In pursuit of fair taxation of digital economy

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ABSTRACT:

Digitalisation has given rise to new tax challenges. As a general rule, business profits shall be taxed in the State where the legal entity has a tax nexus. In this sense, the OECD MC states that an entity is subject to tax on its business profits in the country of which it is a resident. At the same time, a non-resident entity may be taxed in a country of which it is a non-resident if it has a permanent establishment (PE) in that country. According to this, a substantial physical presence is required under the current international tax rules to tax business profits.

However, nowadays there is a new way for carrying business and a non-resident company can operate in a State without having physical presence at all in the country. Under the current tax legislation, in most cases this leads to zero taxation in the source State because there is not a substantial physical presence established in that territory. So, the absence of coherent source rules has created opportunities for profit shifting that have been compounded by the phenomenon of globalisation and the fast growth of digitalisation. The problem is heightened where such companies adopt certain strategies that eliminate taxation also in the State of residence.

Following these premises, the OECD has launched the Action Plan on Base Erosion and Profit Shifting (BEPS) in an attempt to realign corporate taxation with the location of actual business activities. Particularly, Action 1 of the BEPS Plan deals with the challenges of digital economy. Besides, Action 7 is aimed at countering the artificial avoidance of a PE status. A careful reading of both Action 1 and 7 Final Reports shows

that the OECD is determined to expand the definition of a PE and adopt a more flexible concept of it. However, except in the case of the changes in the OECD MC regarding the concept of PE, the OECD has not yet suggested the implementation of specific measures to address the broader direct tax challenges raised by the digital economy. Instead, BEPS Action 1 Final Report simply lists different options, making it clear that countries are free to adopt any of them in their domestic laws in a combined manner or chosen individually. But, as we shall see below, the uncoordinated and unilateral actions undertaken by some countries and the work on the different Actions of the BEPS Action Plan are not enough to address this challenge. On this basis, a destination-based corporate tax has been proposed as an adequate alternative to taxing corporations in an international context in order to build a *fair taxation system* (DEVEREUX & DE LA FERIA, 2014; AUERBACH, DEVEREUX, KEEN & VELLA 2017; AVI-YONAH, 2016).

In a similar vein, the recent European Union's response to the broader tax challenges raised by the digital economy shows that today's international corporate tax rules are not appropriate to capture the new business models that make profits from digital transactions in a jurisdiction without having a physical presence on that territory. In this spirit and in the light of the European Commission's Communication of 21st March 2018 *'Fair taxation of the digital economy',* new rules are proposed to ensure that digital businesses are taxed in a fair and growth-friendly way in the EU. Specifically, this package of measures contains two proposals: (1) a long-term solution and, as long as consensus on the long-term solution has not been reached, (2) an interim option.

The first proposal refers to a reform of the EU's corporate tax rules for digital activities to ensure that profits are taxed where businesses have significant interaction with users through digital channels (a **new tax nexus based on the concept of taxable digital presence**, i.e., the introduction of a virtual permanent establishment concept). To

attain this objective, the Commission proposes a Directive laying down rules relating to the corporate taxation of a significant digital presence as well as recommendations to Member States for including changes in their double taxation conventions with third countries.

Meanwhile, an **interim tax on certain revenue from digital activities** is proposed to ensure that activities that are currently not taxed would start to generate immediate revenues for the Member States. For this purpose, the Commission proposes a Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services (the equalisation levy option).

As far as can be ascertained, the OECD and the EU are pulling in the same direction, although it seems that the European Commission has taken a decisive step towards fair taxation of the digital economy. It remains to be seen whether these proposals are successful or fall by the wayside.

I. THE CONCEPT OF DIGITAL ECONOMY AND ELECTRONIC COMMERCE

The revolution of IT has made a tremendous impact on all fields of human endeavour. Digitalisation allows companies to make a better use of resources, with lower costs, which translates into greater benefits.

All the transformations produced as a result of the irruption of ICT are called Information Society. The European Commission (1993) referred to the rising Information Society as a set of social and organisational changes produced as a result of the emergence of new technologies in the fields of information and communication. The Information Society is one of the key factors that contribute to a country's economic growth. In this context, the EU concept of «Information Society Services» (hereafter, ISS) was defined as *"any service normally provided for remuneration, at a distance, by means of electronic*

equipment for the processing (including digital compression) and storage of data, and at the individual request of a recipient of a service" (Recital 17). That said, *Information Society Services are not solely restricted to services giving rise to on-line contracting but also, in so far as they represent an economic activity, extend to services which are not remunerated by those who receive them"* (Recital 18). So, Information Society Services are onerous and are negotiated or concluded by electronic means; in this context, electronic commerce is part of these services[1].

Because of the development of markets, new vocabulary emerged to refer to this economic space: knowledge economy, innovation economy, network economy, e-conomy or digital economy (COHEN, DE LONG & ZYSMAN, 2000). The expression **«digital economy»** was popularised by TAPSCOTT (1994), but one of the first legal approaches to its legal meaning was achieved in a report published by the US Department of Commerce (1998) entitled *The Emerging Digital Economy*[2]. Later, the OCDE (2012) stated that the *"digital economy is comprised of markets based on digital technologies that facilitate the trade of goods and services through e-commerce"*. This way, digital economy and e-commerce are two different concepts, being e-commerce the main drive of digital economy, and despite the fact the two terms are often treated as synonyms.

