument that this tax may be classified as intermediate business-to-business transactions, there is no necessary connection between the location of the

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[292] "Bilancio di Previsione Dello Stato per l'anno Finanziario 2020 e Bilancio Pluriennale per Il Triennio 2020-2022," 160 19G00165 § (2019), Article 37, bis (f), https://www.gazzettaufficiale.it/eli/gu/2019/12/30/304/so/45/sg/pdf.
[293] *Ibid.,* Article 40.
[294] "Report on Italy's Digital Services Tax" (Office of the Unined States Trade Representative Executive Office of the President, 2021), 19, https://ustr.gov/sites/default/files/enforcement/301Investigations/Report%20on%20Italy%E2%80%99s%20Digital%20Services%20Tax.pdf.
[295] Young Ran Kim, "Digital Services Tax: A Cross-Border Variation of the Consumption Tax Debate," *Alabama Law Review* 72, no. 1 (2020): 159.
[296] Jane L. Seigendall, "A Framework on Consumption Taxes and Their Impact on International Trade," *Dickinson Journal of International Law* 18, no. 3 (2000): 576, http://elibrary.law.psu.edu/psilr/vol18/iss3/14?utm_source=elibrary.law.psu.edu%2Fpsilr%2Fvol18%2Fiss3%2F14&utm_medium=PDF&utm_campaign=PDFCoverPages.
[297] Donald Rutherford, *Routledge Dictionary of Economics*, 3rd ed. (Routledge, 2012), 151.

user and the physical place of consumption since the last depends on the digitally identified Internet Protocol, which can be transferred artificially.[298]

This approach results in 55% of the tax burden will be borne by consumers.[299] This can be seen even now since Amazon has already announced that it will increase seller fees on its Amazon. fire website by 3% in response to France's introduction of the DST.[300] Google has a webpage that explains that DST charges will be applicable in addition to advertisement charges in the State in which an advertisement appears.[301] This will lead to a reduction in sales and reflect excess profits and costs. Moreover, this logic raises the question of whether DSTs, in their current form, can solve the problems of taxation in the digital economy. According to the study prepared by the Congressional Research Service in April 2024, the result of applying this tax will be a reduction of 6.25% of the profits of relevant MNEs.[302] In addition, the study also points out that since the consumers will bear the loss of profit, local consumption will decrease, lowering domestic revenue.[303]

The introduction of DSTs also increases the possibility of double taxation.[304] This is supported by the idea that some authors express that DSTs are essentially "disguised direct or corporate income tax."[305] The idea behind this is that DSTs have the structure of classical income taxes, posing the risk of being qualified as such under national legislation to cover the profit of MNEs. One may invoke that the taxation is still based on revenue and not on income. The response for this provided is that some "direct taxes, such as withholding tax as a collection mechanism of income tax, are also levied on gross profits.[306]

For example, foreign income taxes can be credited against corporate income taxes in the US; However, as was stated previously, since the object of digital taxes is revenue, the tax authorities have discretion on whether to grant credit.[307] In addition, introducing a DST in this form significantly increases the burden of administrative compliance since the amount of profit

[298] Dario Stevanato, "Critical Review of Italy's Digital Services Tax," *Bulletin for International Taxation* 74, no. 7 (2020): 418.
[299] Julien Pellefigue, "The French Digital Service Tax: An Economic Impact Assessment," *Deloitte*, 2019, 27–36, https://blog.avocats.deloitte.fr/content/uploads/2020/03/dst-impact-assessment-march-2019.pdf.
[300] Harpaz, *supra note*, 51: 83.
[301] "Jurisdiction-Specific Surcharges - Google Ads Help", accessed 6 May 2024, https://support.google.com/google-ads/answer/9750227?hl=en.
[302] Jane G Gravelle, "The OECD/G20 Pillar 1 and Digital Services Taxes: A Comparison" (Congressional Research Service, 2024), 15, https://crsreports.congress.gov/product/pdf/R/R47988.
[303] *Ibid*., 15.
[304] Lowry, *supra note*, 287: 13.
[305] Christoph Jescheck and Roland Ismer, "Taxes on Digital Services and the Substantive Scope of Application of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model?" *Intertax* 46, no. 6 & 7 (2018): 576, https://doi.org/10.54648/taxi2018059.
[306] Kim, *supra note*, 296: 166.
[307] Harpaz, *supra note*, 51: 85.

attributed to a specific jurisdiction would have to be calculated individually, creating an additional burden also for tax authorities and posing a need to reassess each transaction.[308]

Some authors also express the view that the imposition of the DST requires the clarification of the tax base, meaning that introducing the open scope list of covered transactions is insufficient to guarantee predictability. The tax base usually comprises not the categories of the covered transactions but operations performed on different multisided platforms. For example, the UK national law applies to search engines, social media platforms, and online marketplaces, but it is not applicable to the provision of online content, software sales, television, and broadcasting. This excludes MNEs such as PayPal, Netflix, Spotify completely, and Google, Amazon, and Uber in the relevant parts.[309] Moreover, the scope of the DST in the UK still does not provide an answer to whether such platforms as LinkedIn or YouTube fall within the scope since their main activity cannot be referred to one group specifically.[310]

However, the core problem of introducing DSTs is the selectivity of taxpayers. DSTs apply to a very limited number of taxpayers, allowing States to assess the potential amount of revenue to be received and even the precise number of taxpayers concerned. From the discussion of the International Community, the introduction of DSTs looks like States' response to the digitalisation of commercial relations, allowing taxpayers to establish aggressive tax planning schemes.[311] This aspect contradicts the neutrality of taxation.[312] This is of particular evidence since most MNEs covered are established in the US, posing no additional questions to the US's opposition to DSTs.[313] The politicisation of international taxation is inevitable but possible to manage. The sensitivity of this sphere is demonstrated by the state practice when France expressed the possibility of imposing trade sanctions on the US in response to the US's unilateral recognition of the imposition of DSTs as discriminative under the US's national law.[314]

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[308] Lowry, *supra note*, 287: 2.
[309] Wei Cui, "The Digital Services Tax: A Conceptual Defense", *Tax Law Review* 73, no. 1 (2019): 6, https://deliverypdf.ssrn.com/delivery.php.
[310] Kim, *supra note*, 296: 163.
[311] *Ibid.*, 161.
[312] Daniel Bunn, "A Summary of Criticisms of the EU Digital Tax" (Washington, D.C: Tax Foundation, 2018), 7.
[313] "Grassley, Wyden Reaffirm Support for Treasury Engagement with OECD Process on Addressing Tax Challenges Arising from Digitalization | The United States Senate Committee on Finance," 2019, https://www.finance.senate.gov/chairmans-news/grassley-wyden-reaffirm-support-for-treasury-engagement-with-oecd-process-on-addressing-tax-challenges-arising-from-digitalization.
[314] "US Moves Ahead on French Tariffs Over Digital Taxes - Law360 Tax Authority," accessed 6 May 2024, https://www.law360.com/tax-authority/articles/1291187/us-moves-ahead-on-french-tariffs-over-digital-taxes.

