ARTICLE

# A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should the Focus Be on a Shared Taxing Rights Mechanism?

Lisa Spinosa* & Vikram Chand**

*The issue arises as to how can the market jurisdiction tax digital business models, in particular, highly digitalized businesses from an international direct tax perspective? It has been argued that creating a new nexus by introducing a digital permanent establishment (PE) or a significant economic presence test seems to be an ideal long-term solution. However, does that solution really resolve the issue or simply create tax uncertainty for businesses?* First, *by referring to the work on BEPS Action 7, the authors argue that not all states like to amend the PE definition. Moreover, for states that adopted the amendments to counter artificial avoidance of the PE status, the authors argue that the profits attributable to the PE will be restricted to the limited functions performed by the PE or, when the PE does not perform any functions, the profits attributable will be negligible. This is illustrated by specific references to online retailers that operate through local warehouses, as well as online advertisers that operate through related local marketing intermediaries. The analysis is based on the premise that the market jurisdiction follows the authorized OECD approach and considers that the concept of 'significant people functions' relevant to risk assumption for the purpose of Article 7 of the OECD Model is similar to the concept of 'control over risk' relevant to risk and return allocation for the purpose of Article 9. Conversely, if the concept of 'significant people functions' includes day-to-day risk mitigation functions, it could be argued that the risks associated with these functions should be allocated to the PE even though they are performed at the level of the head office and consequently, the PE would be entitled to additional income. Thus, the tax outcome would depend on how one interprets the concept of 'significant people functions'. On the other hand, alternate approaches (such as formulary approaches) can be used if the market jurisdiction does not adopt the authorized OECD approach. Therefore, tax uncertainty does exist, as attribution of profits under the current framework is unclear and lacks uniformity.* Second, *the authors argue that prior to introducing a new nexus in the form of a digital PE or a significant economic presence, the approach to profit attribution needs to be investigated. To resolve the attribution issue for the new digital nexus, both academics and the OECD have proposed several solutions, such as modifying the existing attribution framework, relying on deemed profit methods or formulary apportionment. Undoubtedly, these solutions will require a significant departure from existing attribution standards, which themselves are unsettled. Consequently, developing special attribution rules for digitalized businesses only would breach the principle of equality. Moreover, tax uncertainty can arise if the new attribution framework for the digital nexus is not accepted in a clear and uniform manner. Overall, the authors are of the opinion that traditional businesses and digitalized businesses should be treated equally. As a result , unless and until new nexus rules and new attribution rules are developed and applied for 'all enterprises', a digital PE or a significant economic presence PE targeted at digitalized businesses should not be pursued. Nevertheless, if States wish to tax highly digitalized businesses, the authors assert a 'shared taxing rights' mechanism, in other words, a new distributive rule that could be built into tax treaties to tax specified digital activities or services that operate on a remote basis. In a subsequent article, the authors will undertake a detailed analysis of the solution.*

## 1 Introduction

### 1.1 *The Issue*

Enterprises across the globe are benefiting from the impact of the digital innovation.[1] For this reason, it can be argued that the 'digital economy is increasingly becoming the economy itself'.[2] Thus, ring-fencing the digitalized economy for tax purposes would be challenging. In times where 'international tax issues have never been as high on the political agenda as they are today'[3] and 'where non-resident taxpayers can derive

Notes

* PhD Candidate in International Taxation, Swiss Graduate School of Public Administration, University of Lausanne, Switzerland and research assistant for the Tax Policy Center of the University of Lausanne, Switzerland. Email: lisa.spinosa@unil.ch.

** Executive Director – International Tax Education, Tax Policy Center of the University of Lausanne, Switzerland. Email: vikram.chand@unil.ch.

1 *See* OECD, *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project 11 (OECD Publishing 2015), http://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en (accessed 28 Feb. 2018). It is worth noting that an interim report on the tax challenges arising from digitalization has been released by the OECD in Mar. 2018. *See* OECD, *Tax Challenges Arising from Digitalization – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2018), http://www.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-interim-report_9789264293083-en (accessed 16 Mar. 2018). Where appropriate, this report will be cited as '2018 Interim Report'.

2 OECD, *Action 1 Final Report, supra* n. 1, at 11.

3 *Ibid.*, at 3.

substantial profits from transactions with customers located in another country',[4] the main tax issue related to the digitalized economy concerns the way market (source) jurisdictions can tax the income derived by enterprises operating in the digital sphere, as such businesses can earn profits in a country without any physical presence.[5]

## 1.2 *Digitalization and Digitalized Business Models*

### 1.2.1 *Introductory Remarks*

Digitalization has enhanced the manner in which traditional brick-and-mortar businesses operate. At the same time, digitalization has also opened doors for new business models that operate substantially in the digital sphere (in other words, highly digitalized businesses). For the purpose of this article, the authors propose five broad categories of businesses operating in the digital sphere:[6]

- *businesses selling physical products through an online platform.* These businesses could manufacture or create their own physical products for sale. For example H&M[7] sells its clothing line through its shops and through its website. Alternatively, these businesses could buy products from third parties for the purpose of resale. For example Walmart[8] acts as a reseller for tangible products.
- *businesses selling digitalized products and content through an online platform.* These businesses can either produce their own content that is sold through the Internet. For example, Netflix[9] commercializes its original production through the digital sphere. Alternatively, such businesses could act as resellers for digitalized products. Once again, this would be the case where Netflix purchases content for resell. Similarly, in our understanding, Apple[10] resells soundtrack rights through the iTunes stores;
- *businesses providing an online marketplace for the sale of goods and services.* These businesses typically act as intermediaries and connect suppliers of goods or services and potential customers. For example eBay[11] provides an online platform where suppliers can list their products and consumers can buy them. Similarly, Booking.com[12] provides a platform that connects businesses that offer accommodation and accommodation seekers. Likewise, businesses involved in the so-called sharing economy,[13] such as Uber and Airbnb,[14] could fall under this category;
- *businesses providing online services.* This category encompasses, for example, businesses that are involved in online advertising such as Facebook[15] (social network) or Google[16] (search engine), online payments services such as PayPal[17] and online gaming such as GVC Holdings[18] (which owns partypoker.com); and
- *businesses providing online solutions.* This category mainly contains cloud computing companies that provide infrastructure-as-a-service (IaaS), platform-as-a-service (PaaS)

**Notes**

4 OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project 13 (OECD 5 Oct. 2015).

5 *Ibid.*, at 13. *See also* Committee of Experts on International Cooperation in Tax Matters [Committee of Experts], *Tax Challenges in the Digitalized Economy: Selected Issues for Possible Consideration*, E/C.18/2017/CRP.22, 1–35, para. 39 (17–20 Oct. 2017). Further, *see* OECD, *2018 Interim Report, supra* n. 1, para. 33.

6 This list is not to be considered exhaustive.

7 For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. The H&M Group, *Annual Report 2016* 90, https://about.hm.com/content/dam/hmgroup/groupsite/documents/masterlanguage/Annual%20Report/Annual%20Report%202016.pdf (accessed 22 Feb. 2018).

8 For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. Walmart, *2017 Annual Report* 43, http://s2.q4cdn.com/056532643/files/doc_financials/2017/Annual/WMT_2017_AR-(1).pdf (accessed 22 Feb. 2018).

9 For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. Netflix, Inc., *Annual Report 2016* 57, https://ir.netflix.com/static-files/27fa46ea-eb9a-4b64-8d4e-8496ed097587 (accessed 22 Feb. 2018).

10 For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. Apple Inc., *Annual Report 2017* 33, http://files.shareholder.com/downloads/AAPL/6038430634x0x962680/D18FAEFF-460A-4168-993D-A60CBA8ED209/_10-K_2017_As-Filed_.pdf (accessed 22 Feb. 2018).

11 For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. eBay Inc., *Annual Report 2017* F-2 and F-9, https://investors.ebayinc.com/secfiling.cfm?filingID=1065088-18-9&CIK=1065088 (accessed 22 Feb. 2018).

12 For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. The Priceline Group, *Annual Report 2016* 80 and 108, http://ir.bookingholdings.com/static-files/b8b5291e-c57f-4597-96db-96ae95fe7040 (accessed 22 Feb. 2018).

13 For a definition of the 'sharing economy', *see* e.g. G. Beretta, *Taxation of Individuals in the Sharing Economy*, 45(1) Intertax (2017).

14 Both companies are not listed companies. Thus, they do not publish an annual report for the public at large.

15 For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. Facebook, *Annual Report 2016* 39, https://s21.q4cdn.com/399680738/files/doc_financials/annual_reports/FB_AR_2016_FINAL.pdf (accessed 22 Feb. 2018).

16 For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. Alphabet Inc., *Annual Report 2017* 27–28, https://abc.xyz/investor/pdf/20171231_alphabet_10K.pdf (accessed 22 Feb. 2018).

17 For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. PayPal, *Annual Report 2016* 40–41, https://investor.paypal-corp.com/secfiling.cfm?filingID=1633917-17-27&CIK=1633917 (accessed 22 Feb. 2018).

18 For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. GVC Holdings PLC, *Annual Report 2016* 78, note 1.11, https://gvc-plc.com/wp-content/uploads/2017/12/GVC_Annual_Reports_2016.pdf (accessed 14 May 2018).

or software-as-a-service (SaaS). For example the authors understand that Microsoft Azure[19] provides such services.

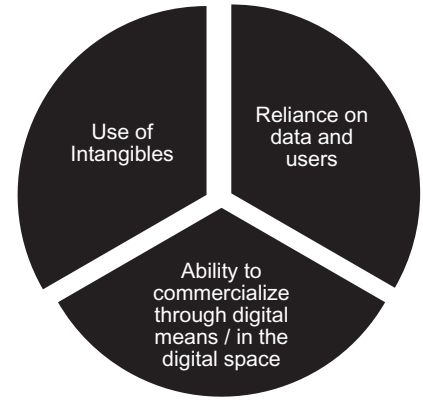
Companies could also be engaged in all the above-mentioned businesses (such as Amazon[20] or Alibaba[21]) or a combination thereof. Therefore, it becomes difficult to classify them under one category or another.[22] Furthermore, new businesses are still emerging with the digitalization of the economy, such as businesses dealing with 3D printing, virtual currencies and robotics. These emerging businesses could further disrupt traditional businesses and may well create new business models.

### 1.2.2 *The Value Creation Process and the Main Characteristics of Digitalized Businesses*

In general, there are three broad value configuration tools that could be used to understand the value creation process. The first tool deals with undertaking a value chain analysis. This model is relevant for businesses where inbound and outbound logistics are of critical importance.[23] For instance, this framework can be used to understand the value creation process for '*businesses selling physical products through an online platform*' or '*businesses selling digitalized products through an online platform*'. The second tool involves undertaking a value network analysis. This model is relevant for businesses where mediation is essential. For example, this framework can be used to understand the value creation process of '*businesses providing an online marketplace for the sale of goods and services*' and '*businesses providing online services*'.[24] Finally, the last tool deals with undertaking a value shop analysis. This tool is relevant for businesses where intensive use of technology is necessary to solve a customer-oriented issue. To illustrate, the tool can be used to understand the value creation process of '*businesses providing online solutions*'.[25] By applying the foregoing tools to digitalized businesses, the following key characteristics emerge.