The European Commission High Level Expert Group on Taxation of the Digital Economy (2014) expressed the difficulties to give a definition of digital economy because

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[1] This concept was introduced by the Directive 2000/31/EC of the European Parliament and the Council of 8 June 2000, on certain legal aspects of Information Society Services, in particular electronic commerce, in the Internal Market ('Directive on electronic commerce') that provides the legal basis for the e-commerce and the ISS.

[2] In this document, digital economy was defined as an intelligent space integrated by information, access to information and information processing, and communication capabilities. On another note, the Australian Government (2009) defined digital economy as *"the global network of economic and social activities that are enabled by information and communications technologies, such as the Internet, mobile and sensor networks"*. Furthermore, the OECD (2011) pointed out that *"an electronic transaction is the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders"*. However, as we will see next, digital goods and services are not addressed adequately under this narrow definition.

of the ever-changing technologies of the ICT sector, in which changes occur quickly and consistently. So, instead of providing definitions that become obsolete in a short space of time, the Expert Group decided to set as the key features of digital economy the following: *mobility*[3], *network effect*[4] from user participation and interaction and *the importance of data*[5].

Action 1 BEPS Final Report (OECD, 2015a) also specifies that the digital economy is *"the result of a transformative process brought by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy".* Additionally, the Final Report refers to the key features of the digital economy, including: *mobility*, with respect to intangibles, users/customers and business functions[6]; *reliance on data and user participation* for the success of operations of the enterprise[7]; *network effects* with respect to the user participation and integration[8]; *the use of multi-sided business models* in which the buyer and the seller are in different

[3] Digitalisation has enhanced mobility of intangible assets and allows companies to reduce core business costs. This makes difficult to delimit the jurisdiction where the economic activity takes place and value is created.

[4] Digitalisation reduces the marginal cost of products and pushes down prices; at this point, competition increases in the quality and utility of the products.

[5] ICT reduces the cost of collecting, storing and analysing data provided by final consumers –sometimes, data of a personal nature- so that companies are enabled to increase competitiveness by meeting individual customer needs.

[6] Mobility opens up many possibilities to assign and transfer intangibles among associated entities, which means that the legal ownership of the assets may be separated from the activities that resulted in the development of the assets. Mobility of users presents several challenges; for instance, the use of virtual personal networks or proxy servers, resulting in difficulties to identify and locate users. The spread of digital economy has also lead to an increasing flexibility of businesses to extend their activities and functions among several locations worldwide.

[7] Business businesses collect data about their customers, users, suppliers and operations. Sometimes it is personal data obtained directly from customers (when they register for an online service). This information collected by businesses from private and public sources is combined to create value improving products and services. The use of data to improve products or services is not an exclusive feature of digital economy, but the massive use of data has been facilitated by an increase of computing power and storage capacity and a decrease in data storage costs. At this point, big data are particularly relevant.

[8] Which means that decisions of users may have a direct influence on the benefit received by the others. These effects are known as positive or negative externalities.

jurisdictions[9]; *tendency toward monopoly or oligopoly[10];* and *volatility* due to low entry and exit barriers[11].

Scholars also pinpointed the basic features of digital economy. BRYNJOLFSSON & KAHIN (2002) said that digital economy is the "largely unrealised transformation of all sectors of economy by the computer-enabled digitisation of information". KLING & LAMB (1999) stated that digital economy "focuses on goods or services whose development, production, sale or provision is critically dependent upon digital technologies". Similarly, ZIMMERMANN & KOERNER (1999) maintain that digital economy is "an economy based on the digitisation of information and the respective information and communication infrastructure"[12]. In essence, all these definitions are based on the same elements: the use of the new information and communication technologies, particularly the Internet; an increase of e-commerce transactions; and digitised goods and services[13].

Moreover, **«electronic commerce»** can be defined as the sale or purchase of goods and/or services whether between businesses, households, individuals, governments

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[9] Different groups of persons (customers and suppliers) interact through an intermediary or platform, and the decisions of one group of persons have an impact on the outcome for the other groups of persons. An example of that is the payment card system: the more consumers use the card, the more valuable this system will be for businesses; and the more merchants accept the card, the more valuable this operating system is for consumers.

[10] Sometimes, network effects may enable a company that takes off in an emerging market to create a dominant position, particularly when Intellectual Property rights are involved, granting the owner the exclusive right to exploit a particular innovation in a specific market.

[11] Even though in the digital economy certain companies may achieve a dominant position in a very short time, substantial investment in R&D must be done in order to maintain and reinforce its position in the market. Also, the acquisition of start-ups with innovative ideas is a key point to maintain the dominant position. In essence, core features of digital economy are the existence of lower barriers to entry to a market, the swift development of technology and the speed with which customers can choose to test new products and services.