3.3.2. The Expansion of the Concept of Permanent Establishment by the Slovak Republic

On 1 January 2008, the Slovak Republic introduced the concept of the digital platform into national legislation, which is defined as a hardware or software platform necessary for the development and administration of applications,[315] expanding the concept of PE to "the performance of activities with a permanent place in Slovak Republic [which] is also considered the repeated intermediation of transport and accommodation services, even via a digital platform."[316] In addition, the obligation of non-resident service providers to register digital PE was introduced. As stated by the Ministry of Finance of Slovakia, if such platforms do not register PE, the services will be subject to a final withholding tax.[317] With this concept of PE, the activities of the MNEs in the digital transport and accommodation sphere are subject to 21% of corporate income tax.[318]

However, a few critical points must be stressed in connection with the operation of the digital permanent establishment introduced. Firstly, the activities attributed to the permanent digital establishment comprise only the transport and accommodation sphere, which itself cannot constitute a permanent solution to the digitalisation of the economy since the number of fields that lose the physical connection for the creation of revenue is constantly increasing.

Secondly, there is the question of whether the changes in national legislation can modify the application of the existing bilateral treaties. Even generally speaking, from the position of international law, national laws are merely facts that express the will of States, and they cannot modify and influence the application of the existing treaties.[319] In addition, unilateral modification of tax treaties through the application of national legislation would threaten the principle *pacta sunt servanda*.[320] Therefore, the Slovak Republic must renegotiate existing bilateral treaties to expand the concept of PE.

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[315] "Act on Income Tax," 595/2003, Article 13b (2003), https://www.mfsr.sk/files/archiv/63/ActNo_595_2003_Coll_on_Income_Taxver_2020.pdf.
[316] *Ibid.*, Article 16(3).
[317] "Digitálne platformy budú na Slovensku musieť platiť dane," Ministerstvo financií Slovenskej republiky, accessed 6 May 2024, https://www.mfsr.sk/sk/media/tlacove-spravy/digitalne-platformy-budu-slovensku-musiet-platit-dane.html.
[318] European Parliament, supra note, 125: 5.
[319] L. Gerzova and O. Popa, "Compatibility of Domestic Anti-Avoidance Measures with TaxTreaties," *European Taxation* 53, no. 9 (2013): 16, https://doi.org/10.59403/1czdddx.
[320] United Nations, "Vienna Convention on the Law of Treaties" 1155 (1969): Article 26.

3.4. Withholding Tax

Third, and another option for taxation of the digital economy, in addition to the DSTs and expansion of the concept of PE, is the withholding taxes. The establishment of this tax was proposed in August 2020 by the United Nations Tax Committee.[321] Offered Article 12B of the UN MTC allows both source and resident States to impose a tax on income received from automated digital services, defined as any service provided on the Internet or another network requiring minimum human involvement. Both business-to-business and business-to-consumer transactions are covered. It established a broad tax base covering online advertising services, supply of user data, search engines, gaming, media platforms, etc.[322] Importantly, Article 12B of the UN MTC would be applicable irrespective of global or local revenue turnover, maximising the benefits for developing States and removing administrative burdens.[323] On the other hand, since both residents and source States obtain the right to tax the same income, it could lead to differences in the treatment of economically equivalent transactions.[324] The same result could potentially be caused by the correlation between Article 12A and 12B of the UN MTC with regard to the separation of technical services and automated digital services since both concepts can cover the same transactions. And since the UN MTC does not establish an autonomous definition of technical services, the freedom of the State with regard to change of interpretation of the concept is limited only by general provisions of international law.[325]

In addition, both Articles establish different applicable tax rates, which may cause disputes over the qualification of the transactions with the taxpayer. The main criticism of Article 12B of the UN MTC lies in the open scope of the tax base since the list of the covered transactions is not exhaustive.[326] This situation will lead to uncertainty for taxpayers, causing multiple disputes,[327] and that was pointed out by the OECD when rejecting the system based on the withholding tax.[328] Another reason for the uncertainty is that the structure of Article 12B UN MTCC provides a possibility to charge the portion of the income obtained in the form of either withholding tax or corporate income tax, leaving a great administrative burden for the stage of

[321] Andres B Moreno, "Because Not Always B Comes after A : Critical Reflections on the New Article 12b of the UN Model on Automated Digital Services", *World Tax Journal* 12, no. 4 (2021): 517.
[322] Avi-Yonah, *supra note*, 24: 3.
[323] Harpaz, *supra note*, 51: 87.
[324] United Nations, *supra note*, 32: 22-24.
[325] Moreno, op cit., 523.
[326] Bruno Peeters and Sharon Waeytens, "The United Nation's Response to the Digitalisation and Globalisation of the Economy: The Introduction of Article 12B into the UN Model Tax Convention," in *Taxes Crossing Borders (and Tax Professors Too): Liber Amicorum Prof. Dr R.G. (Rainer) Prokisch* (Maastricht: Maastricht University Press, 2022), 260.
[327] Anneloes Roelofsen, "UN Tax Committee Incorporates Article on Automated Digital Services in Model: And Does Much More," *Wolters Kluwer* 7385 (2021): 4–5.
[328] OECD, *supra note*, 9: 113.

avoidance of double taxation. In addition, the UN Tax Committee itself gave examples of transactions which will not be covered by Article 12B of the UN MTC as customised professional services, services providing access to the Internet and other devices, income obtained from the sale of physical goods irrespective of the presence of the Internet connection.

In conclusion to this Chapter, the MLC is an insufficient instrument to tackle the problems of taxation in the digital economy, both from the points of view of its regulation and the potential results to be reached. Firstly, the local and global revenue thresholds do not encourage the development and expansion of commercial activity and do not ensure the equal treatment of MNEs on the basis of the origin of taxpayers. It creates a preferable treatment for SMEs whose annual turnover does not reach the threshold for application of the MLC. In addition, such entities would have even more favourable conditions achieved by the means of operation of Amoun B proposal. On the other hand, the EU recognised the need for cooperation at the universal level to achieve uniformity in the international taxation system, hence withdrew the attempts to regulate the field regionally. The same is applicable to unilateral measures for the implementation of DSTs and the expansion of the concept of permanent establishment since they do not ensure the predictability of taxation and require thorough communication with tax authorities in both source and residence States.

CHAPTER 4. PROPOSAL FOR TAXATION OF THE DIGITAL ECONOMY

Having examined the peculiarities of the taxation of the digital economy, the causes why the current concept of PE and the profit attribution rules do not ensure fair taxation, and the international and regional proposals and unilateral measures in previous Chapters, Chapter 4 describes the proposal for taxation of digital economy. For this, Part 1 offers the establishment of the Global Digital Tax (hereinafter – GDT), Part 2 propose the establishment of the Global Tax Authority (hereinafter – GTA), and Part 3 demonstrates the mechanisms of administration of the GDT.

4.1. The Model of New Digital Tax

The primary aim of the creation of a PE was to provide the possibility for source States to receive a fair part of the revenue generated in their territory by a foreign entity, focusing on the physical goods and provision of service.[329] Nowadays, there are two most discussed options for capturing digital economic activity. The first is the expansion of the concept of PE to include digital activity, and the second is the imposition of taxes on the revenue of a foreign entity without the presumption of a separate legal personality acting in a source State.[330]

The first idea was highly discussed both in doctrine[331] and practice, taking into account the unilateral expansion of the concept by Slovakia in national legislation discussed in Chapter 3.[332] However, the inclusion of digital activity in the concept of PE does not seem to be the most rational choice nowadays. A PE is a form of tax nexus for the entity performing economic activity in a source State created to separate profit from the main entity. However, the taxation with PE requires one additional step compared to DSTs, which is the level of applicability, while other steps, such as the bilateral or multilateral agreement between States, identification of the revenue created in a source State, its attribution to a foreign entity or PE, separation of the total revenue of an entity from the revenue generated in the source State and application of the arm's length principle to a transaction are the same. Therefore, the primary disadvantage of PE lies in its administration burden for taxpayers and tax authorities expressed in the need the asses its existence in each individual case. Thus, both unilateral expansion of the concept of permanent establishment

[329] Marcin Jamroży and Filip Majdowski, "Permanent Establishment in Digital Business," *Studia Prawno-Ekonomiczne* 122 (2022): 13, https://doi.org/10.26485/SPE/2022/122/1.
[330] Peeters, *supra note*, 327: 4.
[331] Ibrahim Mu'azu Usman, "An Overview of Virtual Permanent Establishment in Digital Economy," *International Journal of Innovative Science, Engineering & Technology* 09, no. 12 (2022), https://ijiset.com/vol9/v9s12/IJISET_V9_I12_15.pdf.
[332] Cibul'a, supra note: 12 80-88.

and the potential SDP Proposal by the EU are not able to ensure taxation in accordance with the principles of the Ottawa Framework, primarily contradicting the principle of simplicity of taxation.