In the OECD/G20 BEPS Action 1 Final Report, six key features were identified in relation to the tax challenges raised by the digitalization of the economy, namely: (1) mobility of intangibles, users and business functions, (2) reliance on data, (3) network effects, (4) use of multi-sided business models, (5) tendency towards monopoly or oligopoly and (6) volatility.[26] Nevertheless, the authors believe that tax challenges arise from three key features of digitalized businesses,[27] namely (1) their use of intangibles, (2) their reliance on data and users and (3) their ability to commercialize through digital means or in the online sphere (Figure 1).

*Figure 1: Three Key Features of Digitalization*




First, digitalized businesses rely heavily on intangibles in order to grow and create value. Therefore, enterprises operating in this sphere invest substantially in the development of intangibles.[28] Given the mobility of intangibles,[29] enterprises can assign and transfer IP rights within a group,[30] especially to low-tax jurisdictions.

The second key characteristic concerns the importance of users and data in the value creation process.[31] Undoubtedly, data generated from users is important for any business.

**Notes**

[19] For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. Microsoft, *Annual Report 2017* 54–55, https://www.microsoft.com/investor/reports/ar17/index.html (accessed 22 Feb. 2018).

[20] For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. Amazon, *Annual Report 2016* 42, http://phx.corporate-ir.net/phoenix.zhtml?c=97664&p=irol-reportsannual (accessed 22 Feb. 2018).

[21] For more information on this company, as well as on the way it generates revenues, *see* its annual reports, e.g. Alibaba Group Holding Limited, *Annual Report 2017* 116–117, http://www.alibabagroup.com/en/ir/pdf/form20F_170615.pdf (accessed 22 Feb. 2018).

[22] *See* OECD, *2018 Interim Report, supra* n. 1, para. 98.

[23] Michael Porter has developed the value chain analysis tool. *See* Michael Porter, *Competitive Advantage Creating and Sustaining Superior Performance* (The Free Press, 1985). Although the tool has been widely used, both in academia and real-life businesses, its usage has been criticized because of its lack of application to businesses which are service oriented as well as firms that operate on a global basis. Thus, alternate tools have been developed, such as the 'value network' and 'value shop'. *See* OECD, *2018 Interim Report, supra* n. 1, paras 74–79.

[24] *See* OECD, *2018 Interim Report, supra* n. 1, paras 80–88.

[25] *See Ibid.*, paras 89–97.

[26] OECD, *Action 1 Final Report, supra* n. 1, para. 151.

[27] *See* OECD, *2018 Interim Report, supra* n. 1, paras 32–35. *Also see* European Commission, *Taxation of Digital Activities in the Single Market* [leaked report] 1, https://www.politico.eu/wp-content/uploads/2018/02/taxation-of-digital-economy-2.pdf (accessed 28 Feb. 2018).

[28] OECD, *Action 1 Final Report, supra* n. 1, paras 152–153.

[29] *Ibid.*, paras 152–163.

[30] *Ibid.*, para. 153.

[31] *Ibid.*, paras 164–168.

However, the degree of importance depends on the core activity of the enterprise. For example the existence of a cloud computing business does not depend on data generated from users.[32] On the other hand, a social network platform would not exist without users and the data these users generate. Therefore, the data collected from active participation of users plays a vital role in the ability of business to create revenue, for instance, through targeted advertising. From a tax perspective, the question arises as to how states value and tax such data,[33] in particular, 'Big Data'.[34] The authors are of the opinion that it would be extremely challenging for states to develop a framework to tax such raw data.[35]

Lastly, the evolution of information and communication technologies has created a highly integrated and connected world. Barriers to internationalization are thus lowered.[36] It is now possible to manage businesses centrally and reach customers across the globe without being physically present in the location.[37] This characteristic, particularly, challenges the ability of market jurisdictions to tax profits generated within their borders, as the international tax framework traditionally relies on tangible/physical features.[38]

## 1.3 *The Response of Policy Makers and States*

### 1.3.1 *Policy Makers*

In the Action 1 Final Report, the OECD proposed five non-binding options that states can consider adopting to tax digitalized businesses, namely: (1) amendment of the existing definition of 'permanent establishment' (PE)[39] in the OECD Model Tax Convention[40] (OECD Model) which was partially achieved through the Multilateral Instrument (MLI),[41] (2) introduction of a 'significant economic presence' test,[42] (3) application of a withholding tax on goods or services,[43] (4) adoption of an equalization levy[44] and (5) a VAT solution.[45] However, none of these options (1 to 4) were recommended for implementation. In July 2017, the G20 mandated[46] that the OECD provide a solution for tax issues raised by the digital economy. Subsequently, the OECD invited public input on the tax challenges of digitalization[47] and thereafter held a public consultation in California.[48] An interim report on this matter has been published in March 2018. The report discusses the merits and demerits of a short-term solution viz., an excise tax on e-services (*see* section 1.4) and the path that has to be followed to develop a long-term solution i.e. revising the nexus and profit allocation rules (*see* section 3). The OECD will issue a final report in 2020.

The UN, similar to the OECD, has not yet made a formal proposal, but has already discussed its view on possible solutions.[49] For example the UN discusses the expansion of the treaty article on fees for technical services,[50] the introduction of the concept of a digital PE[51] or a significant economic presence

Notes

[32] *See also* OECD, *2018 Interim Report, supra* n. 1, para. 35.

[33] *See Ibid.*, para. 372.

[34] OECD, *Action 1 Final Report, supra* n. 1, para. 166.

[35] This position is also highlighted in S. de Jong, W. Neuvel & Á. Uceda, *Dealing with Data in a Digital Economy*, 25(2) Int'l Transfer Pricing J. 6 (2018).

[36] M. P. Devereux & J. Vella, *Implications of Digitalization for International Corporate Tax Reform*, 07 Working Paper Series 1 (Oxford University Centre for Business Taxation 2017).

[37] OECD, *Action 1 Final Report, supra* n. 1, para. 159.

[38] M. Olbert & C. Spengel, *International Taxation in the Digital Economy: Challenge Accepted?*, 9(1) World Tax J. 4 (2017).

[39] OECD, *Action 1 Final Report, supra* n. 1, paras 215–217.

[40] OECD, *Model Tax Convention on Income and on Capital 2014 (Full Version)* (OECD 2015). All references to this Model Tax Convention are based on this version. Where appropriate, references are also made to the recently updated OECD Model. OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (OECD 2017).

[41] The MLI is an instrument that allows countries to modify, to various degrees, all of their tax treaties. The MLI has been signed by sixty-eight countries during the signing ceremony on 7 June 2017. Since then, ten additional states signed the Convention and six jurisdictions have expressed their intent to do so. *See* OECD, *Multilateral Convention to Implement tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (OECD 2017) http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf (accessed 19 Feb. 2018).

[42] OECD, *Action 1 Final Report, supra* n. 1, para. 277. It could result in a new form of nexus or take the form of a significant economic presence PE. For more information on the proposal, *see* OECD, *Action 1 Final Report, supra* n. 1, paras 277–291.

[43] OECD, *Action 1 Final Report, supra* n. 1, para. 292. For more information on the proposal, *see* OECD, *Action 1 Final Report, supra* n. 1, paras 292–301.

[44] OECD, *Action 1 Final Report, supra* n. 1, para. 302. For more information, *see* OECD, *Action 1 Final Report, supra* n. 1, paras 302–308.

[45] For more information on that proposal, *see* OECD, *Action 1 Final Report, supra* n. 1, paras 309–339.

[46] OECD, *OECD Secretary – General Report to G20 Leaders* 14 (OECD 2017) http://www.oecd.org/ctp/oecd-secretary-general-tax-report-g20-leaders-july-2017.pdf (accessed 22 Feb. 2018).

[47] OECD, *OECD Invites Public Input on the Tax Challenges of Digitalization* (22 Sept. 2017) http://www.oecd.org/tax/beps/oecd-invites-public-input-on-the-tax-challenges-of-digitalisation.htm (accessed 22 Feb. 2018).

[48] For public inputs, *see* OECD, *Tax Challenges of the Digitalisation: Comments Received on the Request for Input – Part I,* 1 (2017); OECD, *Tax Challenges of the Digitalisation: Comments Received on the Request for Input – Part II* 279, paras 7–13 and 20–42 (2017). For a summary of these inputs, *see* de Jong, Neuvel & Uceda, *supra* n. 35.

[49] Committee of Experts, *supra* n. 5, paras 51–65.

[50] *Ibid.*, para. 51.

[51] *Ibid.*, paras 53–57.

test.[52] Moreover, the UN also discusses fundamental corporate tax reforms, such as the introduction of a destination-based cash flow tax, but warns of the uncertainties that such a radical reform would generate.[53]

The EU Commission has also voiced its opinion on the issue at stake in the context of its strategy with respect to the Digital Single Market.[54] In its report issued in September 2017, the Commission discusses both long-term and short-term solutions. For the former, it seems that the Commission favours a revision of the PE concept that could be implemented through the common consolidated corporate tax base (CCCTB).[55] For the latter, the Commission listed the following three options: (1) an equalization levy on turnover of digitalized companies, (2) a withholding tax on digital transactions and (3) a levy on revenues generated from the provision of digital services or advertising activity.[56] However, the Commission did not recommend any specific option and has highlighted that further work should be undertaken in this area, notably regarding the compatibility of such solutions with EU law requirements.[57] In another report issued in late November 2017, the Commission takes the view that the introduction of a virtual PE, along with the necessary changes to profit attribution as well as the transfer-pricing framework, should be explored.[58] Finally, in March 2018, the Commission released its draft proposals for a digital services tax as a short-term solution (*see* section 1.4) and a significant digital presence PE as a long-term solution (*see* section 3).[59]

### 1.3.2 *The Response of Selected States*

While policy makers are still discussing and debating the appropriate solution, several countries have already enacted unilateral measures. These measures, depending on the jurisdiction, could apply to 'all enterprises' or could be targeted only at 'digital enterprises'.[60]

The first type of unilateral measures is targeted towards large multinational taxpayers. For instance the *United Kingdom* has enacted a diverted profits tax which aims at taxing 25% of all the profits earned through mechanisms either used by non-UK companies to avoid trading through a UK PE or by UK companies engaging in intragroup transactions that lack economic substance.[61] *Australia* adopted a similar law, the Tax Integrity Multinational Anti-Avoidance Law, targeting foreign companies that generate sales in Australia through local activities/initiatives but conclude contracts with customers on a remote basis.[62]

The second type of measures targets alternate applications of the PE concept. For example, the tax administration of *Saudi Arabia* has asserted that physical presence in the market state is not required in order to trigger the existence of a service PE. Thus, a foreign service provider could be considered to have a service PE in Saudi Arabia even if the services are provided remotely for more than six months.[63] Needless to say, it could be argued that this interpretation clearly conflicts with the international understanding of the service PE concept.[64] *Israel* has released a Circular on the Internet activity of foreign companies in Israel.[65] The Circular states that foreign companies that are resident in treaty jurisdictions, will be deemed to have a PE in Israel if they operate in Israel with a significant digital presence.[66] Lastly, India[67] has

## Notes

[52] *Ibid.*, paras 58–61.