[12] On this basis, digital economy incorporates different subsectors: infrastructures and applications – hardware and software-, e-commerce and the appearance of new intermediaries –content developers, malls, Internet portals…- (AGUILA OBRA, et al., 2001)

[13] The phenomenon of digitalisation and the possibility of using distance communication have facilitated a new business model, which does not require the simultaneous physical presence of the parties. Digital economy allows the development of economic relations without a typical business structure or physical presence in order to conduct substantial sales of goods and services in a market jurisdiction. At the same time, the use of digital means in business transactions is highly beneficial because it drastically lowers the cost of operations. In addition, digital economy saves time and helps developing new business opportunities.

and other public or State organisations, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders (OECD, 2011). WESTIN (2007) maintains that any digital transaction exceeding domestic borders falls within the definition of e-commerce. PINTO (2003) opts for a focused definition, whereby electronic commerce means any "commercial transaction involving the production, distribution, sale and delivery of goods and services carried out over open networks like the Internet". In this sense, electronic procurement covers any transaction based on the electronic processing and transmission of data, including text, sound and video. So, e-commerce basically encompasses two types of activities: on the one hand, the electronic ordering of tangible goods that must still be physically delivered to the purchaser by mail and private courier services (indirect electronic commerce); and, on the other hand, the direct electronic commerce, i.e., the online ordering, payment and delivery of intangible goods and services, such as computer software and entertainment content. In short, e-commerce refers to commercial transactions in which the order is placed electronically and the goods or services are delivered either in tangible or digitalised form. In any case, by its very nature, this is a constantly evolving concept.

In this light, e-commerce is a subgroup of the Information Society Services. According to the European Commission communication entitled '*A European initiative in the sector of Electronic Commerce'* (1997), e-commerce refers to "any activity which involves enterprises interacting and doing business with customers, with each other or with administrations, by electronic means". It is about carrying out business transactions by digital means, being interactivity a key feature.

Consequently, the concept of e-commerce is excessively broad and covers either pre-sale and after-sale activities or transactions that take place before or after the contract conclusion, such as advertising, certain information prior to the conclusion of the

contract or after-sales service, amongst others. Well then, only business activities deemed to express economic capacity are relevant for Tax Law. In this sense and for tax purposes, some scholars argue that activities such as advertising shall not be included in the concept of e-commerce (NOCETE CORREA, 2005). Besides that, the more relevant and interesting operations from a tax perspective are the so-called online e-commerce transactions, i.e. transactions completed using interactive digital means. By contrast, the badly named offline e-commerce does not appropriately fit into the e-commerce category, but instead is traditional commerce excluded from the scope of Directive 2000/31/EC, under Article 11.3.

In this regard, when electronic means started being used to conduct business transactions, a re-evaluation of traditional concepts of contract law and a revision of many traditional tax laws and principles became necessary (ASPIS, 2006; COCKFIELD, 2002a; ASOREY & BILLARDI, 2011) Tax systems must evolve to catch new business models and a fair taxation of the digital economy is essential.

As far as the OECD is concerned, the first important steps regarding **taxation of electronic commerce** started with the publication of the report of the Committee on Fiscal Affairs entitled "*Electronic commerce: taxation framework conditions*" (1998). The general tax principles that should be applied to e-commerce transactions were outlined in this document: *neutrality, efficiency, certainty and simplicity, effectiveness and fairness,* and *flexibility.* At that moment, it was revealed that tax havens and offshore financial services would become more widely utilised for tax avoidance or tax evasion purposes.

Previously, the US Department of the Treasury had released a white paper entitled "*Selected tax policy implications of global electronic commerce*" (1996) in which was stated that tax policy in this area should be guided by the principle of *neutrality*,

rejecting the imposition of new or additional taxes on electronic transactions. This report singled out the significant aspects in the field of e-commerce: the identification of the country (or the countries) with a right to tax the income, and the characterisation of the income received (royalties, business income, etc). In parallel, the Electronic Commerce Project Team *"Tax and the internet"* report of the Australian Taxation Office (ATO) of 1997 –followed by a second report in 1999- also contributed to the development of subsequent guidelines issued by the OECD[14] (SPRAGUE & BOYLE, 2001).

The European Union's response to the tax challenges of digital economy was, at first, focused on the area of indirect taxation and, particularly, VAT[15]. But the scope of action has gradually been extended. Following publication of the 2012 *"Action Plan to strengthen the fight against tax fraud and tax evasion",* the European Commission (2012) declared its willingness to cooperate with the OECD to address the complexities of taxing electronic commerce by developing appropriate international standards. In 2013 the Commission set up the High-Level Expert Group of the Digital Economy, aimed at studying the best ways of taxing the digital economy in the EU. The Expert Group presented its Report on 28 May 2014, which focuses on identifying the key problems of digital taxation from the EU perspective and presents a variety of solutions (EUROPEAN COMMISSION, 2014). Furthermore, the 2015 *Action Plan for fair and efficient Corporate Taxation in the EU* (EUROPEAN COMMISSION, 2015) developed in parallel with, and complementary to, the OECD BEPS Action Plan, identifies five key areas for action: (1)

[14] The ATO defined electronic commerce in a very narrow way as "the buying and selling of goods and services on the Internet".

[15] Directive 2006/112/EC –the EU's common system of value added tax- provides the regulatory framework for electronically supplied services. After the successive amendments of this Directive, from 1 January 2015 the rules around the EU VAT place of supply of services changed. From then on, the legal framework of these activities revolves around two main questions: (1) the redefinition of the rules governing the provision of services; and (2) the establishment of special schemes for electronically supplied services – being these rules applicable when a consumer resident or located in a EU Member State buys electronically supplied services online, no matter if the seller is established inside or outside the EU-.

re-launching the Common Consolidated Corporate Tax Base (CCTB/CCCTB); (2) ensuring fair taxation where profits are generated; (3) creating a better business environment; (4) increasing transparency; and (5) improving EU coordination.