On the other hand, there is a need to take into account the experience of the efficiency assessment of the Pilar One, since, despite the agreement of the International Community on its model, it still does not ensure the equal treatment of taxpayers and employ the sourcing rules which do not reflect the complexity of digital transactions and contribution of information for multiple users.

4.1.1. Global Revenue Threshold

To solve the problems of taxation in the digital economy, the proposal has to meet such requirements:

- It shall not be based on physical criteria of applicability;
- Its application shall not create the assumptions of discrimination on the basis of the origin of taxpayers;
- It shall be administrated effectively;
- It shall respect the principles of taxation.[333]

The main problem with the existing principles of taxation is the clash between the equality and efficiency of taxation. For example, while the Pilar I Amount A proposal, as a narrow-scope instrument, ensures the efficiency of taxation, it is highly criticised for being contradictory to the principle of equality on the basis of the origin of taxpayers. Even though the MLC does not establish the nationality criterion for applicability, it is caused by the global revenue threshold. Some authors support the application of the threshold for taxation of the digital economy,[334] however, the fact that most of the MNEs covered are incorporated in the US shall not be ignored, at least from the perspective of reaching a common global consensus.

In addition, the doctrine does not discuss the protection of the interests of the MNEs and the creation of additional burdens due to their high volume of annual turnover. Once the MLC enters into force, the entities that operate in multiple source States but do not reach the threshold for its applicability will receive the advantages. From the perspective of business activity, the MLC does not favour the increase of turnover and expansion of economic activity into different jurisdictions. The MLC is less favourable to MNEs since the proposals do not cover SMEs, which is another source of inequality. Some authors state that despite the International Community's

[333] Ran, *supra note*, 28: 223.
[334] Hentschel, *supra note*, 17: 117.

agreement on the Ottawa Ministerial Broad Taxation Principles, those are not completely addressed in the OECD proposals.[335]

The same is applicable to the practice of implementation of DSTs, which are applicable on the basis of global and local revenue thresholds. For example, in a situation when the local revenue threshold is fulfilled, but two MNEs have global revenue of EUR 750 million and EUR 749 million, the DST would not be applicable to the second taxpayer, while the first would have an additional burden of EUR 22.53 million, under 3% of DST rate. This approach contradicts the principle of vertical equality and encourages MNEs to lower their global revenue.[336] Therefore, the proposals for taxation of the digital economy shall not establish revenue criteria and should be applicable to transactions without physical elements if revenue arises per se.[337]

4.1.2. Local Revenue Threshold

Both the practice of the implementation of DSTs and the MLC support the application of the local jurisdiction revenue threshold.[338] Some authors also uphold such an approach, defining that it would ensure some level of flexibility for taxpayers.[339] However, the main problem with the local revenue threshold is that it favours aggressive tax planning since the MLC does not provide the possibility to adapt the threshold to the GDP of the jurisdiction, meaning that the lowest threshold of applicability is EUR 250 000 of revenue from the jurisdiction with GDP less than EUR 40 billion. This results in a situation when the same threshold would be applicable in North Macedonia and Vanuatu, which had EUR 38 billion and EUR 978 million of the GDP in 2022, respectively.[340] It will be harder for MNEs to reach the threshold in States with relatively low GDPs even despite the fact that the MNE might use the whole potential of the market, leaving source States without the fair part of the value created proportionally to the market resources used. Therefore, the local revenue threshold shall either be established in a matrix table establishing dependence between the threshold and GDP or not applicable.

Additionally, the taxation of the digital economy shall not be fragmented between the industries, and one proposal shall be as broad as possible,[341] since it overcomplicates the

[335] Yasmin Ismail, "The Global Debate on Taxation in Digital Economy: State of Play and Implications for Developing Countries" (Geneva: CUTS International, 2020), 15.
[336] Singh, *supra note*, 37: 955.
[337] Harpaz, *supra note*, 51: 85.
[338] "Report on France's Digital Services Tax Prepared in the Investigation under Section 301 of the Trade Act of 1974" (United States Trade Representative, 2019), 22; OECD, *supra note*, 217: Article 8.
[339] Harpaz, *supra note*, 51: 89.
[340] "Gross Domestic Product 2022" (World Bank Group), https://databankfiles.worldbank.org/public/ddpext_download/GDP_PPP.pdf.
[341] Ran, *supra note*, 28: 333.

administration of taxation for both taxpayers and tax authorities. Even the MLC, establishing the sourcing rules, is regarded as overburdening the taxpayers with accounting since MNEs shall be given more freedom to choose the appropriate indicator that best suits their available information.[342]

4.1.3. Protection of Users and MNEs

The imposition of DSTs and MLC would result in an increase in prices for end users proportionally to the tax rate imposed by a source State.[343] The same is applicable to such proposals expressed in the doctrine as Internet Access Tax,[344] levied directly on users and which is more correct to recall as fees,[345] and Data Excise Tax, establishing that the information produced by the consumer by inputting the requests on web search would be taxed attributed to the webpage search holder and subsequently taxed.[346] Such taxation would contradict the principle of neutrality of taxation, the measurement for which is the impact of the potential taxation on the economic activity.[347] The immediate effect generated by such a form of taxation would be either the reduction of business activity in the jurisdiction, where the business conduct becomes irrational due to additional costs or the inclusion of taxes levied into prices for the users. Both results will reduce the economic activities of specific sectors, and additional revenue collected by the State might be compensated by the outflow of the profit caused by the termination of business activities. Therefore, the tax base of the new proposal shall be as broad as possible to ensure the principle of neutrality to safeguard the development of economic activity.

In addition, the MLC is being criticised for complex sourcing rules that do not ensure the principles of certainty and simplicity of taxation.[348] Moreover, the sourcing rules do not provide a fair solution for allocation between source States since the MLC take into account only the place of location of the viewer in case of the provision of digital advertisement.[349] The application then would require constant communication with tax authorities or the conclusion of advance pricing agreements, giving them a margin of appreciation in the case of the definition of the place where the intangible property is used or the location of the user to whom the online advertisement is

[342] Hentschel, *supra note*, 17: 418.
[343] Kim, *supra note*, 296: 175.
[344] José-Andrés Rozas and Joshua Pownall, "A European Internet Access Tax," *Intertax* 50, no. 8 & 9 (2022): 608.
[345] Sowmyan Jegatheesan, "Taxing the Internet Is That Feasible?" *Cornel University* ArXiv, abs/1502.02081 (2014): 5.
[346] Ran, *supra note*, 28: 338.
[347] Shu-Chien Jennifer Chen, "Neutrality as Tax Justice: The Case of Common Consolidated Corporate Tax Base under the EU Law," *European Studies* 5 (2018): 36, https://repub.eur.nl/pub/118576/Neutrality-as-Tax-Justice.pdf.
[348] Lorraine Eden, "The Simple Analytics of Pillar One Amount A," *Tax Management International Journal* 50, no. 4 (2021): 141, https://deliverypdf.ssrn.com/delivery.php.
[349] OECD, *supra note*, 217: Article 7(1)(d)(ii).

shown. Therefore, what is needed to tax online business activity effectively is the criteria for identifying a source profit, which, even if based on the physical location of a user, establishes an objective method for definition.