[53] *Ibid.*, para. 66. On the subject of fundamental reforms, *see* e.g. Devereux & Vella, *supra* n. 36, at 25.

[54] European Commission, *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market*, COM(2017) 547 final (21 Sept. 2017), at 1–11.

[55] European Commission, *supra* n. 54, at 9.

[56] *Ibid.*, at 10.

[57] *Ibid.*, at 10.

[58] European Commission, *'A' Item Note: Council Conclusions on 'Responding to the Challenges of Taxation of Profits of the Digital Economy'*, 15175/17 FISC 320 ECOFIN 1064 (30 Nov. 2017), at 1–8, paras 13–22.

[59] *See* European Commission, *supra* n. 27. *See also* European Commission, *Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services*, COM (2018) 148 final (21 Mar. 2018), at 1–36; European Commission, *Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence*, COM(2018) 147 final (21 Mar. 2018), at 1–20.

[60] *See* OECD, *2018 Interim Report, supra* n. 1, paras 341–366.

[61] E.g. H. Self, *The UK's New Diverted Profits Tax: Compliance with EU Law*, 43(4) Intertax 333 (2015); S. Wagh, *The Taxation of Digital Transactions in India: The New Equalization Levy*, 70(9) Bull Int'l Tax'n 538, 539–540 (2016); Committee of Experts, *supra* n. 5, para. 24.

[62] S. Basak, *Equalization Levy: A New Perspective of E-Commerce Taxation*, 44(11) Intertax 845 (2016); Olbert & Spengel, *supra* n. 38, at 20; Committee of Experts, *supra* n. 5, para. 25.

[63] V. A. Gidirim, *Taxation of Foreign Multinationals Enterprises Conducting Business in and with Saudi Arabia*, 70(4) Bull Int'l Tax'n 230, 233–234 (2016); Committee of Experts, *supra* n. 5, para. 27.

[64] Committee of Experts, *Article 5: The Meaning of the Same or a Connected Project*, E/C.18/2015/CRP.9 (19–23 Oct. 2015), 1–8, paras 1–2.

[65] EY, *Israeli Tax Authorities Publish Official Circular on Internet Activity of Foreign Companies in Israel*, Global Tax Alert (15 Apr. 2016) http://www.ey.com/gl/en/services/tax/international-tax/alert–israeli-tax-authorities-publish-official-circular-on-internet-activity-of-foreign-companies-in-israel (accessed 14 May 2018).

[66] Committee of Experts, *supra* n. 5, para. 28.

[67] Government of India, *Memorandum to the Finance Bill 2018*, at 7 (2018).

recently adopted the significant economic presence test that applies to all enterprises.[68]

The third type of measures introduces turnover taxes for specific digital businesses. *Hungary*, for its part, has introduced an advertisement tax for the publishing sector that could also apply to online advertisers.[69] *India*, introduced the equalization levy[70] for business-to-business online advertisement. In the recent budget, *Italy* introduced a web tax on certain digital transactions.[71]

Finally, the fourth type of measure introduces targeted withholding taxes. For example, *Turkey* has issued a draft law with regard to withholding taxes on income derived by social network platforms or selected online activities.[72]

### 1.4 *Focus on a Long-Term Solution*

With respect to a short-term solution, the European Commission has put forward a Directive for a digital services tax. However, the OECD, in its report, recognizes 'that there is no consensus on the merits of, or need for, interim measures'.[73] Nevertheless, for States that wish to adopt equalization levies or (excise taxes), both the European Commission and the OECD state that the measures should be applicable to selected digitalized businesses such as businesses providing an online marketplace or businesses engaged in online advertising.[74] Such levies, in the authors' opinion, depending on the way they are adopted, could conflict with the international legal tax framework. First, it could be argued that tax treaties could cover such levies (under the provision that deals with covered taxes) and thus the business profit provision of the respective treaty would prohibit their application.[75] Second, if the levies are applied only to non-residents within the EU, such rules could conflict with EU primary law, in particular the fundamental freedoms.[76] Third, equalization levies could raise compatibility issues with international trade obligations.[77] The OECD in the interim report also identifies these issues.[78] Moreover, such rules could be incompatible with the Constitutional Law provisions of certain States.

On the other hand, with respect to a long-term solution, in light of the responses of policy makers and selected states, it is clear that one of the potential long-term options for taxing digitalized businesses is to create a new nexus by introducing a digital PE or a significant economic presence test. This article will discuss and comment on whether that solution really resolves the issue at stake or creates tax uncertainty for businesses. In this regard, the authors, by referring to the work on BEPS Action 7, emphasize that changing the PE definition may have several shortcomings. Notably, these shortcomings are illustrated through two case studies dealing with digitalized businesses such as online retailers that operate through local warehouses, as well as online advertisers that operate through related local marketing intermediaries (section 2). Next, the authors discuss the current state of play as regards the new nexus (digital PE or significant economic presence) and express their perspective on adopting this new option. They put forth the view that if the PE definition as well as the profit attribution rules are amended, these changes should apply to all enterprises (section 3). In light of the tax uncertainty that may arise by pursuing the digital PE option, the authors consider an alternate targeted solution. This solution is briefly presented (section 4) and will be discussed in a subsequent article.

## 2 Lessons from BEPS Action 7 with specific references to digitalized business models

### 2.1 *Non-Uniform Implementation of Amendments to the PE Definition*

#### 2.1.1 *Introductory Comments*

Business profits of a non-resident enterprise are taxable in the market state only when a PE is constituted therein.[79] The definition of the term 'permanent establishment' is

**Notes**

[68] Government of India, *supra* n. 67, at 8–9.

[69] Olbert & Spengel, *supra* n. 38, at 20.

[70] Wagh, *supra* n. 61, at 541; Basak, *supra* n. 62, at 848–849; Committee of Experts, *supra* n. 5, para. 22.

[71] D. Anghileri, *Italy Introduces Web Tax, Update PE Definition*, MNE Tax (7 Jan. 2018), https://mnetax.com/italy-introduces-web-tax-updates-pe-definitions-25490 (accessed 23 Feb. 2018); M. Allena, *The Web Tax and Taxation of the Sharing Economy: Challenges for Italy*, 57(7) Eur. Tax'n 304 (2017).

[72] EY, *Turkish Tax Authorities Proposes tax on Electronic Commerce*, Global Tax Alert (10 Aug. 2016), http://www.ey.com/gl/en/services/tax/international-tax/alert–turkish-tax-authority-proposes-tax-on-electronic-commerce (accessed 14 May 2018).

[73] *See* OECD, *2018 Interim Report, supra* n. 1, para. 27.

[74] *See Ibid.*, paras 406–411 and 434–463.

[75] R. Ismer & C. Jescheck, *The Substantive Scope of Tax Treaties in a Post-BEPS World: Article 2 OECD MC (Taxes Covered) and the Rise of New Taxes*, 45(5) Intertax 382, 386 (2017).

[76] International Observatory, in OECD, *Tax Challenges of the Digitalisation: Comments Received on the Request for Input – Part II*, *supra* n. 48, para. 21.

[77] *Ibid.*, para. 33.

[78] *See* OECD, *2018 Interim Report, supra* n. 1, paras 413–431.

[79] OECD, *Model Tax Convention on Income and on Capital 2014 (Full Version), supra* n. 40, Art. 7(1). *See also* OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017, supra* n. 40, Art. 7(1).

found in Article 5 of the OECD Model. Article 5(1) and Article 5(2) address the situation when a fixed place/physical PE arises. Article 5(3) deals with situations where construction-related activities constitute a PE. Article 5(5) and Article 5(6) deal with situations where an agency PE arises. Finally, Article 5(4) contains exceptions to the PE definition.

In the Action 7 Final Report, it has been highlighted that taxpayers could circumvent the creation of a PE: (1) by splitting up contracts in order to take advantage of the 12-month threshold provided by Article 5(3),[80] (2) by relying on the specific activity exceptions listed in Article 5(4)[81] and (3) through the use of commissionaires or other arrangements by relying on the literal wording of Article 5(5) and (6).[82] Thus, the rationale of BEPS Action 7 was to modify Article 5 of the OECD Model.[83]

For the purpose of this article, amendments to Article 5 (4), (5) and (6) of the OECD Model will be discussed. These amendments, which do not represent minimum standards,[84] have been adopted by a number of states pursuant to Articles 12 and 13 of the MLI, respectively. Consideration of Article 5(3) is beyond the scope of this article, as it is not directly concerned with the issue at stake.

### 2.1.2 *Preparatory and Auxiliary Activities*

Article 5(4) of the OECD Model lists the exceptions to the PE concept. If the activities performed in the market jurisdiction are covered by this provision, a PE does not arise. The key aim of this provision is to exempt activities that are 'preparatory or auxiliary' in nature.

However, due to the evolution of business models, activities once considered as non-core activities have now become core activities.[85] Moreover, over the past few years, multinational groups have been fragmenting their activities in the market jurisdiction in such a way that these activities, on an isolated basis, would be considered to be 'preparatory or auxiliary' even though, taken from an overall perspective, they would be considered to constitute core activities.[86] To counter such avoidance strategies, the Action 7 Final Report proposed amendments to Article 5(4) to 'prevent the exploitation of … specific exceptions to the PE definition … , an issue which is particularly relevant in the digital economy'.[87] Two solutions were proposed which can be selected by states independently of each other.

First, to link Article 5(4) back to its original purpose, i.e. is the exemption applies only to 'preparatory and auxiliary activities',[88] states can choose between two options (Article 13(1) of the MLI).[89] Option A, which is reflected in Article 13(2) of the MLI, results in the addition of a specific 'preparatory or auxiliary' condition to each exemption listed in Article 5(4) of the OECD Model.[90] Thirty-nine signatories to the MLI have adopted this option.[91] On the other hand, Option B, which is reflected in Article 13 (3) of the MLI,[92] allows contracting states to preserve the existing exemptions of Article 5(4)(a)–(d), 'to ensure that those exceptions will apply irrespective of whether the activity is of a preparatory or auxiliary character'.[93] This option has been provided for states that considered the addition of a specific condition (i.e. in Option A) superfluous, as the listed activities of Article 5(4) are intrinsically 'preparatory or auxiliary' in nature. Although it is argued that Option B provides for greater certainty,[94] only seven signatories to the MLI adopted it.[95]

Second, to prevent fragmentation of activities, states can adopt an anti-fragmentation rule which is reflected in

**Notes**

[80] OECD, *Action 7 Final Report, supra* n. 4, paras 16–17. *See also* OECD, *Model Tax Convention on Income and on Capital: Commentary on Article 5*, paras 52–53 (Condensed Version 2017).