On a similar line as BEPS Action Plan approach, the EU *Action Plan on Corporate Taxation* specifies that the current rules for corporate taxation do not fit the modern context. Business profits are taxed at national level, but the economic environment has become more globalised, mobile and digital, enabling companies to shift profits. It must be noted that the expression "fair taxation" or "fair share of taxation" refers to a desire to fight tax evasion and tax avoidance. Actually, it is a subjective term and has to do with everyone making their contribution to society, to the infrastructure and the public services. Fair taxation depends on international cooperation, because that is the only way to prevent that MNEs avoid taxes taking advantage of tax mismatches between domestic tax laws. It is necessary to make sure companies pay their fair share of tax. For that purpose, a rational review of tax concepts is mandatory to bring them in line with the current situation in order to combat tax avoidance and evasion.

II. THE INCIDENCE OF THE OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT IN DIGITAL ECONOMY AND THE EUROPEAN COMMISSION PROPOSALS ON FAIR TAXATION OF THE DIGITAL ECONOMY

Fighting against base erosion and profit shifting by multinational corporations that take advantage of gaps in the interaction of different tax systems has become one of the current priority issues of G20 and OECD countries. The BEPS Action Plan was launched in July 2013, seeking to find the primary cause of base erosion and profit shifting and developing solutions to address multinational companies' aggressive tax strategies. As it reflects, *"the BEPS project marks a turning point in the history of*

international co-operation on taxation" (OECD, 2013). In fact, BEPS Project origin can be traced back to when civil society found out multinational enterprises avoid paying what most citizens would consider fair taxes through tax base erosion and profit shifting, i.e., the relocation of income to low or no-tax jurisdictions far from the territory where the wealth is created and the economic capacity is manifested, leading to a reduction of public revenue. Through BEPS schemes, MNEs shift profits across borders to take advantage of tax rates that are lower than in the State where the profit is made[16]. In this line, the 2013 BEPS Report concludes that *"the tax practices of some multinational companies have become more aggressive over time, rising serious compliance and fairness issues",* and added that *"current international tax standards may not have kept pace with changes in global business practices".* A response is needed to address the problems of profit shifting and base erosion, and BEPS Project is the legal instrument to achieve these objectives.

BEPS project identifies 15 strategic actions focused on various pressure areas to tackle these problems, and makes recommendations aimed at restoring confidence in the tax system and ensuring that profits are taxed where economic activities take place and value is created. The **15 actions** are based on **three key pillars:** *"(1) introducing coherence in the domestic rules that affect cross-border activities; (2) reinforcing substance requirements in the existing international standards; and (3) improving*

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[16] CRIVELLI, DE MOOIJ & KEEN (2015) reveal that the revenue loss from base erosion and profit shifting by MNEs stands at approximately 1% of GDP in OECD member countries, and around 1,3% of GDP in non-OECD member countries. In this regard, the OECD's best estimate indicates that there is a global corporate income tax (CIT) revenue loss of between 4 and 10% of global CIT revenues, equivalent to \$100-240 billion (EUR 81-195 billion) annually (OECD, 2015b). Further still, the 2013 BEPS Report refers to AVI-YONAH and LAHAV research (2011), which reveals that the effective tax rates of MNEs in the US tend to be lower than the effective tax rates of MNEs in the EU, despite the fact that the corporate tax rate in the US is approximately 10% higher than the average corporate tax rate in EU countries. Basing on an estimate of GUVENEN et al. (2017), US MNEs shifted \$280.1 billion (EUR 228 billion) in profits abroad in 2012; considering that the state and federal statutory rate is 40% and being the total US corporate tax revenue around \$327 billion (EUR 266 billion) in 2012, this would mean a loss of revenue of around 34% of the total collected (AUERBACH, DEVEREUX, KEEN & VELLA, 2017). And when multinationals avoid taxation, governments lose revenue, which in turn leads to cut public services and increase taxes on everybody else.

transparency as well as certainty". After two years, the OECD presented the final package of measures, including recommendations to change domestic legislation and practices, a revision to the OECD MC and the development of a multilateral instrument to swiftly implement BEPS project measures in tax treaties. But work does not end up here. Some of the final reports identify certain outstanding issues where further work is required.

The OECD/G20 countries are aware of the tax challenges of the digital economy. Action 1 of BEPS Action Plan *"Addressing the tax challenges of the digital economy"* affirms that the digital economy models ease the artificial shifting of income, the avoidance of the direct tax nexus and the avoidance of VAT (OECD 2015a) In this sense, BEPS Project Action 1 states that the so-called **broader tax challenges** raised by the digital economy are the following: the *taxable nexus*, the *use of data and the respective attribution of value*; *characterisation of income,* and *VAT/GST collection*.

Thus, the Task Force on the Digital Economy (TFDE) –a subsidiary body of the OECD's Committee on Fiscal Affairs- was created in September 2013 to prepare a report identifying problems raised by the digital economy and possible solutions to tackle them. The deadline for an Action 1 interim report was September 2014. The 2014 interim report (OECD, 2014a) was the basis for the 2015 Action 1 Final Report *"Addressing the tax challenges of the Digital Economy"* (OECD, 2015a). That said, not all the recommendations and possible solutions contained in the TFDE interim report were included in the Final Report. The **2015 Final Report** on Action 1 analyses different potential **options** to address the **broader tax challenges** raised by the digital economy, namely: (1) the option to change the exceptions to PE status, to ensure that they are applicable only to preparatory or auxiliary activities; (2) the introduction of a new nexus in the form of a significant economic presence; (3) a withholding tax on certain types of

digital transactions; (4) an equalisation levy; (5) the implementation of the principles of the international VAT/GST Guidelines on cross-border transactions, particularly those between businesses and consumers, considering the introduction of the collection mechanisms included therein. Options 2, 3 and 4 are not recommended by the TFDE at this stage. In any case, countries could introduce any of the options in their domestic regulation as additional guarantees against base erosion and profit shifting, as long as they respect the existing tax treaty obligations.