4.1.4 Mechanism of Global Digital Tax

Having analysed the proposals for the taxation of the digital economy and identified their disadvantages previously, this section proposes the establishment of a GDT, the application of which would ensure the proportional allocation of revenue derived from digital economic activities. It is important to note that this taxation model's success is conditioned upon its support by the International Community and the creation of the international authority responsible for the maintenance of the international taxation system of communication with national tax authorities to ensure the efficiency of communication to combat the practice of aggressive tax planning and tax avoidance.

The tax base of the GDT is revenue deriving from data contribution from a State covering the provision of online advertising services, online intermediation services, licencing, sale or other alienation of intangible property or user data and other economic transactions with purely digital elements. The application of this tax would not be based on revenue creation volume but merely on the fact that the contribution of data by source States ensuring that both MNEs and SMEs are treated equally.[350] The general definitions of residence and source would have to be amended to include the function of utilisation of data, including storage, performed by an entity established in a residence State and the function of contribution of data, including personal information, from the digital or physical jurisdiction of a Source State.

The GDT would be applicable to both business-to-business and business-to-customer transactions in the form of limited tax liability to the transaction occurring in the digital jurisdiction of a State. Since the GDT aims to capture a significant digital presence, which requires interaction with a website or web page, the GDT would be applicable not only to bandwidth and servers but also to web hosting services.

The sourcing rules, contrary to the MLC, would comprise the jurisdiction of the creation of value in addition to the physical criteria for attribution of profit to a State. Such rationale is

[350] Loizos Heracleous, Kevin Morrell, and Orlando Fernandes, "How Can Governments Tax Multinational Enterprises More Fairly? A Discourse Analysis," *Policy Press* 49, no. 4 (2021): 507, https://doi.org/10.1332/030557321X16292210017454.

explained by the fact the sourcing rules proposed by the MLC do not ensure the attribution of profit to the jurisdiction of value creation.[351]

The reason for attribution of profit to the State of location of a user is that the users are relatively immovable,[352] and the user's location is the most common jurisdiction for the contribution of data, which creates value in the place of residence. While somebody could argue that in the modern world, the physical reallocation of users has become simpler, this is contrary to the fact that even in the EU, which upholds freedom of movement, the average interstate mobility rate for all periods of movement is 9.1%.[353] Therefore, the place where the user is located is a relatively stable criterion for the attribution of a profit to a source State.

However, it is important to stress that the jurisdiction of the user's location is not the only State that creates value. In 2020, 40% of Internet users were from East and Southeast Asia, while only 22% of the entities creating value from digital economic activity originated from there.[354] The taxation of the digital economy shall take into account the network effect created by interactions on the Internet.[355] This means that the value is created in three stages of the commercial activity, namely, in the facilitation of value creation by an entity in the form of development, exploitation, protection, maintenance and enhancement of an object, the joint sphere of interaction between a user and entity by clicking the advertisement, and end-user sphere, by payment for a product or service.[356]

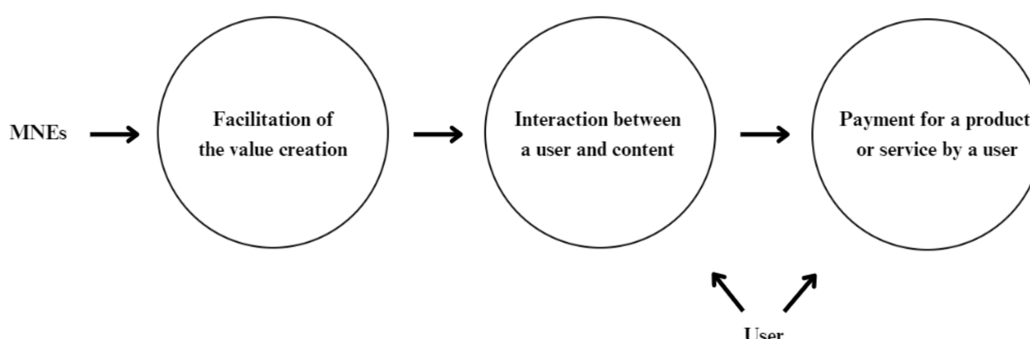

Table No. 3. Stages of revenue creation

[351] Christian Fuchs, *The Online Advertising Tax as the Foundation of a Public Service Internet* (University of Westminster Press, 2018), 60, https://doi.org/10.16997/book23.
[352] Michael P Devereux and John Vella, "Are We Heading towards a Corporate Tax System Fit for the 21 St Century?" *Fiscal Studies* 35, no. 4 (2014): 471, https://doi.org/10.1111/j.1475-5890.2014.12038.x; John Vella and Michael P. Devereux, "Implications of Digitalization for International Corporate Tax Reform," *Intertax* 46, no. 6 & 7 (2018): 551, https://doi.org/10.54648/taxi2018056.
[353] Holger Bonin et al., "Geographic Mobility in the European Union: Optimising Its Economic and Social Benefits" (IZA, 2008), 30, https://docs.iza.org/report_pdfs/iza_report_19.pdf.
[354] Daniel Bunn, Elke Asen, and Cristina Enache, "Digital Taxation Around the World," 7, https://files.taxfoundation.org/20200527192056/Digital-Taxation-Around-the-World.pdf.
[355] Gary D Sprague, "A Critical Look at the European Commission Staff Impact Assessment Relating to the Proposed EU Directives on Taxation of the Digital Economy," *Tax Management International Journal* 47, no. 7 (2018): 4, https://www.bakermckenzie.com/-/media/files.
[356] Juha Häikiö and Timo Koivumäki, "Exploring Digital Service Innovation Process Through Value Creation," *Journal of Innovation Management* 4, no. 2 (2016): 120, http://dx.doi.org/10.24840/2183-0606_004.002_0006.

The GDT aims to allocate the revenue created from all three stages to source States, in which either the data contributed to the creation of value or the end user received some digital goods or services. One could claim that the allocation of revenue generated by means located in a source State exclusively to such States would create inequality with residence States since the former would obtain more taxing rights.[357] However, even the case of inequality will be compensated by the possible higher CIT rates, allowing residence States to charge a surplus of 15% taxes in a source State, corporate gain tax, the application of which does not depend on the income taxes, withholding taxes on dividends, interest, royalties, and operational taxes such medical, social security, employment taxes.

However, importantly, the MLC proposal does not capture revenue generated in the second stage of value creation since the user location and data contribution may occur in different States. This can be demonstrated by the example of the functioning of a social media platform established in State B, creating value from digital advertisement and data analytics services targeting users in State A. While interaction with advertisement and the origin of data may overlap with the place of the location of the user, the platform may operate on servers located in State C, meaning that the digital place of interaction is defined through the place of location of servers. Under the proposed sourcing rules, State C would not obtain revenue created with resources (servers) located in its territory. However, this situation involves the chain of information contribution. Firstly, the information was contributed by the user from State A to the servers located in State C and from the servers in State C to the entity in State B.