[81] OECD, *Action 7 Final Report, supra* n. 4, paras 10–15. *See also* OECD, *Model: Commentary on Article 5, supra* n. 80, paras 58–78.

[82] OECD, *Action 7 Final Report, supra* n. 4, paras 5–9. *See also* OECD, *Model: Commentary on Article 5, supra* n. 80, paras 82–101 & 102–114.

[83] OECD, *Action 7 Final Report, supra* n. 4, at 14.

[84] The MLI agreed minimum standards are (1) the peer review process to address harmful tax practices pursuant to BEPS Action 5, (2) the treaty abuse provisions pursuant to BEPS Action 6, (3) country-by-country reporting pursuant to BEPS Action 13 and (4) the effective mutual agreement procedure pursuant to BEPS Action 14.

[85] OECD, *Action 7 Final Report, supra* n. 4, at 10. *See also* M. de Wilde, *Tax Jurisdiction in a Digitalizing Economy; Why 'Online Profits' Are So Hard to Pin Down*, 43(12) Intertax 796 (2015).

[86] OECD, *Action 7 Final Report, supra* n. 4, at 13.

[87] *Ibid.*, at 9.

[88] *Ibid.*, para. 11.

[89] They can also choose not to apply any of these options.

[90] OECD, *Action 7 Final Report, supra* n. 4, at 28–29.

[91] *See* the MLI positions adopted by Argentina, Armenia, Australia, Austria, Burkina Faso, Cameroon, Colombia, Costa Rica, Côte d'Ivoire, Croatia, Curaçao, Egypt, Fiji, Gabon, Germany, India, Indonesia, Israel, Italy, Jamaica, Japan, Kuwait, Malaysia, Mexico, Netherlands, New Zealand, Nigeria, Norway, Romania, Russia, Senegal, Serbia, Slovak Republic, Slovenia, South Africa, Spain, Tunisia, Turkey and Uruguay.

[92] OECD, *Action 7 Final Report, supra* n. 4, at 38.

[93] OECD, *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* para. 169 (OECD Publishing 2016).

[94] M. De Wilde, *Lowering the Permanent Establishment Threshold via the Anti-BEPS Convention: Much Ado About Nothing?*, 45(8/9) Intertax 556, fn. 33. *See also* OECD, *Explanatory Statement to the MLI* (2016), *supra* n. 93, para. 173.

[95] *See* the MLI positions adopted by Belgium, France, Ireland, Lithuania, Luxembourg, San Marino and Singapore.

Article 13(4) of the MLI.[96] States that choose either Option A or Option B will, by default, adopt this rule, unless they specifically reserve their position pursuant to Article 13(6)(a) or (c) of the MLI.[97] Notably, the anti-fragmentation rule may also apply even if the parties to a covered tax agreement do not choose either option,[98] as well as if their choice of option does not match.[99] Initially, it seemed that the rule was aimed at states that ultimately adopt Option B.[100] However, some states that have selected Option B have reserved their position on the applicability of the rule.[101] Therefore, the implementation of the amendments to Article 5(4) through the MLI does not reflect the original policy purpose laid out in Action 7.[102]

### 2.1.3 *Agency Permanent Establishments*

Article 5(5) stipulates the conditions for triggering an agency PE[103] in the market jurisdiction. However, Article 5(6) contains an exception for independent agents.[104] The relative narrowness of Article 5(5) arising from the terms: 'acting *on behalf of* an enterprise' (emphasis added) and 'authority to conclude contracts *in the name of* the enterprise' (emphasis added), coupled with the broad definition of 'independent agent', have allowed taxpayers to prevent the creation of a PE,[105] especially with regard to commissionaire structures.[106] To counter such practices, the Action 7 Final Report proposed amendments to paragraphs 5 and 6. Changes in paragraph 5, which are reflected in Article 12(1) of the MLI, lower the threshold for triggering an agency PE.[107] Modifications to paragraph 6, which are reflected in Article 12(2) of the MLI, make the independence rule stricter.[108] Thirty-five signatories to the MLI[109] have adopted this provision with respect to their covered tax agreements.[110]

## 2.2 *Non-Uniform Attribution of Profits rules to a Permanent Establishment*

### 2.2.1 *Various Approaches Followed in Tax Treaties*

Even if a PE arises as a result of the amendments, it is necessary to determine the profits attributable to the PE. Under Article 7(2) of the OECD Model (2010/2014/2017 version), which provides for the separate entity principle,[111] the profits attributable to the PE are those that the PE would have earned acting on an arm's length basis.[112] A two-step approach, also known as the authorized OECD approach, is provided to determine the profits attributable to a PE.[113] The first step involves carrying out a functional and factual analysis to hypothesize the PE. In other words, this step entails understanding the activities carried out by the PE (considering its significant people functions, assets and risks) and its dealings with associated enterprises, including the head office.[114] The second step involves pricing the dealing with the associated enterprise(s) by reference to transfer pricing principles.[115]

**Notes**

[96] OECD, *Action 7 Final Report, supra* n. 4, at 39. For more information on the proposal, *see* OECD, *Action 7 Final Report, supra* n. 4, paras 14–15, 27.1 & 30.2–30.4.

[97] OECD, *Multilateral Convention to Implement tax Treaty Related Measures to Prevent base Erosion and Profit Shifting*, *supra* n. 47, Art. 13, para. 4.

[98] Neither Chile nor the United Kingdom adopted either Option A or Option B. Nevertheless, the anti-fragmentation rule applies to their tax treaty (2003).

[99] The anti-fragmentation rule applies to the New Zealand-Belgium tax treaty (1981), even though New Zealand adopted Option A and Belgium adopted Option B.

[100] OECD, *Action 7 Final Report, supra* n. 4, para. 13.

[101] For instance Luxembourg.

[102] According to the OECD, the provisions on Art. 5(4) of the OECD Model are estimated to apply only to 277 bilateral tax agreements. *See* OECD, *2018 Interim Report, supra* n. 1, para. 272.

[103] OECD, *Model Tax Convention on Income and on Capital 2014 (Full Version), supra* n. 40, Art. 5, para. 5.

[104] *Ibid.*, Art. 5, para. 6.

[105] OECD, *Action 7 Final Report, supra* n. 4, para. 9.

[106] For cases where commissionaire arrangements were deemed not to constitute a PE, *see* e.g. France: *Zimmer Ltd. v. Ministre de l'Economie, des Finance et de l'Industrie* (Cases 304715 and 308525) (31 Mar. 2010); Norway: *Dell Products v. Tax East* (Case HR-2011-02245-A) (2 Dec. 2011); Italy: *Boston Scientific International BV. v. Agenzia della Entrate* (Case 3769) (9 Mar. 2012). For cases where commissionaire arrangements were deemed to constitute a PE, *see* e.g. Spain: *DSM Nutritional Products Europe Ltd. (Formerly Roche Vitamins Europe Ltd.) v. Agencia Estatal de Administracion Tributaria* (Case 1626/2008) (12 Jan. 2012); Spain: *Dell Spain v. TEAC* (Case 00/2107/2007) (15 Mar. 2012).

[107] OECD, *Action 7 Final Report, supra* n. 4, at 16.

[108] *Ibid.*, at 16–17.

[109] *See* the MLI positions adopted by Argentina, Armenia, Burkina Faso, Cameroon, Chile, Colombia, Costa Rica, Côte d'Ivoire, Croatia, Egypt, Fiji, France, Gabon, India, Indonesia, Israel, Jamaica, Japan, Lithuania, Malaysia, Mexico, Netherlands, New Zealand, Nigeria, Norway, Romania, Russia, Senegal, Serbia, Slovak Republic, Slovenia, Spain, Tunisia, Turkey and Uruguay.

[110] According to the OECD, the provisions on Art. 5(5) and 5(6) of the OECD Model are estimated to apply only to 206 bilateral tax agreements. *See* OECD, *2018 Interim Report, supra* n. 1, para. 272.

[111] OECD, *Model Tax Convention on Income and on Capital 2014 (Full Version), supra* n. 40, at C(7)-6, para. 15. The Indian Supreme Court has also upheld the applicability of the separate entity principle. India: *Mumbai v. Morgan Stanley and Co. Inc.* (Civil Appeal 2914) (9 July 2007).

[112] OECD, Ctr. for Tax Policy & Admin., *2010 Report on the Attribution of Profits to Permanent Establishments* 12–13, para. 8 (OECD 22 July 2010).

[113] OECD, *Model Tax Convention on Income and on Capital 2014 (Full Version), supra* n. 40, at C(7)-8, para. 20. *See also* OECD, *2010 Report on the Attribution of Profits to Permanent Establishments, supra* n. 112, at 13, para. 10.

[114] For a detailed analysis of this step, *see* OECD, *2010 Report on the Attribution of Profits to Permanent Establishments, supra* n. 112, at 24–49, paras 57–182.

[115] For a detailed analysis of this step *see ibid.*, at 49–57, paras 183–223.

On the other hand, even though the Commentary on Article 7(2) of the OECD Model (2008) endorsed the authorized OECD approach, differences did exist between both versions.[116] The major difference related to recognition of intra-enterprise dealings, specifically the deduction of dealings between the head office and PE. Also, the 2008 version included provisions that were considered not to be consistent with the arm's length principle, i.e. Article 7(3),[117] (4)[118] and (5).[119]

Provisions similar to Article 7 of the OECD Model (2008) are also found in Article 7 of the UN Model[120] (2011)(with certain exceptions). However, the Committee of Experts on international taxation has rejected the application of authorized OECD approach to interpret the business profits provision of the UN Model.[121]

States typically conclude tax treaties with each other by using either the OECD Model (various versions) or the UN Model. Accordingly, the attribution of profits to a PE depends on the exact wording contained in the particular tax treaty. In other words, states can follow the authorized OECD approach and non-authorized OECD approaches. For the purpose of the examples discussed in the next section, the case studies are analysed in light of treaties that follow the authorized OECD approach.

### 2.2.2 *Special Considerations for the Concept of Control over Risks v. Significant People Functions Relevant to the Assumption and/or Management of Risks*

Article 9 of the OECD Model endorses the arm's length principle for pricing transactions between associated enterprises. The revised OECD Transfer Pricing Guidelines[122] state that the application of the arm's length principle requires a comparison of the related party transaction with comparable uncontrolled transactions. The two steps of this analysis are to (1) identify the commercial or financial terms between related parties and the economically relevant aspects attached to such terms in order to properly delineate the related party transaction and (2) undertake a comparability analysis to compare the controlled transaction with uncontrolled transactions.[123] In the context of accurately delineating the transaction, the revised OECD Guidelines state that returns will be allocated to an entity if that entity controls the risk and has the financial capacity to bear the risks.[124] Control over risk involves:

(1) the capability to make decisions to take on, lay off or decline a risk-bearing opportunity, together with the actual performance of that decision-making function; and
(2) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.[125]

Significantly, the revised guidance clearly states that (3) 'the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation'[126] is not necessary in order to have control over the risks.[127] In other words, day-to-day risk mitigation functions are not necessary for attributing risks to a party.