In a similar way, the **European Commission's Communication** of 21st March 2018 ***'Fair taxation of the digital economy'*** contains a package of measures to ensure that digital businesses are taxed in a fair and growth-friendly way in the EU. The recent EU Commission proposals are consistent with the spirit of some of the OECD suggestions. On the one hand, the Commission proposes the implementation of a **new tax nexus** based on the concept of taxable digital presence (i.e., the introduction of a virtual PE concept). But, and, as long as consensus on this long-term option has not been reached, the Commission proposes the introduction of an **interim tax on certain revenue from digital activities** (the equalisation levy option) to make sure that activities that are currently not taxed would start to generate immediate revenues for the EU Member States.

Since these are the proposals posed by the EU Commission, the following sections will discuss the basic issues relating to its implementation considering the OECD suggestions on these matters. Furthermore, an analysis of some unilateral defensive measures introduced by certain countries to combat the tax challenges of digitalisation will also be presented.

III. AN APPROACH TO SOME OF THE OPTIONS PRESENTED TO ADDRESS THE BROAD DIRECT TAX CHALLENGES POSED BY DIGITAL ECONOMY

1. A new nexus based on the concept of significant economic presence: the digital permanent establishment

A. The significant economic presence test

Among the four available options raised on BEPS Action 1 Final Report to address the broader direct tax challenges of the digital economy, the TFDE only recommends the introduction of modifications to the exceptions from PE status (basically, changes on the preparatory and auxiliary exceptions and amendments on the agency-PE definition). But the fact is that as long as the physical presence requirement within the PE concept remains, the proposed changes on Articles 5(4) and 5(5) OECD MC will not contribute to the attainment of a fair allocation of taxing rights between the State of residence and the market jurisdiction.

Chapter 7 of Action 1 BEPS Final Report addresses the issue of the **nexus** and the ability of a company to have a **significant economic presence** in a market jurisdiction without being liable to tax. As mentioned above, despite not having a physical presence in a territory or a dependent agent therein, a digital company can have a *significant economic presence* in the market jurisdiction.

The new nexus based on a significant presence goes beyond the PE concept. Actually, the new nexus is not aimed at strengthening taxation at source, but to *restore* taxation at the market jurisdiction when activities are linked to its territory. In this sense, in order to avoid an unfair erosion of sovereignty in the market jurisdiction in terms of value created by companies, taxing rights should be recognised to whenever the digital or physical presence of business in a country gives rise to value creation.

This is not a totally new concept. Previously, AVI-YONAH (1997) suggested the re-evaluation of the PE concept in order to make it appropriate for e-commerce transactions and recommended the inclusion of an absolute threshold of sales into a given host jurisdiction (AVI-YONAH, 2013), –which in this case would be $1.000.000 in any given calendar year, according to the in-depth analysis presented by AVI-YONAH and HALABI (2014). In this regard, AVI-YONAH suggested levying a withholding tax (WHT) at the corporate tax rate on the income obtained in source countries that exceeds the said threshold. By doing so, the market jurisdiction would be compensated for the costs borne to support infrastructure through which the non-resident digital company enters and operates in its territory. Conversely, HINNEKENS (1998) suggested a new virtual PE threshold for source-based taxation; under the new nexus, only core or mainstream business activities would be subject to tax in the market jurisdiction, while ancillary activities would not. The virtual PE approach seeks to tax businesses in the market jurisdiction even in the absence of a fixed place of business in that territory (SKAAR, 1991). However, this alternative presents some practical difficulties at the time of attributing profits to a virtual PE, specifically in an e-commerce context. It should also be noted that the OECD Report *'Are the current treaty rules for taxing business profits appropriate for e-commerce?'* (2005) already examined the option of introducing a new nexus of "electronic (virtual) permanent establishment" as an alternative to the current treaty rules for taxing business profits. The virtual PE would be an alternative nexus that would apply to digital transactions[17].

[17] According to the 2005 Report, this could be done in different ways: (1) by extending the PE definition to cover a so-called "virtual fixed places of business PE" through which the enterprise carries on business – the digital equivalent of the traditional PE-; (2) by extending the definition to cover a so-called "virtual agency PE" –the digital equivalent of the dependent agent PE; or (3) by extending the definition to cover a so-called "on-site business presence PE", proposing a new threshold for source taxation which would depend on the economic presence of an enterprise within a jurisdiction in circumstances where the foreign enterprise provides what the proponents of that approach view as on-site services or other business interface