In addition, the proposed sourcing rules do not take into account the change in the chain of data in the subsequent alienation of user data.[358] For example, if, in the situation described above, the entity in State B would sell the data collected from users in State A by means of servers located in State C, the value associated would only be attributed to State A by the rule of users' location.

The same approach is applicable to the alienation of intangible property created with the information collected since the MLC establishes the location of consumption for the attribution of profit,[359] meaning that the State which contributed information for the creation of intangible property, for example, in the case of databases, would not be able to receive the portion of value generated by such alienation despite the fact that information was collected from those States.

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[357] Jane G Gravelle, "Reform of U.S. International Taxation: Alternatives" (Congressional Research Service, 2017), 2, https://sgp.fas.org/crs/misc/RL34115.pdf.
[358] Jiang-Hua Zhang et al., "The Profit Distribution of Supply Chain under E-Commerce," *Discrete Dynamics in Nature and Society* 2014 (2014): 6, http://dx.doi.org/10.1155/2014/287925.
[359] OECD, *supra note*, 217: Article 7(3).

In addition, the situation is not resolved with the temporal criterion for attribution of profit when the user was located in the State when the information was collected but moved its location before the alienation of collected information by an entity. However, under the GDT, the value created would be attributed to a State of the contribution of information for commercial purposes.

With regard to the tax rate the best option which would ensure tax certainty and significantly decrease the practice of tax avoidance is flat rate of 15%, consistent with the Pillar Two proposal, ensuring predictability for taxpayers.[360] However, due to feasibility concerns and delegation of sovereignty to the GTA, it is possible to consider the establishment of adjustable tax rate, depending on the GDP of jurisdiction.

While the EU refused the implementation of Bit Tax, having a volume of information transferred as a tax base, due to the impossibility of pricing the information,[361] GDT would establish the market and value-based approaches for determining the value of information. The first would apply to the regular information contribution in the form of finished goods, such as the databases or provision of digital advertisement, consistently with the MLC, while the second would be applicable to the unique information with no comparable available and assess the economic benefits it grants to the holder of such information.

The principle of single taxation would be ensured by double tax relief against foreign income in the source State by the credit for domestic tax attributed to foreign income. This approach would eliminate the different treatment of taxpayers between source and resident States.[362] In addition, to mitigate tax abuse, Wilde offers the establishment of the subject-to-tax clause, meaning that the double tax relief mechanism might be conditional upon the foreign income being the subject of corporate income tax.[363] With regard to risks of double counting, those would be eliminated by means of sourcing rules and administration by the DTA, meaning that if it is identified that the value was generated by means of information contributed from the digital jurisdiction of a source States, the profit from such transaction would be prevented to include into CIT base in a resident State.

In addition, contrary to the unilateral or coordinated expansion of the concept of permanent establishment, the functioning of the GDT shall be based on the agreement of the International Community in the form of universal treaty, which would override the existing DTA and national legislation, which would be consistent with the principle of *pacta sunt servanda*.

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[360] OECD, "Minimum Tax Implementation Handbook (Pillar Two)" (Paris: OECD, 2023), 9, https://www.oecd.org/tax/beps/minimum-tax-implementation-handbook-pillar-two.pdf.
[361] Max Cash and Lensen Anton, "Electronic Commerce and Tax Base Erosion" (European Parliament, 1999), 47, https://www.europarl.europa.eu/RegData/etudes/etudes/join/1999/168015/DG-4-ECON_ET(1999)168015_EN.pdf.
[362] Philip R West and Amanda P Varma, "The Past and Future of the Foreign Tax Credit," *International Tax Journal* 38 (2012): 44, https://www.steptoe.com/a/web/2648/4391.pdf.
[363] Wilde, *supra note*, 203: 300.

Hence, this model of the taxation of the digital economy, while goes beyond the concept of a PE, is capable of ensuring the taxation consistently with the Ottawa Framework since it ensures equal treatment of MNEs independently of the origin of taxpayers and with SMEs operating internationally since the application of the GDT does not depend on global or local revenue thresholds. However, even with this model of taxation, there is still a problem of communication between national tax authorities, which is to be solved by the establishment of the international authority responsible for the maintenance of the system of international taxation.

4.2. Establishment of the Global Tax Authority

The diversification of the unilateral and coordinated measures for taxation of the digital economy showed the need for effective cooperation on a universal level. The OECD cannot be described as the most effective form of international cooperation since developing States have no confidence that their interests are primarily considered. Moreover, the scope of the OECD's activities cannot be described as covering fully international scope.[364] Dietsch and Rixen argue that the form of the OECD is ineffective in the coordination of States since it has no competence to issue binding decisions.[365] However, the importance of engaging developing States in cooperation is demonstrated by the fact that economic development and taxation are inseparable for those States.[366] The International Tax Dialogue, created under the auspice of the OECD, engaging the European Commission, the Inter-American Development Bank, the International Monetary Fund (hereinafter – IMF), the World Bank Group and the Inter-American Center of Tax Administration, showed no substantive result of cooperation between the major stakeholders, which is evidence by the fact that the last conference, the main form of cooperation, was held in July 2015.[367] Additionally, the International Tax Dialogue itself cannot be regarded as an international organisation or a forum that ensures the participation of developing States; it is only a platform for the coordination of major economies.[368]

International cooperation experience shows that once the field reaches a cross-border character, a special body responsible for administration must be created. Such experience includes

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[364] Dale Pinto and Adrian Sawyer, "Towards Sustaining the Future of Taxation: Is a World Tax Organisation Necessary and Feasible in Today's Globalized World?" *Australian Tax Forum* 179, no. 199 (2009): 39.

[365] Rixen Dietsch and Thomas Rixen, "Tax Competition and Global Background Justice," *Journal of Political Philosophy Special* 22, no. 2 (2017): 163.

[366] Horner, *supra note*, 26: 179.

[367] "International Tax Dialogue - OECD," accessed 5 May 2024, https://www.oecd.org/ctp/tax-global/international-tax-dialogue.htm.

[368] Dries Lesage, "Global Taxation Governance after the 2002 UN Monterrey Conference," *Oxford Development Studies* 36, no. 3 (2008): 288, https://doi.org/10.1080/13600810802264415, http://dx.doi.org/10.1080/13600810802264415.

the creation of the World Wide Web Consortium, the World Customs Organisation, the World Intellectual Property Organisation, etc.

The essential criteria for the creation of an international organisation responsible for taxation were laid down by Horner, a formed OECD employee responsible for tax competition and transfer pricing guidelines, such as:

- Gag rules: all issues must be eligible for discussion at the forum;
- Fair share: attention should be given to profit allocation rules;
- Link to official development assistance: development issues should be relevant in formulating tax policy;
- Tax administration efficiency: developed States should assist developing States in improving tax administration;
- Governance: developing States should have a meaningful voice in any world tax.[369]

The most effective way to ensure the participation of developing States in the international taxation system is the establishment of the GTA. A similar proposal has already been upheld by the International Bank for Reconstruction and Development (hereinafter – IBRD). However, the scope of competence in that proposal included the collection of the proposed Digital Data Tax.[370] However, as demonstrated in Chapter 1, due to the constant development of commercial relations, more relations will be subject to transformation, meaning that the archaic nature of PE is only the first object of such development.