On the other hand, under the authorized OECD approach, assumption of risks by a PE depends on the significant people functions carried out by the PE's personnel at the PE location.[128] Significant people functions relevant to risk assumption 'are those which require active decision-making with regard to the acceptance and/or management (subsequent to the transfer) of those risks'.[129]

The question arises as to whether the risk allocation framework for the purpose of Article 9 and Article 7 of the OECD Model are similar. The OECD discussion draft on profit attribution states, 'While there may be functions that would be considered both significant people functions for the attribution of risk for the purposes of the AOA and risk control

**Notes**

[116] For a comparison of the two versions, *see* e.g. A. Wintsch, *Attribution of Profits to Permanent Establishments: The 2008 Article 7 Versus the 2010 Article 7 of the OECD Model*, 24(5) Int'l Transfer Pricing J. 51 (2017).

[117] The provision provided for deduction of expenses for purposes of the PE, whether incurred in the PE State or elsewhere. This provision was deleted, as it could have been argued that the rule is an exception to the arm's length principle in the sense of limiting the deductibility of certain charges. Wintsch, *supra* n. 116, para. 2.4.1.

[118] The provision allowed states to allocate profits to a PE using an apportionment method based upon various formulae up to the extent it was customary in that state. Wintsch, *supra* n. 116, para. 2.4.2.

[119] Under the provision, profits could not be attributed to a PE that performed purchasing functions for the head office. Wintsch, *supra* n. 116, para. 2.4.3.

[120] *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (2011).

[121] *Ibid.*, Art. 7(1).

[122] OECD, *Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administrations 2017* (OECD 2017).

[123] *Ibid.*, para. 1.33.

[124] *Ibid.*, para. 1.60.

[125] *Ibid.*, para. 1.65.

[126] *Ibid.*, para. 1.61.

[127] *Ibid.*, para. 1.65.

[128] OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 112, paras 15 and 68.

[129] *Ibid.*, para. 22.

functions for the purposes of Article 9, the conclusion cannot be drawn that these two concepts are aligned or can be used interchangeably for purposes of Article 7 and Article 9'.[130] Specifically, the key question that arises is whether active decision-making with regard to risk acceptance and management in the context of the authorized OECD approach includes the afore-mentioned elements (1) and (2) only or elements (1), (2) as well as (3) which have been discussed in the context of the revised OECD Transfer Pricing Guidelines. In other words, do significant people functions include day-to-day risk mitigation functions?

While this position is debatable, for the purpose of the case studies in section 2.3, the authors take the position that significant people functions relevant to risk assumption include elements (1) and (2)[131] only. Nevertheless, the outcome when they include day-to-day functions is also discussed.

## 2.3 *Impact on Digitalized Business Models*

### 2.3.1 *Introductory Comments*

This section considers the impact of the BEPS Action 7 amendments on two key digital business models, namely online retailers and online advertisers. The impact for each model, along with the related profit attribution issue, will be illustrated through a case study.

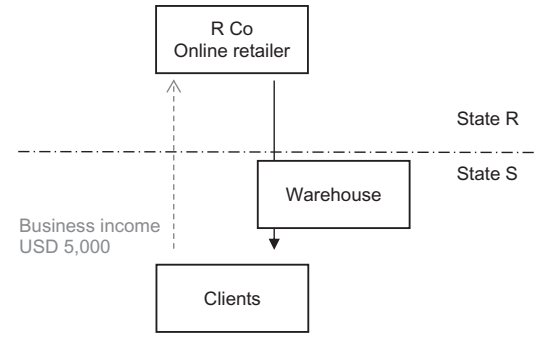
### 2.3.2 *Online Retailer Operating in the Market Jurisdiction Through a Local Physical Warehouse*

#### 2.3.2.1 Facts

Online retailers could sell either physical goods or digitalized goods (such as e-books, videos and downloadable music) through the Internet.[132] The focus of this section is on online retailers selling physical goods (that are owned by the them) through a local warehouse, as the sale of digitalized goods may not require any physical presence in the market jurisdiction.[133]

Consider the following example (Figure 2). An online retailer, *R* Co, situated in State *R*, sells goods through an online platform in State *S* (the total sales generated in State *S* amount to USD 5,000). The customers (individuals and business owners) from State *S* log on to the website (developed by *R* Co) and place an order for a product. The product is then delivered to the customer from a warehouse that *R* Co operates directly in State *S*. The warehouse, which is operated by several employees, is used only for the purposes of storing and delivering goods to customers. On the other hand, employees of *R* Co take key decisions and perform the necessary functions related to intellectual property development and management; technology development; buying products from third parties for resale; manufacturing own products for sale; overseeing storage and delivery activities; global marketing and sales and after sales services.

*Figure 2: The Case of Online Retailer Operating in the Market Jurisdiction Through a Local Physical Warehouse*




#### 2.3.2.2 Permanent Establishment in the Market Jurisdiction

Under the old version of Article 5(4), it was argued that even though a fixed PE place were constituted under Article 5(1), the exemption of Article 5(4)(a) would apply, as the provision states 'the term "permanent establishment" shall be deemed not to include: (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise'. Accordingly, *R* Co did not have a PE in State *S*.[134] However, under the new

Notes

[130] OECD, Discussion Draft, *BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments* para. 17 (OECD 22 June 2017). *See also i OECD, Additional Guidance on the Attribution of Profits to Permanent Establishments* (OECD March 2018) para. 40.

[131] The issue has also been raised by other authors. *See* J. F. Dutriez, *Attribution of Profits to a Permanent Establishments of a Company engaged in Online sale of Goods Through a Local Warehouse*, 25(3) Int'l Transfer Pricing J., section 3 (2017). *See also* P. Drobnik, *The Attribution of Profits to a Depednent Agent PE - If the Dependent Agent PE is a Commissionaire (Wholly Owned Subsidiary) of the Principal*, 25(3) Int'l Transfer Pricing J., section 7 (2018).

[132] OECD, *Action 1 Final Report, supra* n. 1, para. 111.

[133] Online retailers selling digitalized goods often have no physical presence in market jurisdictions. Thus, they may not create a PE in that jurisdiction. However, if such retailers operate through a local server in a market jurisdiction, a PE may get triggered. OECD, *Model Tax Convention on Income and on Capital 2014 (Full Version), supra* n. 40, at C(5)-24, paras 42.2–42.10. However, the 'server PE' raises profit allocation issues, as significant people functions may not be performed therein. In situations where significant people functions are not performed at the level of the server PE, the profits allocated to the PE would be negligible. OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 112, para. 66. This conclusion holds true for other online businesses too.

[134] This position was not accepted by a court in Japan. A US-based taxpayer operating an enterprise, as an individual, sold automobile parts to Japanese customers through websites. To do so, the parts were stored, packed and shipped by employees located in the United States to an apartment and a warehouse rented by the enterprise in Japan. Arguably, under the old Art. 5(4), the activities in Japan should have fallen within the scope of Art. 5(4)(a) or (b) of the OECD Model. However, the Tokyo Regional Court

wording that is reflected in Article 13(2) of the MLI (i.e. Option A), such activity will trigger a PE as 'the term "permanent establishment" shall be deemed not include: (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise … provided that such activity of the fixed place of business, is of preparatory or auxiliary character'. The Commentary on Article 5 of the OECD Model confirms this position.[135]

#### 2.3.2.3 Attribution of Profits to the Permanent Establishment

In the context of the case at hand, applying the two-step approach put forward by the authorized OECD approach will lead to the conclusion that:

- under the first step, the PE of the online retailer will be hypothesized (characterized) as a taxpayer that is carrying out warehousing activities which entail providing storage and delivery services to the head office. These functions could be considered to be routine in nature, as the key decisions associated with them are performed at the level of the head office; and
- under the second step, the PE must be remunerated on an arm's length basis for its storage and delivery activity by reference to transfer pricing principles.

Assume that the following expenses are incurred in State *S* for the storage and delivery activity:

- the salary of the employees engaged in the warehousing activity (storage and delivery) amount to USD 40;
- the cost for delivering the products through independent service providers (i.e. courier or post) is USD 10;
- the warehouse is rented for USD 40; and
- other operating costs related to the warehouse amount to USD 10.

Furthermore, a comparability analysis indicates that independent storage and delivery service providers in State *S* operate on a total operating cost-plus basis of 10%.[136] Taking into consideration these facts, the profits attributable to the PE, are as follows (Table 1):

*Table 1 Attribution of Profits to the PE that Performs Storage and Delivery Activity*

| *Particulars* | *Profit and Loss Account of the PE* |
|---|---|
| **Income**[*] | **110**[*] |
| Salary | 40 |
| Delivery costs | 10 |
| Rent | 40 |
| Other operating expenses | 10 |
| **Expenses** | **100** |
| **Profit**[†] | **10**[†] |

[*]The amount that *R* Co would have paid to an independent enterprise performing similar storage and delivery activities

[†]A return of 10% on total operating costs which can be considered to be at arm's length in light of operating margins earned by independent comparable service providers.

Even though a PE arises and profits are attributed to the PE, by reference to the transactional net margin method,[137] the market jurisdiction will not be able to tax a significant portion of the sales revenue derived by the online retailer. This is because, under the authorized OECD approach, the profits attributed to the PE will be limited to the activities carried out by the PE, namely storage and delivery activities as opposed to the activities that generate sales. Nevertheless, it could be argued that the profit split method should be applied to this case, as the warehousing activity represents a high value added activity that involves making unique and valuable contributions. However, if the employees in the head office make/perform the key decisions associated with all the activities in the value chain, especially with respect to storage and delivery, the profit split method should not be applied.[138] Put differently, the day-to-day risk mitigation functions performed at the level of the PE cannot be considered to constitute significant people functions relevant to the assumption of risks (storage and delivery risks). On the other hand, if it is argued that significant people functions include day-to-day functions, the risks associated with those day-to-day activities could be allocated to the PE (storage and delivery risks), even if the risks are controlled at the level of the head office.

**Notes**

held that the exceptions listed in that provision should be of 'preparatory or auxiliary character', which was not the case, as the storing of such parts in Japan was essential for conducting the business. Moreover, the Court held that Art. 5(4) of the OECD Model provided a list of examples and was thus not exhaustive. N. Oka, *Court Ruling on Whether the Warehouse of an Online sales Business Constitutes a Permanent Establishment*, 23(3) Int'l Transfer Pricing J. 250 (2016).