By contrast, there are clearly opposing views on this subject matter, like the US Council for International Business' argument, expressed in the *Comments received on Public Discussion Draft of BEPS Action 1* (OECD, 2014b) but, alongside that, the new nexus based on a significant presence does not contravene the principle of *neutrality*, since the new threshold based on digital presence would not be applied to specific companies, but all companies. As HONGLER and PISTONE (2015) claim, "if the mere introduction of a new nexus were to be regarded as an infringement of the neutrality principle, the current PE definition would also be an infringement of the neutrality principle, as it only affects enterprises operating abroad through a fixed place of business". Anyway, further research is needed to avoid distortions between the real economy and the digital economy. Additionally, the proposal also complies with the principle of *efficiency*, according to which compliance costs for taxpayers and administrative costs for the tax authorities should be reduced as far as possible. Actually, digital presence needs to be significant and a specific threshold may be exceeded for tax liability to arise. According to the principle of *certainty and simplicity*, tax rules should be clear and simple to understand, so that taxpayers know in advance the tax consequences of their operations. The design of a new nexus inevitably involves questions and lead to uncertainties that will have to be addressed appropriately. In accordance with the e*ffectiveness* and *fairness principles,* taxation should produce the right amount of tax at the right time. To this aim, appropriate measures to counteract tax avoidance and tax evasion should be implemented, being a new nexus based on significant presence one of them. Finally, tax systems should not be static, but *flexible* and *dynamic*, to go hand in hand with technological and commercial developments. In

at the customer's location. All of them would require a modification of the PE definition, or the addition of a new nexus rule in tax treaties.

this sense, the new PE nexus must be designed in a flexible way to cover future developments. In the end, the design of a new tax nexus must respect the principles of neutrality, efficiency, certainty, simplicity, effectiveness, justice, flexibility, sustainability and proportionality.

Thus, the significant economic presence is an undefined legal concept that will be determined on a basis of *factors* that reveal a permanent interaction with the economy of a country via technology and other automated tools. Therefore, the *significant economic presence test* takes into consideration the following factors: a revenue-based factor, digital factors and user-based factors. Sales, the frequency of digital transactions, and the number of users are thus the substantive factors that shall be taken into account to establish a nexus based on the concept of significant economic presence. However, the TFDE does not provide for a specific threshold of digital presence. In this respect, the introduction of a new nexus without setting of a minimum amount of revenue may lead to an extreme fragmentation of the worldwide taxable income, creating a remarkable compliance burden for taxpayers and tax administrations. As will be seen, a brief mention on how the threshold shall be determined is not sufficient to meet the proposed objectives.

So, starting with the analysis of the **revenue-based factor**, income obtained within a country is certainly one of the strongest indicators of the existence of a significant economic presence in the country concerned. Revenues cannot be considered in isolation to establish nexus; however, in combination with other factors can be used to establish nexus in the form of a significant economic presence in a country's market. In this sense, the selection of factors that should be combined with the revenue-based factor to test the significant presence of a foreign company in the market jurisdiction shall be done taking into account the features and characteristics of the particular market.

The TFDE provides information regarding technical aspects. Firstly, in defining a

basic revenue factor, it would be preferable to include all revenue generated by operations concluded remotely by a non-resident company with in-country customers. The expression “all revenue generated” covers online transactions –where ordering, payment and delivery of intangible goods and/or services take place in digital form- and offline transactions –where there is an electronic order of tangible goods than can only be delivered by traditional means-. Besides, the threshold should be based on the amount of gross revenue generated, in absolute terms and local currency. Additionally, in order to minimise the administrative tax burden for tax authorities, just as the compliance burden on and level of uncertainty for the taxpayer, the threshold should be set at a high enough level. For that matter, the size of a country’s market can be relevant in setting the level of the revenue threshold. This is important in order to comply with the principles of neutrality and proportionality. Also, in order to prevent any risk of artificial fragmentation of foreign affiliated entities, the amount of gross revenue should be calculated on a related-group basis rather than on a separate-entity basis. The aggregation rule could be implemented as a rebuttable presumption, allowing the taxpayer to demonstrate that there was no artificial fragmentation of activities. Apart from that, Action 1 Final Report suggests the introduction of a mandatory registration system containing sufficient information on determining factors of a significant economic presence.

Secondly, **digital factors** could also be used in order to determine that a non-resident entity has a permanent interaction with the users and consumers of a country. Therefore, a *local domain name* is the digital equivalent of a local physical address. It is fairly common that a foreign enterprise doing substantial cross-border business uses a generic domain name (.com) at its home country and local domain names in each market jurisdiction. The use of local domain names is completely optional but recommended, as it makes easier for users in that country to locate the website and reduces the reputational

risk from domain squatting and trademark infringement. Additionally, the use of a *local website or other digital platform* including relevant linguistic and cultural peculiarities of target audiences is a good way of connecting with local users and customers. The same applies to *prices* of products or services, taxes, duties and fees that usually *appear in local currency* with the option of using a local form of payment –the last option is relevant in countries that have strict banking regulations, currency controls or limited penetration of international credit cards-. All in all, these digital factors reflect the contribution to value of a closer and more intense customer relationship in the digital economy.

And thirdly, due to the importance of network effect in the digital economy, **user-based factors** may reflect the level of participation in the economy of a country. Different alternatives are suggested, specifically: the number of monthly active users[18], the regular conclusion of online contracts[19] and the volume of data collected through the digital platform from users and customers[20].

Once the new nexus is established, the determination of income attributable to the significant economic presence is a key aspect. Existing principles and rules for allocating profits –currently based on an analysis of the functions, assets and risks of the enterprises concerned- require substantive reformulation in the context of the digital economy. In other words, although the current PE definition was amended and even if a new nexus based on the concept of significant economic presence is implemented, if allocation rules

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[18] The *number of monthly active users* (MAU) in a country reflects the level of penetration in a country's economy. This expression refers to the number of registered users who access to a digital platform in a 30-day period. However, it is still difficult to interpret the meaning of an "active" user and identify them adequately. Besides that, the reliability of this indicator decreases when multiple accounts or bot accounts come into play. HONGLER and PISTONE (2015) also suggest that the time spent by users on a specific online platform reflects the level of use of the infrastructure in the market jurisdiction.