Even in doctrine, the idea of the creation of a world tax authority was expressed by Vito Tanzi in 1988,[371] the competence of which would include the collection of taxes resulting from cross-border transactions.[372] However, the more sovereignty is delegated from States to the organisation, the harder it is to reach an agreement on its establishment.[373] The optimal way, nowadays, to address the problem of coordination of taxation is the assignment of administrative functions to the GTA and the introduction of the dispute settlement mechanism between States. This form would clearly identify the functions of Chapter 6 of the UN Charter, regulating the pacific settlement of disputes. To reach broader international fora, the GTA shall be established under the auspice of the UN with close cooperation of the OECD, which would ensure the consolidation of different fields of public law. In addition, the establishment of the GAT under the UN would solve the financing procedure, and it could benefit from well-developed rules for the

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[369] Horner, *supra note*, 26: 185-187.
[370] Lucas-Mas, *supra note*, 27: 87.
[371] Herbert Stein, ed., *Tax Policy in the Twenty-First Century*, 1st edition (New York: Wiley, 1988), 266–277.
[372] Tanzi, *supra note*, 25: 182.
[373] Oona A Hathaway, "International Delegation and State Sovereignty," *Law and Contemporary Problems* 71, no. 1 (2008): 138, https://scholarship.law.duke.edu/lcp/vol71/iss1/6.

representation of States. This would also lead to closer cooperation with agencies such as the IMF, the International Telecommunication Union, and the IBRD.

The competence of the GTA would consist of such main functions:

- Administration of the existing DTA;
- Maintenance of the register of cross-border taxation-related matters;
- Identification and reporting of the development of international taxation;
- Coordination of taxation of the digital economy;
- Forum for the elimination of double taxation;
- Dispute resolution between States.

The prerequisite for the effective functioning of the GAT is the availability of information from the national tax authorities. Contrary to the proposal by the IBRD, which established that the organisation should communicate with national financial institutions to receive the information,[374] this would overburden the GTA with the number of sources of information. On the other hand, the national tax authorities would have to provide information on eligible taxpayers through the communication system. The information obtained by the GTA shall include information on taxpayers involved in international economic activity, turnover, tax rates applied, and credits and exemptions granted against foreign taxes. The GTA, therefore, would unite the legal basis for information exchange between tax authorities, creating a new model of tax cooperation.[375]

In addition, the GTA would provide a model for forming international rules and standards,[376] by uniting the practical experience of allocating revenue between States and actively engaging with other international organisations, such as the OECD, to address subsequent changes in international taxation. This could result in the establishment of commonly accepted accounting rules for businesses engaged in cross-border economic activity, procedures for mutual assistance in tax collection, and simplification of taxation of MNEs.[377]

It is necessary to stress that the GTA's competence in this form would mainly consolidate the functions separated between different international organisations, such as the OECD and the IMF.[378] A clear separation of the roles between the GTA and the OECD shall be performed to avoid confrontation of functions. However, since the GTA would be established under the UN,

[374] Lucas-Mas, *supra note*, 27: 88.
[375] Eva Andrés Aucejo, "Towards an International Code for Administrative Cooperation in Tax Matter and International Tax Governance," *Revista Derecho Del Estado*, no. 40 (2017): 65, https://doi.org/10.18601/01229893.n40.03.
[376] Satoru Araki, "A Global Framework on the Formulation and Implementation of International Taxation Standards," *Journal of Tax Administration* 2 (2016): 70.
[377] Aucejo, *op. cit*., 74.
[378] "2021 Report of the High-Level Panel on Financing for Development" (United Nations General Assembly, 2001), 42, https://digitallibrary.un.org/record/449151?ln=en&v=pdf.

this would increase the efficiency of the monitoring function of the IMF and the International Bank for Reconstruction and Development.

To ensure the fair representation of States, the GTA could operate on the basis of delegations with a mandate for a specific period. To tackle the conflict between the developed and developing States, each State shall have the right to propose the agenda reaching a certain threshold of agreement between States reflecting the relevance of the question. The decision of the GTA shall be taken by the majority agreement of Members in the form of voting.[379] Additionally, each Member of the GAT shall be formally equal despite their administrative-territorial division, GDP, participation in other international organisations, etc. The same shall be applicable to the structure of the GTA, having only one organ with decision-making powers and no right of veto, contrary to the structure of the UN.

4.3. Administration of Global Digital Tax

The core of GDT is the question of its administration. Two elements shall be developed to identify the informational contribution in a source State. Firstly, the performance of the cross-border commercial activity shall be possible only upon registration with the residence State tax authorities of the Unified Business Locator (hereinafter - UBL). Such an idea is based on Australia's experience of the introduction of the Business Number.[380] The administration of the UBL would be the responsibility of the GTA, tracking the cross-border information exchange between entities and users. Secondly, the national system of access to the digital market for users shall be established, meaning that the identification of the access by a user and interaction with the non-resident digital platform shall be performed on the basis of the digital number of users and the UBL. To detect the activity in digital space and ensure openness of the Internet, the multisided business platforms would have the reporting obligation to tax authorities of the transactions performed on the platform with the information, including the UBL of the provider of digital services or products and the digital number of users. The schematic table presents the procedure for the administration of the GDT.

[379] Peter Dietsch and Thomas Rixen, *Global Tax Governance: What Is Wrong with It and How to Fix It* (Colchester: ECPR Press, 2015), 338–339.
[380] Elaine Lawrence and Brain Garner, "Global eT@xation: Competing Visions," *Bled Electronic Commerce Conference*, 2001, 725, https://domino.fov.um.si/proceedings.nsf/0/145abf69dd7494dec1256e9f003231b0/$FILE/46_Lawrence.pdf.

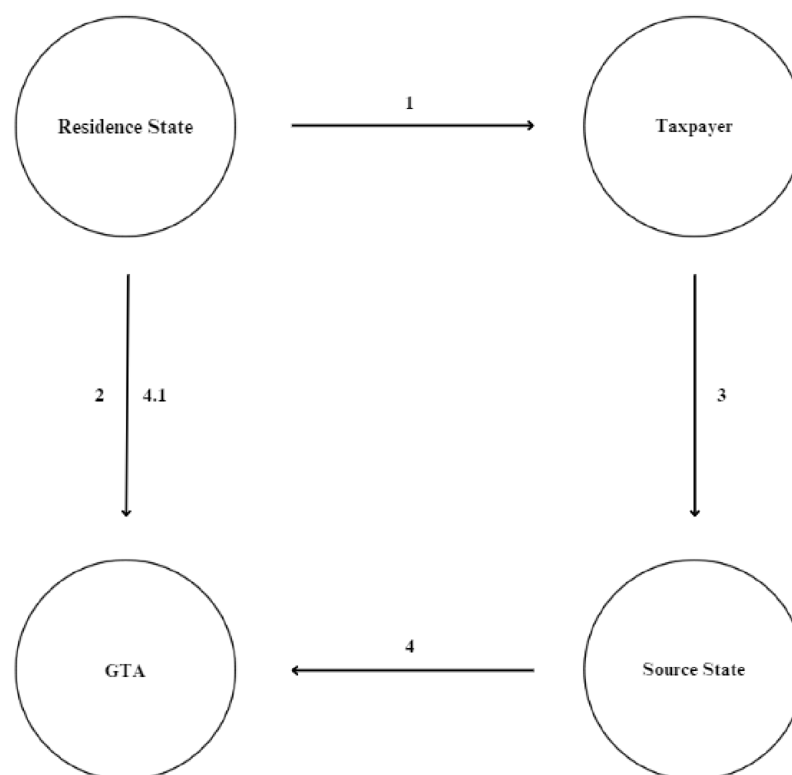

Table No. 4. Administration of GDT

Step 1. Assignment of the UBL by the residence State tax authorities to the entity before the involvement in cross-border economic activity. Step 2. Notification by the tax authorities of the residence State of the UBL assigned to the entity to the GTA. Step 3. Conduct of economic activity resulting in the creation of revenue by the non-resident entity in the source State. Step 4. Notification of the revenue generated from the economic activity captured by the tax authorities of a source State to the GTA. Step 4.1. Notification of the annual total revenue generated by an entity by the tax authorities of a residence State to the GTA.