[135] OECD, *Action 7 Final Report, supra* n. 4, para. 13. *See also* OECD, *Model: Commentary on Article 5, supra* n. 80, paras 62–64.

[136] A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. OECD, *Transfer Pricing Guidelines, supra* n. 122, paras 2.93 & 2.98–2.102.

[137] OECD, *ibid.*, paras 2.64–2.105.

[138] OECD, Discussion Draft, *BEPS Action 10: Revised Guidance on Profit Splits* paras 12–27 (OECD 22 June 2017). For a discussion of a case where the profit split method should apply, *see* Dutriez, *Attribution of Profits to a Permanent Establishments of a Company engaged in Online sale of Goods Through a Local Warehouse*, *supra* n. 131, para. 4.2.

Therefore, the PE should be entitled to a higher profit attribution by resorting to the profit split method. There is no doubt that this position is debatable.

### 2.3.3 *Online Advertisers Operating in the Market Jurisdiction Through a Related Local Marketing Service Provider*

#### 2.3.3.1 Facts

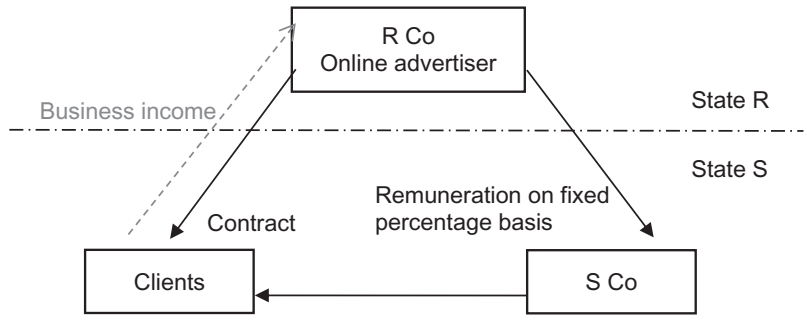
Online advertisers typically assist their customers to advertise their product/service on the Internet in order to attract potential buyers.[139] The focus of this section is on online advertisers that operate in the market jurisdiction through a related marketing service provider (associated intermediary).[140] This is because online advertisers that do not operate with agents (employees or associated enterprises) in the market jurisdiction may not create a PE therein.[141]

Consider the following example (Figure 3): *R* Co, a company resident in State *R*, provides targeted online advertising services to its clients on its social network website. *S* Co, resident in State *S* and an associated enterprise, enters into a marketing/sales service contract with *R* Co. Pursuant to this agreement, *S* Co markets the online advertising services of *R* Co to potential clients. Essentially, the employees of *S* Co play an active role to convince prospective clients to acquire *R* Co's online advertising services. When the client agrees to buy the online advertising service, the employees of *S* Co indicate the price at which the service will be provided. However, the employees clearly state that the client will have to enter into a contract with *R* Co (via an online medium such as email). For its sales services, *S* Co is remunerated on a fixed percentage basis (5% of the sales it generates).[142] On the other hand, employees in *R* Co take key decisions and perform the necessary functions related to intellectual property development and management, technology development, establishing users for the social network through active promotion, social network platform management, client advertising as well as global marketing and sales (including overseeing marketing and sales activities of *S* Co).

#### 2.3.3.2 Permanent Establishment in the Market Jurisdiction

Under the old wording of Article 5(5), it is argued that *R* Co did not have a PE in State *S*, as *S* Co (through its employees) did not have the authority to conclude contracts in the name of *R* Co. For instance in a recent French case, the Court held that the marketing activities of the local subsidiary did not constitute a PE for the non-resident under the Ireland-France tax treaty (1968).[143] However, under the new wording that is

*Figure 3: The Case of Online Advertisers Operating in the Market Jurisdiction Through a Related Local Marketing Service Provider*




**Notes**

[139] OECD, *Action 1 Final Report, supra* n. 1, para. 136.

[140] It is assumed that the intermediary in this case is a taxpayer that would qualify as an 'associated enterprise' for the purpose of Art. 9 of the OECD Model. Therefore, the analysis in this section excludes the situation wherein the intermediary does not qualify as an 'associated enterprise' (e.g. when it is an employee of the foreign enterprise). For the meaning of the term 'associated enterprise', *see* OECD, *Transfer Pricing Guidelines, supra* n. 122, at 17, para. 11.

[141] E.g. India: *Right Florists Pvt. Ltd. v. ITO* (Case ITA 1336/Kol./2011) (12 Apr. 2013); India: *Publimatic India Pvt. Ltd. v. Department of Income Tax* (Case ITA 7044/Mum/2011) (18 Aug. 2011).

[142] OECD, *Action 7 Final Report, supra* n. 4. *See also* OECD, *Model: Commentary on Article 5, supra* n. 80, para. 90.

[143] France: *Google Ireland Limited v. Administration générale des finances publiques* (Case 1505113/1-1) (12 July 2017). Moreover, in the Indian *Ebay* case, a Swiss resident taxpayer operated with two group companies in India. The Indian companies provided marketing and support services to the Swiss company. While the Swiss company was not considered to have a PE in India, the Indian authorities concluded that the taxpayer's income was taxable in India as 'fees for technical services'. India: *eBay International AG v. ADIT* ITA (Case 6784/M/2010) (21 Sept. 2012).

reflected in Article 12(1) of the MLI, *R* Co would trigger a PE in State *S*, as *S* Co is acting on its behalf and 'in doing so, … habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts' are 'in the name' of *R* Co or are for 'provision of services' by *R* Co.[144] The Commentary on the OECD Model provision confirms this position.[145]

#### 2.3.3.3 Attribution of Profits to the Permanent Establishment

In this case, *S* Co is a dependant agent enterprise and the PE of *R* Co is a dependant agent PE (DAPE). Consequently, Article 9 of the OECD Model[146] would apply to test whether or not the conditions/prices between *R* Co and *S* Co are at arm's length.[147]

If an accurate delineation of the transaction through a proper functional analysis[148] indicates that the 'contractual assumption of risks' and the 'actual conduct' coincide,[149] in the sense that *R* Co 'controls' and has the 'financial capacity'[150] to assume economically significant risks (such as risks associated to sales and marketing as well as credit and collection activities), *R* Co will be attributed those risks. On the other hand, *S* Co would be attributed limited operational risks associated with the marketing/sales activity. In these circumstances, *S* Co will be characterized as a taxpayer that provides routine marketing and sales services. Consequently, it will be treated as the tested party for undertaking a transfer pricing analysis, given its 'least complex' profile.[151]

Assume the following numerical facts in the example. The total sales generated by *S* Co in State *S* on behalf of *R* Co amount to USD 10,000. As *S* Co is compensated on a fixed percentage on sales basis (5% on sales), its compensation amounts to USD 500. Moreover, assume that the total operating expenses incurred by *S* Co (including the salaries of the employees engaged in the marketing activities) amount to USD 400. Consequently, as shown in Table 2A, *S* Co operates on a 25% return on its total operating costs.[152] Furthermore, a comparability analysis indicates that independent marketing/sales service providers in State *S* also operate on a 25% return on their total operating costs. Accordingly, the remuneration derived by *S* Co, by applying the transactional net margin method,[153] can be considered to be at arm's length.

Nevertheless, it could be argued that the profit split method should be applied to this case, as the activities of *S* Co represent a high value added activity that involves making unique and valuable contributions. However, if the employees in *R* Co make/perform the key decisions associated with all the activities in the value chain, especially with respect to sales and marketing, in the authors' opinion, the profit split method should not be applied.[154]

*Table 2A Profit and Loss Statement of* S *Co (Dependant Agent)*

| *Particulars* | *Profit and Loss Account of* S *Co* |
|---|---|
| **Service fee received from *R* Co*** | **500*** |
| Total operating expenses (salaries, rent, others) | 400 |
| **Profit†** | **100†** |

*represents remuneration of 5% on sales

## Notes

[144] OECD, *Action 7 Final Report, supra* n. 4, at 16, new Art. 5(5).

[145] OECD, *Action 7 Final Report, supra* n. 4. *See also* OECD, *Model: Commentary on Article 5, supra* n. 80, para. 90.

[146] OECD, *Model Tax Convention on Income and on Capital 2014 (Full Version), supra* n. 40, Art. 9. *See also* OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017, supra* n. 40, Art. 9.

[147] OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 112, para. 230; OECD, *Action 7 Discussion Draft*, *supra* n. 130, para. 11. *See also i* OECD, Additional Guidance on the Attribution of Profits to Permanent Establishments, supra n. 130, para. 34.

[148] OECD, *Transfer Pricing Guidelines, supra* n. 122, paras 1.51–1.55.

[149] OECD, *Action 7 Discussion Draft*, *supra* n. 130, para. 13. *See also ibid.,* para. 36.

[150] OECD, *Transfer Pricing Guidelines, supra* n. 122, paras 1.60–1.109.

[151] *Ibid.*, paras 3.18–3.19.

[152] A return on total operating costs can be considered to be an appropriate profit level indicator for service oriented transactions. OECD, *Transfer Pricing Guidelines, supra* n. 122, paras 2.93 & 2.98–2.102.

[153] OECD, *ibid.*, paras 2.64–2.105.

[154] OECD, *Action 10 Discussion Draft*, *supra* n. 138, paras 12-27. *See also* OECD, Transfer Pricing Guidelines, *supra* n. 122, paras 12–27. However, in the authors' opinion, the profit split method could be applied to a situation where an accurate delineation of the transaction through a proper functional analysis indicates that the 'contractual assumption of risks' and the 'actual conduct' *do not coincide*, in the sense that S Co performs and *controls* substantial risks rather than *R* Co. In this situation, *S* Co cannot be characterized as a routine marketing service provider. Accordingly, pursuant to Art. 9, *S* Co needs to be remunerated on an arm's length basis for its additional functions, risks and assets that it employs. On this issue, *Olbert and Spengel* also argue that the profit split method could be applied in situations where the local entity in the market State is carrying out high value added activities. Olbert & Spengel, *supra* n. 38, at 34.

[†]A return of 25% on operating costs which can be considered to be at arm's length

On the other hand, as discussed, the two-step approach under Article 7(2) of the OECD Model will apply to determine the profits attributable to the DAPE.[155] To reiterate, the first step involves carrying out a functional and factual analysis in order to hypothesize the PE, i.e. to understand the activities carried out by the PE in light of its significant people functions, assets and risks, and to understand its dealings (transactions) with associated enterprises (including the head office). It could be argued that, under this step, the DAPE does not perform any significant people functions relevant to the assumption of risks. The significant people functions relevant to economically significant risks (such as risks associated to sales and marketing), as accurately delineated under Article 9, are performed and controlled by personnel working in State *R* for *R* Co. Therefore, as the DAPE does not carry out any significant people functions, it should not be attributed any risks, and consequently no profits, as illustrated in Table 2B.[156] Accordingly, it could be argued that once the intermediary has been compensated on an arm's length basis, there would not be further income attribution to the DAPE.[157]

*Table 2B Profit and Loss Statement of DAPE*

| | | *Notes* |
|---|---|---|
| **Particulars** | Profit and loss account of DAPE | The DAPE does not perform any significant people functions |
| **Sales** | **0** | |
| **Expenses** | **0** | |
| **Profit** | **0** | |

However, if one applies the approach followed by the recent OECD Action 7 Discussion Draft (2017) on profit attribution, different results could arise. The discussion draft[158] states that the profits attributable to the DAPE are equal to sales to third-party customers,[159] as reduced by (1) the amount that *R* Co would have received from the DAPE for selling the advertising space, (2) the amount that *R* Co would have received as compensation for other activities carried out for the purpose of the DAPE[160] and (3) arm's length remuneration of *S* Co. As discussed, the information with respect to the sales to third parties and arm's length remuneration of *S* Co is already available. Moreover, assume that the other expenses incurred by the head office on behalf of the PE amount to USD 100 (*see* Table 2C).