[19] The *regular conclusion of online contracts* is another factor that reflects the level of participation of a foreign entity in the economic life of a country. In the context of digital economy, contracts are usually concluded through a digital platform, without the intervention of a dependent agent in the market jurisdiction. On this basis, the regular conclusion of contracts with residents in a given country might be a factor to consider when applying the significant economic presence test.

[20] The variety of data collected includes personal data, as well as user created content, product reviews or search histories. This said, difficulties might arise in the application of this indicator because data collected and stored by businesses are not usually classified on a country-by-country basis.

rely on a physical presence threshold and there is not a major change of the rules for the attribution of profits, no reallocation of income will take place in digital economy (HONGLER/PISTONE, 2015). The TFDE's Final Report analyses the alternative use of methods based on fractional apportionment and modified deemed profit methods.

B. Special mention to HONGLER & PISTONE and AVI-YONAH & HALABI proposals on the new PE nexus

Following publication of Action 1 Final Report, HONGLER and PISTONE (2015) came forward with an innovative proposal supporting the introduction of a new Article 5(8) of the OECD MC. The aim of this new provision is not to strengthen taxation at source or replace the existing rules on the allocation of taxing powers, but to allow the market jurisdiction to preserve its sovereignty on taxation of business profits that have arisen in connection with activities effectively linked to that territory. In other words, it is just about adapting the PE concept to the new era of digital economy and taking in consideration the evolution of the PE towards a new PE nexus based on digital presence, while respecting the essence of the existing principles of International Tax Law. This new PE concept, as a nexus for the exercise of taxing powers on business income in the context of digital economy, is grounded in both the sourcing theory[21] and the benefit theory[22].

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[21] As the authors claim, "a modern dimension for the *sourcing theory* in the era of the digital economy should regard as source all jurisdictions in which value creation occurs in respect of business income either on the supply or on the demand side". This latter reference takes into account the theory of taxation of income in the country of origin developed by KEMMEREN (2010), for whom only persons on the supply side can create value. But HONGLER and PISTONE take a step forward and say that it is even more appropriate considering as well new factors that arise in the market jurisdiction and have an effect on the performance of business and value creation arising in that context. Actually, the role of consumers and users is important because by making choices on product markets they validate the value of products (PRIEM, 2007). So, both the supply and the demand-side of a company lead to value creation, and both should be taken into account for income allocation.

[22] Following the *benefit theory* –sometimes referred to as "cost and benefit theory" or "equivalence theory"-, a new PE definition should take into account the services or goods obtained by a taxpayer in the market jurisdiction in order to allocate taxing powers to this territory. As SKAAR stated (1991), "the taxpayer should pay taxes equivalent to the benefits [it] has, or the expenses [it] causes, through the use of the infrastructure of a country, in particular the use of public goods and natural resources". Indeed, even in the absence of a physical presence, digital activities receive benefits from the State of residence of the customer or user. Such benefits are: the existence of a legal system that allows businesses offering their products online and enforces customers to pay, the protection of Intellectual Property rights, the maintenance of the e-business

In this manner, for HONGLER and PISTONE, the new PE nexus should consist of four main elements: (1) digital services, (2) user threshold –instead of a customer-based threshold-, (3) a certain time threshold, and (4) a *de minimis* revenue threshold. The suggested new paragraph to be added to Article 5 OECD MC would be worded as follows: *"If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum"*.

However, HONGLER and PISTONE recall that such a proposal would require further clarification. More specifically, the terms "database", "online marketplace", "storage room", "advertising services", "website", "per month" or "domiciled" shall be adequately defined by the OECD in the respective Commentary. Additionally, customer location is a key element in determining where value creation occurs. At this point EU VAT rules could be used as a model for an adequate legal definition of a PE in the customer's jurisdiction.

There is common ground between the proposal presented by HONGLER and

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environment –technical infrastructure- and infrastructure in general that allows the enterprise to sell its products –for instance, infrastructure that allows delivery vehicles to travel on its territory-, the supply of energy, or waste recycling for packaging materials, so the market jurisdiction should have the possibility of taxing such business income in order to compensate the cost of services provided (PINTO, 2006). The provision of these benefits supports source-based taxation under the benefit theory. This position was also defended by COCKFIELD (2002b) in the following way: "the use of location of consumption to allocate tax revenues to importing countries can be justified under a number of theories, including the fact that e-commerce importing countries created the market opportunities that enabled the profits to be made through the cross-border transaction (for example, by subsidising the physical network infrastructure within their country that permitted the transaction to go forward). Ultimately, allocating taxable profits to the location of consumption can be seen as a practical political measure that will satisfy both net e-commerce exporting nations and net e-commerce importing nations".

PISTONE (2015) and the suggestions submitted by AVI-YONAH and HALABI (2014). The latter authors presented two alternatives to deal with the challenges of the digital economy. The first alternative was adding a new Article 5(3) to the OECD MC as follows: *"Notwithstanding the preceding provisions, a remote seller constitutes a permanent establishment in a Contracting State if it has gross annual receipts in total remote sales in a Contracting State in the preceding calendar year exceeding $1,000,000, whether such a remote seller satisfy any other definition in this Article 5 or not"*.