In this model, for example, in case of the provision of online advertisement in the territory of the source State A by an entity resident of State B, the tax authorities of State A would be able to receive revenue generated from the covered transactions, in case where the payment for such was processed through the financial institution established in State A or the revenue generated from the interaction with an advertisement by the users located in the territory of State A, which was subsequently monetised as collected personal or non-personal data or the servers on this the platform operates established in that States. The identification of the location of users would be conducted with an Internet Protocol address, tracing the location of the access point or through the transaction performed through State A's financial institutions. After notification of the GTA by the tax authorities of State A and State B, it would be able to define the portion of revenue that shall be allocated to State A.

The same approach would apply in the case of a multiplicity of source States. They would transfer information on the data contributed to the value created by non-resident entities to the GTA, including the State of delivery of physical goods, place of access of the user, provider of advertisement, and data contributed by users, and it would define the proportion of revenue allocation, taking into the resources used in source States.

The Internet Protocol is administered by the Internet Assigned Numbers Authority, a private standardisation organisation that assigns the number corresponding to the location of access to the Internet globally.[381] Thus, the creation of such a model would require the transfer of such competence to the GTA. There is some substantive criticism of the application of the IP address to the users' location due to the simplicity of avoidance of its assignment and change by means of a VPN.[382] However, as pointed out by Marian, even if a user artificially changes the IP address, the profit from the digital economic activity would be attributed to the jurisdiction of the VPN service provider if the solution is implemented worldwide.[383] The same approach applies to the GDT since even if the user changes the Internet access point, the source State, in the digital borders of which the interaction with advertisement occurred, would obtain the right to tax profit from such interaction.

However, to avoid the practice of transferring the IP address, the mandatory registration of Internet users could be presented.[384] This approach would ease tax supervision and make the attribution of profit to a particular jurisdiction more efficient. One could allege that the practice of registration of Internet access would constitute the overregulation of the market and pose risks to privacy, however, such practice of the identification of digital users has already been implemented by a number of States establishing the obligation of mandatory registration of SIM cards.[385] The maintenance of the Internet user's register would be the shared competence of national tax authorities and the GTA. This would require the comprehensive coordination of all States to ensure the proportional allocation of profit between source States since, due to the lack of operations in some types of digital transactions, such as the interaction between a user and advertisement, it is hard to track the revenue creation,[386] therefore, States shall identify the data flow from users to non-resident entities.

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[381] Oliver Voggenreiter and Ankit Gupta, "Determining User Location Using IP Address and Historical Device Locations," *Technical Disclosure Commons*, 2017, 3, http://www.tdcommons.org/dpubs_series/547?utm_source=www.tdcommons.org%2Fdpubs_series%2F547&utm_medium=PDF&utm_campaign=PDFCoverPages.

[382] Nevena Vratonjic et al., "A Location-Privacy Threat Stemming from the Use of Shared Public IP Addresses," *IEEE Transactions on Mobile Computing* 13, no. 11 (2014): 12, https://doi.org/10.1109/TMC.2014.2309953.

[383] Omri Marian, "Taxing Data", *BYU Law Review* 47, no. 2 (2022): 511.

[384] Lucas-Mas, *supra note*, 27: 96.

[385] Ewan Sutherland, "The Mandatory Registration of SIM Cards" *Computer and Telecommunications Law Review*, 2010, 62, https://ssrn.com/abstract=1566769.

[386] Ran, *supra note*, 28: 339.

Comparing this approach with a proposal for significant digital presence, the operation of the former would be more burdensome, considering that it requires the application of the transfer pricing methods for the attribution of profit to a particular jurisdiction, while the application of the GDT is based on the data contribution.[387] In addition, this would eliminate the distortion of approaches for the application of transfer pricing methods between national tax authorities and provide a unified approach for ensuring the arm's length principle, which only takes into account the portion of the data contributed.

The proposed taxation model would preserve the idea of a classic PE, namely, taxation in the place of interaction.[388] However, due to the lack of physical elements in the digital economy, the taxation system shall employ the criterion of data contribution, resulting in value creation. Due to the openness of the Internet, for example, the possibility of a user located in the EU ordering goods on a website with the domain name of the US, the imposition of more strict restrictions would significantly limit the circulation of goods globally.

In addition, this approach is more consistent than the Data Excise Tax proposal, the tax base of which is the volume of collected data, since it does not take into account the situation that the same amount of different types of data can create different values depending on its quality.[389] The GDT is based on the fact of value creation and not on the presumption that a particular conduct can generate value. Moreover, the Data Excise Tax does not completely address the situation of intermediary provision of digital services and attributes the profit created by the end user only to the source State of the location of such user.

It also ensures the equality of taxation, taking into account the US counterargument for the MLC,[390] since source States obtain the taxing right not in the conjugation of the requirements of economic presence in the jurisdiction and volume of such activity but merely on the basis of the place of creation of value by interactions with users. This would eliminate the possibility of arguing that the application of this model would target entities within a particular territorial range.

The absence of the cliff effect is ensured by the application of the GDT on a general basis without the global or local revenue thresholds, which also significantly impacts the reduction of tax avoidance practices. The cliff effect exists "when a differential change to some characteristic of an individual [or entity] has significant economic consequences to that individual [or entity] characterised as relatively small increase of income, which could result in proportionally higher

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387 European Commission, *supra note*, 279: 2.

388 Primavera De Filippi, "Taxing the Cloud: Introducing a New Taxation System on Data Collection?" *Internet Policy Review* 2, no. 2 (2013), 4, https://doi.org/10.14763/2013.2.124.

389 Ran, *supra note*, 28: 338

390 Lorraine, *supra note*, 15: 3.

taxes."[391] The possible economic loss negatively affects tax planning and creates additional administrative burdens for taxpayers. In the case of the implementation of the MLC, such a cliff effect could result in the eligibility of the MNE for taxation in another source State. The proposed model would ensure tax certainty, and the taxpayers would be able to plan the taxation consistently.

The implementation of such a model requires comprehensive cooperation between States, in particular, to reach a consensus on the establishment of the GTA, creation of registers and mechanisms of the information exchange. More importantly, the national implementation process shall be analysed, taking into account the different treatment of international agreements in different law systems. Neither doctrine nor practice provides the solution to the interaction between the user and platform, which does not itself create revenue, therefore, the agreement of the International Community shall include the question of proportional allocation of value between the State of, for example, delivery of goods, and the State, in digital jurisdiction of which the purchase occurred if the transaction was proceed by the financial institution established in that State.

In conclusion, the new system of taxation in the digital economy shall take into account the impossibility of the application of physical criteria for the allocation of profit between States and new ways for revenue creation, including the interaction between a user and digital product, not resulting in consumption. Given the diverse approaches to taxation of digital presence, the cooperation of the International Community is a crucial element in ensuring the principles of neutrality, proportionality, certainty and simplicity. Moreover, the effectiveness of the information exchange between national tax authorities, taxpayers and possibly international organisations shall be the cornerstone of a new model of taxation. While the question of regulation of the Internet, access points, and users is a complex and long-term process associated with the right to privacy, it is necessary to achieve fairness in the taxation system.

[391] Singh, *supra note*, 37: 935.