*Table 2C Profit and Loss Statement of the DAPE*[161]

| *Particulars* | | |
|---|---|---|
| **(A) Sales to third-party customers as reduced by** | | **10,000** |
| (1) | Purchase of services from head office | ?? |
| (2) | Other expenses incurred by head office for the PE | 100 |
| (3) | Arm's length remuneration of *S* Co | 500 |
| **(B) Total operating expenses** | | **??** |
| **(C) Profit (loss)** | | **??** |

The question arises as to how one interprets and calculates (1), which represents the amount that *R* Co would have received if it had sold the advertising space to an 'unrelated party performing the same or similar activities under the same or similar conditions [that *S* Co] performs on behalf of [*R* Co] in Country *S* (attributing to such party ownership of the assets of [*R* Co] related to such functions, and assumption of the risks related to such functions)'.[162] The footnote in the Action 7 Discussion Draft (2017) states that this 'is conceptually equivalent to the amount paid by the PE for the rights to the advertising space from [*R* Co]. This would correspond to a "dealing" under the [authorized OECD approach]'.[163]

## Notes

[155] OECD, *Action 7 Discussion Draft*, *supra* n. 130, para. 11. *See also ibid.,* para. 34.

[156] OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 112, paras 233–244.

[157] Several commentators agree with this position. *See* e.g. P. Baker & R. Collier, *IFA Cahiers 2006 – Volume 91b. The Attribution of Profits to a Permanent Establishment*, General Report, at 21 (2006). Moreover, the issue has been litigated on several occasions in India. The Mumbai and Delhi High Courts are of the opinion that once the dependent agent is remunerated on an arm's length basis, the tax liability of a foreign company in India is extinguished. Thus, no further profits are to be attributed to the DAPE. E.g. India: *SET Satellite (Singapore) Pvt. Ltd. v. Deputy Director of Income-Tax* (Case IT Appeal 994 of 2007) (22 Aug. 2008); India: *BBC Worldwide Ltd v. DY Director of Income* (Case ITA 1188 (Del)/06) (15 Jan. 2010).

[158] OECD, *Action 7 Discussion Draft*, *supra* n. 130, para. 30.

[159] *Ibid.*, para. 30, fn. 8.

[160] *Ibid.*, para. 30, fn. 10.

[161] The table has been created in light of the recent discussion draft issued by the OECD. *i* OECD, Additional Guidance on the Attribution of Profits to Permanent Establishments, supra n. 130 para. 30, fn. 9.

[162] OECD, *ibid.*, para. 25. *See also ibid.,* para. 67.

[163] OECD, Action 7 Discussion Draft, supra n. 130 para. 25, footnote 6.

The framing of these sentences seems to be rather confusing. It could be argued that the DAPE, as an unrelated party, would pay USD 10,000 to purchase the advertising space (the amount at which it is sold to the third party), as it does not perform any additional functions (other than the functions for which *S* Co has already been remunerated). If one follows the approach of the Discussion Draft, a reasonable argument could be made that the attribution exercise leads to the conclusion that the DAPE will be attributed a loss (*see* Table 2D).

*Table 2D Profit and Loss Statement of the DAPE*

| *Particulars* | | |
|---|---|---|
| **(A) Sales to third party customers as reduced by** | | **10,000** |
| (1) | Purchase of services from head office | 10,000 |
| (2) | Other expenses incurred by head office for the PE | 100 |
| (3) | Arm's length remuneration of *S* Co | 500 |
| **(B) Total operating expenses** | | **10,600** |
| **Profit (loss)** | | **(600)** |

On the other hand, another reading of the sentences could lead to the conclusion that (1) the functions performed by *S* Co such as day-to-day marketing/sales, which would constitute significant people functions, should be attributed to the DAPE, and consequently (2) all risks associated with those functions should be attributed to the DAPE, irrespective of the place where they are performed. If this approach were followed, the functions performed at the level of the head office and the associated risks (marketing or sales related risks) could be attributed to the DAPE. This would, thus, enhance the profits attributable to the DAPE. There is no doubt that this position is debatable.

### 2.4 *Summary: The Key Lessons from BEPS Action 7*

Not all signatories of the MLI adopted the revised versions of Article 5(4), (5) and (6). It is thus clear that states have not implemented Action 7 on a uniform basis. A first red flag emerges which indicates that changing the PE definition may not be a suitable proposition for all.[164] Second, even for states that adopted the amendments, the issue of profit attribution persists. Specifically, with respect to digital business models, online retailers (sellers and re-sellers) that operate through local warehouses will no longer be able to argue that a PE does not arise in the market jurisdiction. Even if a PE arises, the taxable profit in the market jurisdiction will be restricted to the limited functions performed by the PE, namely storage and delivery activities. Moreover, online advertisers (and any other digital businesses) that operate through related marketing intermediaries in the market jurisdiction could trigger a DAPE therein. However, as illustrated, it could be argued that once the related intermediary is compensated on an arm's length basis, there should not be further profit attribution to the PE.[165] The analysis rests on the premise that the market jurisdiction follows the authorized OECD approach and considers that the concept of 'significant people functions' relevant to risk assumption for the purposes of Article 7 of the OECD Model is similar to the concept of 'control over risk' relevant to risk allocation for the purpose of Article 9 of the OECD Model.[166] On the other hand, if the concept of 'significant people functions' include day-to-day risk mitigation functions, it could be argued that the risks associated with these functions should be allocated to the PE even though they are controlled at the level of the head office, and consequently, the PE would be entitled to additional income. Thus, the tax outcome would depend on how one interprets the concept of significant people functions. Thus, a second red flag emerges with regard to profit attribution.

## 3 THE NEW NEXUS AND PROFIT ALLOCATION RULES

### 3.1 *The Current State of Play for Taxing Digital Business Models*

#### 3.1.1 *Defining Nexus for Digitalized Businesses*

In order to ensure market state taxation of digital businesses that operate on a remote basis, commentators have expressed the opinion that the concept of a digital or a virtual PE should be introduced. For example Pistone and Hongler make a commendable proposition, stating follows:

> If an enterprise resident in one Contracting State provides access to (or offers) an electronic application,

**Notes**

[164] *See* OECD, *2018 Interim Report, supra* n. 1, paras 273–274.

[165] *See also* Committee of Experts, *supra* n. 5, paras 43–44.

[166] Petruzzi & Holzinger also discuss that allocation of risks and returns for the purpose of Arts 7 and 9 should be similar in the post BEPS world. R. Petruzzi & R. Holzinger, *Profit Attribution to Dependent Agent Permanent Establishment in a Post-BEPS Era*, 9(2) World Tax J. 263, 294 (2017). *See also* K. Dziurdz, *Attribution of Functions and Profits to a Dependent Agent PE: Different Arm's Length Principles Under Articles 7(2) and 9?*, 6(2) World Tax J. 135, 138 (2014).

> database, online marketplace, storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum.[167]

Furthermore, among several solutions discussed in the BEPS Action 1 Final Report, the OECD suggested the introduction of a significant economic presence test for digital businesses. This test proposes to create a new nexus based on either revenue, digital or user related factors, or a combination thereof.[168] The EU Commission, as a long-term solution, has also put forward a similar proposal to introduce a Digital PE. According to this proposal, a Digital PE arises in a Member State when the digital services provided through a digital interface either (1) exceeds a revenue threshold (Euro 7,000,000) or (2) the number of users availing the digital services exceeds 100,000 users or (3) the number of business contracts for digital services concluded by users in a Member State exceeds 3,000 contracts.[169]

### 3.1.2 *Allocation of Profits to the New Nexus*

#### 3.1.2.1 Modifying the Existing Attribution of Profits Framework (AOA Approach)

As discussed (*supra* section 2.3), under the current framework, profit attribution to a PE depends on physical factors in the market state such as significant people functions performed in the PE or for the PE in the PE state or assets located in the PE state. If the non-resident enterprise does not have such physical affiliation, the income attributable to the PE may be negligible.[170] Thus, alternate options may have to be considered to attribute profits to the digital PE or the significant economic presence.

In this regard, Pistone and Hongler suggest a modification of the existing profit split method with an upfront allocation of a partial profit to the market jurisdiction. Specifically, they assert that the market jurisdiction will receive an upfront allocation of one third of the profit following the relation between domestic and overall revenues. Thereafter, the balance of two thirds will be split on the basis of existing transfer pricing principles.[171] Pistone and Hongler do not substantiate the reason for allocating one third of the profit to the market jurisdiction,[172] nor do they discuss how the current transfer pricing principles should be used to split two thirds of the profits.

On the other hand, the OECD states that several adjustments to the existing principles were considered to allocate profits to the new significant economic presence nexus. For example, depending on the circumstances, the significant economic presence could be allocated business functions handled remotely through automated systems (typically, in cloud computing businesses that do not rely on active user participation) or the customers and users could be considered to perform certain functions on behalf of the non-resident enterprise[173] (typically, in multi-sided business models that rely on active user participation). Overall, changes will need to be made to the authorized OECD approach if the new nexus is introduced in the form of a significant economic presence PE, and clarifications will have to be made as regards both steps of the authorized OECD approach, in particular as to whether automated functions or functions related to users/customers or data gathered from such users/customers can constitute significant people functions.

In fact, with respect to profit attribution to the significant digital presence, the EU Commission's proposal states that under the first step of the authorized OECD approach, a functional analysis needs to be performed. In this regard, it is stated that 'In order to determine the functions of, and attribute the economic ownership of assets and risks to, the significant digital presence, the economically significant activities performed by such presence through a digital interface shall be taken into account. For this purpose, activities undertaken by the enterprise through a digital interface related to data or users shall be considered economically significant activities of the significant digital presence which attribute risks and the economic ownership of assets to such presence'.[174] In other words, functions, assets and risks

**Notes**

[167] P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, IBFD Working Paper 1, 3 (2015).

[168] OECD, *Action 1 Final Report, supra* n. 1, at 107–111.