CONCLUSIONS

1. Digitalisation, a socio-economic phenomenon, significantly impacted classic models of business activity. Existing models become more commercially rational as a result of the indirect network effect, mobility, and effective use of information, which allow for more rapid demand and supply formation and transfer of information without physical intermediaries by means of multi-sided platforms that provide effective coordination of market participants. Digitalisation also resulted in the emergence of new business models, such as information sharing, services and goods provision platforms and methods of value creation, since information itself becomes a source of value generation. This also increased the complexity of transactions since the same information collected may be used to generate profit on a self-standing basis and to support the development of goods or provision of services.

2. The concept of permanent establishment is strictly tied to a physically fixed place of business in a source State, while purely digital business models enable revenue generation from transactions which lost physical links, such as digital advertisement services. This allows multinational enterprises to conduct commercial activity while not reaching the threshold for the existence of a permanent establishment. However, even if tax authorities defined the presence of permanent establishment in a source State on the basis of the location of servers, the rules for attribution of profit require fulfilment of the concept of significant people function conditional upon human presence in a place of location of permanent establishment to attribute profit to it. In addition, the exceptions to Article 5 of the OECD MTC do not ensure the consistency of application with regard to ancillary or preparatory activities or dependant agent permanent establishment, which does not address the problem of complex corporate structures conducting business activity from the jurisdictions with low cross-border communication between national tax authorities.

3. The European Union formed two models for addressing the digitalisation of commercial relations, namely the Proposal for Digital Services Tax Directive and the Proposal for Significant Digital Presence Directive, establishing digital service tax and expanding the concept of permanent establishment, respectively. However, both models did not gain support due to the possible fragmentation of the international taxation system. The unilateral measures by States commonly involve the modification of the tax base and global and local thresholds for the application of digital service tax. For example, Austria, France, Italy, and Hungary established taxes covering the provision of online advertising services exclusively; the United Kingdom, the Czech Republic, Belgium, and Spain target revenue derived from user data sales. The national tax rate also fluctuates significantly from 2% in the United Kingdom to 7.5% in Hungary and Turkey.

Slovakia expanded the concept of permanent establishment to cover online intermediation services in transport and accommodation services. However, this differentiation of national approaches contradicts the principle of efficiency and simplicity of taxation, creating an enormous administrative burden for taxpayers and requiring the creation of separate accounting models for each State of conduct of commercial activity.

4. The Pillar One Proposal by the Organisation for Economic Co-operation and Development abandons the concept of permanent establishment and offers the creation of a proportional allocation of revenue between resident and source State on the basis of the place where the revenue was created. However, the major criticism of this approach lies in the requirements of global and local market revenue thresholds to be reached for granting a source State a right to tax the profit of a non-resident. This approach is not compatible with the principle of an equal treatment since the majority of entities covered are incorporated in the United States of America and creates a cliff effect which does not encourage business entities to expand commercial activity with the aim not to reach the threshold of application of the Multilateral Convention to Implement Amount A of Pillar One, possibly creating the outflow of capital and revenue Moreover, the Pillar One Proposal does not ensure the equal treatment between MNEs and SMEs conducting cross-border commercial activity by favouring the latter with lower tax burden applicable to the same transaction but with different volume of revenue obtained.

5. The proposed sourcing rules under the Pillar One Proposal do not ensure the allocation of profit to the State in digital jurisdictions of which the revenue was created. The proposal relies on the place of the location of users. However, user participation does not reflect the value creation within different stages of business activity, such as in the case of the provision of advertisement services when servers and viewers are located in different States. In addition, the proposal is silent on the value of creating databases comprising non-personal information generated by users from different States.

RECOMMENDATIONS

1. To solve the problem of administration of an international system of taxation and combat the practices of taxation avoidance, it is recommended to establish the Global Tax Authority with the competence of maintenance registers of entities involved in cross-border digital activity, identification and reporting of development of international taxation, coordination of the new system of taxation of commercial activity, elimination of double taxation and pacific settlement of tax disputes between States. The Global Tax Authority should be created under the auspice of the United Nations, consolidating the related function of the International Monetary Fund and the International Bank for Reconstruction and Development. This Authority shall ensure equal participation of the developing and developed States with regard to the further development of the international tax system and cooperate with the Organisation for Economic Co-operation and Development to gain the support of the whole International Community.

2. To ensure the taxation of the digital economy consistently with the principle of the Ottawa Taxation Framework Conditions, it is necessary to establish the Global Digital Tax, the application of which is based on the fact of information contribution from source State covering online advertising and intermediation services, licencing and other purely digital transaction. The global and local revenue thresholds shall not be applicable to ensure the equality of treatment of taxpayers. The access point of users to the Internet shall be tracked, and information contribution is to be detected by national authorities of source States by existing means such as the Internet Protocol address or new system, for example, the registration of Internet users. The conduct of cross-border commercial activity must be conditional upon the receipt of the Unified Business Located assigned by the national tax authorities of residence States and the Global Digital Tax shall be the shared competence of the national tax authorities and the Global Tax Authority.

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ABSTRACT

The thesis is devoted to an analysis of the impact of digitalisation on international taxation and approaches to address the associated problems. The research examines the concepts of source and residence, permanent establishment and its inability to be effective mean for taxation of digital economy. Both coordinated proposal and unilateral measures for expansion of the concept of permanent establishment and implementation of digital service taxes were assess on consistency with the Ottawa Taxation Framework Condition.

The research offered an optimal way for taxation of the digital economy, taking into account doctrinal proposals and the establishment of the Global Tax Authority, ensuring effective administration of the international tax system.

Keywords: digital economy, MLC, DST, concepts of source and residence, permanent establishment.

SUMMARY

This thesis, titled "The Impact of Digitalisation in the Attribution of Profits to Permanent Establishment," is devoted to analysing the development of technologies on the international taxation system and the methods to address such effects.

The first chapter examines the concepts of source and residence and their development. Taking into account the identified in model tax convention and national legislations, it concludes that basic categories implemented more than a century ago became archaic and they are not able to capture profit generated from digital transactions, given the development of new ways of profit generation and business model under the impact of digitalisation. It lays down the principle of international taxation identified in the Ottawa Taxation Framework Conditions, explaining the need for new proposals to be consistent with these principles.

The second chapter is devoted to the concept of permanent establishment as a prerequisite for granting a source State to impose taxation on the commercial activity of non-residents. It identifies the elements of the permanent establishment and its types to address the lack of physical elements in commercial digital cross-border transactions since its existence is strictly tied to physical presence in a source State. It is concluded that the rules for attribution of profit to permanent establishment, based on significant people function, are disabled to capture the profit generated for digital activity as digital transactions, in addition to losing physical elements, can be performed automatically without human intervention.

The third chapter analyses existing proposals for taxation from the European Union, the Organisation for Economic Co-operation and Development and unilateral measures for expansion of the concept of permanent establishment and establishment of digital service taxes by Slovakia and Italy, respectively. It is defined that the expansion of permanent establishment is not an effective instrument to address the problem of digitalisation since it creates an additional administrative burden for taxpayers and national tax authorities, along with other proposals being discriminatory due to the establishment of global and local application thresholds. Thus, these proposals are not compatible with the requirements of the Ottawa Taxation Framework Condition.

The fourth chapter formulate the sources of contradiction with the principles of international taxation of the digital economy and proposes the establishment of a global digital tax, applicable on general basis, inspired by doctrinal works coupled with a Global Tax Authority which would be responsible for administrating of the system of international taxation.

In summary, the new proposal for taxing the digital economy shall be compatible with the requirements of digitalisation and the principle of taxation, while an effective system of administration shall be established to eliminate the practice of tax avoidance.