[169] *See* European Commission, *supra* n. 27. *See also* European Commission, European Commission, *Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, supra* n. 59, art. 4(3).

[170] E.g. Hongler & Pistone, *supra* n. 167, at 2.

[171] *Ibid.*, at 34–35.

[172] *Ibid.*, at 34.

[173] OECD, *Action 1 Final Report, supra* n. 1, at 111–112. Another approach that was considered pertains to replacing a functional analysis with a bargaining power analysis that is based on game theory principles.

[174] *See* European Commission, *supra* n. 27, art. 5(3)

that relate to data or users in the market State shall be attributed to such a digital PE even if all these activities are performed at the level of the head office. Moreover, the profit attribution principles should take into account the development, enhancement, maintenance, protection and exploitation of intangible assets. Furthermore, with respect to the second step, it is stated that taxpayers should use the profit split method to allocate profits to such a digital presence unless and until the application of another method is put forward. It is indicated that further guidance on such rules will be developed in the due course of time.[175]

### 3.1.2. 2Deemed Profit Mechanism

Another approach that was dealt by the OECD relates to a deemed profits mechanism. This method, initially, deems the significant economic presence to be equivalent to a physical presence from which the non-resident enterprise is operating a business. Thereafter, the method determines deemed net income of the significant economic presence by applying a ratio of presumed expenses to the non-resident enterprise's revenue derived from transactions concluded with customers in the market jurisdiction. Notably, the OECD states that the ratio could be determined on the basis of a number of factors, such as by making references to industry profit margins of domestic taxpayers. For example an online advertiser (non-resident enterprise) could be classified under the advertisement industry and its nexus (significant economic presence) would be allocated profits on the basis of profit margins derived by comparable advertisement businesses in the market state. Thus, a comparability analysis would be required.

While the approach could be easy to administer, it is acknowledged that it may be difficult to ascertain industry-specific presumptive profit margins for taxpayers operating in many lines of business. Moreover, several expense-related adjustments might be required to the industry margins, especially when the comparable businesses consist of traditional businesses.[176]

### 3.1.2. 3 Formulary Apportionment

The OECD also discusses a formulary apportionment mechanism. The mechanism aims to apportion the profits of the whole enterprise to the significant economic presence, either on the basis of a predetermined formula or on the basis of variable allocation factors determined on a case-by-case basis.[177] However, the OECD states that such an option is not desirable, as it departs significantly from current international tax policy standards.[178]

## 3.2 *Perspective of the Authors: New Nexus and Profit Attribution Rules for all Enterprises*

In order to appropriately tax the profits of digital business models, Olbert and Spengel argue that the OECD Transfer Pricing Guidelines need to be amended. Essentially, they propose that a proper functional or value chain analysis needs to be carried out to understand the roles and responsibilities of all the entities in the multinational group.[179] In particular, they stress that when the staff of the related local entity carries out core value adding functions for digital businesses (software or sales related functions), those functions cannot be considered to be routine in nature. Consequently, as high value added functions are performed, the profit split method should be applied to split the profits between the local entity and the non-resident entity. Thus, the taxpayer in the market state should be compensated appropriately. By following such an approach, the market state can tax additional income.[180] While such an approach is more than welcome, the issue still remains as to how digital businesses are to be taxed that operate on a remote basis, i. e. without any market state presence in the form of related local entities or activities.

One of the policy options is to create a new nexus in the form of a digital PE or significant economic presence PE for digital businesses, in particular, highly digitalized businesses.[181] However, in the present authors' opinion,

**Notes**

[175] *See* European Commission, *supra* n. 27, Art. 5(3) to Art. 5(5). *See also* HM Treasury, *Corporate Tax and the Digital Economy: Position Paper Update* (Mar. 2018). On the issue of a possible new nexus and the authorized OECD approach, Petruzzi & Buriak also provide a solution. They firstly argue that the digital PE concept needs to be developed on the basis of '*value creation*'. However, the authors themselves state that such a definition creates tax uncertainty for businesses. Secondly, the authors, by referring to the example of a social network, state that the profits attributable to a digital PE should be based on the difference between the revenues derived from exploiting the data generated from the PE State as reduced by costs associated with data collection and data processing. *See* R. Petruzzi & S. Buriak, *Addressing the Tax Challenges of Digitalization of the Economy – A Possible Answer to the in the Proper Application of Transfer Pricing Rules*, 72(4a) Intl. Transfer Pricing J. (2018).

[176] OECD, *Action 1 Final Report, supra* n. 1, at 112–113.

[177] On that subject, *see* e.g. L. U. Cavelti, C. Jaag & T. F. Rohner, *Why Corporate Taxation Should Mean Source Taxation: A Response to the OECD's Actions Against Base Erosion and Profit Shifting*, 9(3) World Tax J. 352 (2017); R. Avi-Yonah, K. A. Clausing & M. C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, Michigan Public Law Working Paper No. 138 (University of Michigan Law & Economics 2008).

[178] OECD, *Action 1 Final Report, supra* n. 1, at 112.

[179] Olbert & Spengel, *supra* n. 38, at 41. *See also* de Jong, Neuvel & Uceda, *supra* n. 35, at 7.

[180] Olbert & Spengel, *supra* n. 38, at 42.

[181] A selected group of States support this proposal. *See* OECD, *2018 Interim Report, supra* n. 1, para. 389.

that option is loaded with challenges. First, it could be rather difficult to define nexus to capture all digital businesses. For example the proposal put forward by Hongler and Pistone as well as by the OECD, in addition to a revenue threshold, makes reference to monthly individual users. In some digital businesses, users play an active role (social network platforms), while in others, they may not (cloud computing businesses). The question then may arise as to why a user threshold is necessary for the latter type of businesses. Further, as rightly pointed out by the UN, such monthly thresholds could be circumvented and the concepts used in the definition could become obsolete. Also, they 'may not create equity when the different sizes of the population are taken into consideration'.[182] This being said, and as evidenced by the Proposal of the European Commission, nexus rules can surely be designed for selected digital business models on the basis of either revenue or user related factors. Second, and most critically, it is extremely challenging to develop new attribution rules for digitalized businesses. Several options discussed (*supra* section 3.1.2) above could surely be considered on a standalone basis or on a combined basis. Against this background, the most favourable option seems to focus on amending the authorized OECD approach. Nevertheless, as illustrated in the case studies in section 2, the authorized OECD approach is itself unsettled and unclear. Moreover, profit attribution standards are not uniform. Therefore, building new rules on an unstable foundation will surely cause tax uncertainty for businesses and open the doors for tax disputes.

One might also raise the question as to why there should be a new nexus and new attribution rules only for digitalized businesses? If one seeks to move in this direction, should not the new rules apply to 'all enterprises' in a neutral, efficient, simple and certain, fair and equal, as well as flexible manner?[183] The authors agree with this position and have the opinion that national and international tax principles for conventional as well as e-commerce should be the same. Accordingly, new nexus and new attribution rules should be developed for all enterprises and unless and until such new rules are developed we also believe that simpler targeted bilateral solutions should be considered to tax digitalized businesses, in particular, highly digitalized businesses (*see supra* section 4).

With respect to defining a nexus, a reference could be made to the recent Indian approach. To elaborate, India has opted for such an approach and recently introduced a significant economic presence test in its domestic tax law (*supra* section 1.3). The test applies to all enterprises when they exceed either a revenue based or user-based threshold.[184] Therefore, in order to ensure quality between traditional commerce and electronic commerce, new nexus rules could be built on such thresholds.

Secondly, with respect to profit allocation, the rules need to apply in a similar manner for all businesses. At the outset, we would like to state that *'full'* formulary approaches should not be pursued as they conflict with the arm's length standard. A solution needs to be found within the existing arm's length standard by either putting forward a new interpretation or introducing formulary approaches within the standard. The former approach puts forward a new interpretation that the functions, assets and risks performed at the level of the head office in relation to sales made into the PE State could be attributed to the new nexus. In fact, the recent work of the OECD on profit attribution in the context of BEPS Action 7 (*see* section 2.4), although unclear, as well as the work of the EU Commission in the context of the significant digital presence proposal (*see* section 3.1.2) provides a basis to reach this conclusion. The latter approach modifies the arm's length principle and moves from a functions, assets and risks (FAR) analysis to a functions, assets, risks and market (FARM) analysis. This approach takes into consideration demand side factors (such as the market in which sales are made). For instance, the new nexus could be attributed a certain percentage of profits derived from sales into the market jurisdiction. A detailed analysis of these new concepts is outside the scope of this contribution.

## 4 Targeted solution for highly digitalized businesses: A new distributive rule on specified digital services or activities

An alternate solution would involve the introduction of a new distributive rule in tax treaties that would deal with fees for specified digital services or activities. The distributive rule could be developed on the basis of the distributive rules currently found in Article 10 (dividends) or Article 11 (interest) of the OECD Model[185] (2017) or Article 12 (royalties) of the UN Model[186] (2011) or the proposed Article 12A of the forthcoming updated UN Model.[187] A high level overview of the solution is discussed here.

### Notes

[182] Committee of Experts, *supra* n. 5, para. 23.

[183] OECD, *Electronic Commerce: Taxation Framework Conditions*, OECD Publishing, para. 9 (1998). A selected group of States support this proposal. *See* OECD, *2018 Interim Report, supra* n. 1, para. 391.

[184] Clarifications are expected with respect to both thresholds and attribution rules. *See* Government of India, *supra* n. 67.

[185] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017, supra.* n. 40.

[186] *UN Model, supra* n. 120.

[187] Committee of Experts on International Cooperation in Tax Matters, *Proposed Changes to the UN Model Tax Convention Dealing with the Cyber-Based Services*, E/C.18/2014/CRP.9 (27–31 Oct. 2014), at 1–14, para. 4.2.1.

Paragraph 1 of the provision would provide that the residence state may tax income from specified digital services or activities. Paragraph 2, on the other hand, would provide that the source (market) state may tax the income from specified digital services or activities if that income exceeds a certain amount (an amount threshold needs to be put in place). However, the tax so charged *will be the lesser of* either a certain percentage of gross revenues or profits taxed under a net mechanism. The net mechanism will be developed on the basis of deemed profit mechanisms. Paragraph 3 would define the specified digital services or activities that are to be covered by this provision. The authors are of the initial opinion that such a provision should cover digitalized businesses which provide an online marketplace for the sale of goods and services, online services and online solutions such as cloud computing services, in particular, business that provide infrastructure and platforms as a service (IaaS and PaaS). The provision could also be extended to businesses that sell digitalized products through an online platform. Notably, the provision should not cover businesses that own and sell/purchase and resell physical products through an online platform (*supra* section 1.2.1). Paragraph 4 would provide that if the income is connected to a PE, the provisions dealing with business profits take precedence. Paragraph 5 would provide sourcing rules. Finally, paragraph 6 would contain a special relationship provision. The provision could be implemented through bilateral negotiations or the MLI. A detailed analysis of this solution will be presented in a subsequent article.