The second alternative suggested by AVI-YONAH and HALABI was making an amendment to Article 7 OECD MC in the following terms:

"(1) Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein, or unless the income is of a remote seller, in whatever capacity, which has gross annual receipts in total remote sales in the other Contracting States in the preceding calendar year exceeding $1,000,000. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2, or the profits of a remote seller, may be taxed in the other Contracting State".

(2) For the purposes of this Article and Article 23A [exemption method] -23B [credit method], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise".

As stated above, in order to avoid practical difficulties at the time of attributing profits to a virtual PE, AVI-YONAH suggested levying a withholding tax at the corporate tax rate on the income obtained in source countries that exceeds the said threshold.

Then, once the nexus is established, HONGLER and PISTONE suggest the application of a modified split method, combined with an upfront allocation of a partial profit (one third) to the market jurisdictions fulfilling the PE nexus. The other two thirds of the profits would be allocated according to the current transfer pricing standards, which most likely would lead to the allocation of the remaining profit to the State of residence. Regarding the enforcement of the profit attribution method, the authors suggest that just one or several jurisdictions collect the tax due on behalf of the others, while being aware that this may require a great degree of consensus among the countries concerned. Apart from that, other issues such as determining the taxpayer –particularly, in cases where the entity collecting the revenue is not a qualifying company but a mere shelf company-, the interaction with other treaty provisions –especially, Articles 5(1), 6, 10, 11 or 12 OECD MC- or a multilateral implementation shall require substantial further development. Nonetheless, some questions arise regarding the tax treatment of companies relying on both digital and physical presence, as well as the interaction of the new digital nexus with the PE provisions for traditional businesses and distributive rules.

The new PE nexus is not incompatible with the use of withholding taxes; but, according to HONGLER and PISTONE, the introduction of a new PE nexus would be a preferable option than a standalone gross-basis final withholding tax.

C. Other alternatives to the new PE nexus?

a) The UN Model services PE provision

It is worth recalling that the **UN Model** contains a **services PE** provision, as a reaction of the developing countries against the obtention of a high return in the source

State by foreign companies involved in the provision of technical services without having a physical presence in that jurisdiction. However, the services PE covers services in general, irrespective of their nature. In this context, Article 5(3)(b) UN Model includes a services PE provision, with the following wording: the term 'permanent establishment' also encompasses *"(b) the furnishing of services, including consultancy services, by an Enterprise through employees or other personnel engaged by the Enterprise for such purpose, but only if activities of that nature continue (for the same or a connected Project) within a contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned"*. As can be seen from the UN Model service PE clause, the current services PE definition requires the existence of physical factors in the source State –a fixed place of business or workforce; so, if no personnel are used or the time threshold is not met because of the use of digital means, a services PE will not be deemed to exist under the current UN Model service PE provision. As a result, the source State will not be attributed a taxing right on business services[23].

Although the service PE concept was initially developed under the UN Model, later it has also been introduced into the OECD Commentary. The OECD's discussion on

[23] Many countries have included a service PE clause on the lines of the UN Model clause: Austria, Belgium, Chile, India, Peru, Spain or the US, amongst others. In addition, when the service PE clause is included in tax treaties, it is common that countries describe the nature of services covered under the clause. Therefore, services in the nature of commercial, technical, advisory and other mediation services are covered under the service PE clause contained in the tax treaties negotiated by the Czech Republic (SKÁLOVÁ, SOSKA & VANICKOVA, 2014). In the case of tax treaties negotiated by India, the service PE clause shall apply only to services that do not qualify as fees for technical services or included services (GADA & SINHA, 2014). In this regard, many tax treaties based on the UN Model indicate that technical and managerial services will not give rise to a PE; however, technical and managerial services are not uniformly exempted from service PE provisions –this is the case of the US-China, US-Thailand or US-Jamaica tax treaties- (ARTHUR, HERBERT & LEVEY, 2014). Meanwhile, some of the tax treaties concluded by Austria –specifically, the ones signed with China, Cuba, Czech Republic, Greece, Hong Kong, Indonesia, Mexico, New Zealand, Singapore and Thailand, amongst others- include the service PE definition as determined by or similar to the UN Model; what is interesting in this case is that the Austrian Ministry of Finance interprets the term services as active services and therefore does not consider lease arrangements to constitute service PEs (NAUX, 2014).

the service PE concept suggests optional clauses which countries may include in their tax treaties to determine the existence of a service PE, specifically an additional revenue test in certain cases, which ensures that a service PE will be created only where more than 50% of the non-resident's business activities are carried on by a single individual in the source jurisdiction[24].

In any case, some authors consider that the elaboration of a "digital services PE" clause would be an interesting alternative that, moreover, would allocate more income to the source country than applying the new PE nexus (BLUM, 2015).

b) The new Article 12A for technical services on the UN Model

The introduction of a new provision on the OECD MC that regulates taxation of services could be another way of strengthening the taxing rights of the source State. In fact, this is precisely the intention of the UN with the inclusion of a ***new Article 12A for technical services on the UN Model***, granting the source State the right to tax the gross amount of services fees by means of a withholding tax, without requiring any physical presence in the country of the recipient of the services, neither by the use of workforce nor by a fixed place of business. The rendering of services in another contracting State through digital means would be considered, by itself, sufficient engagement and hence nexus in that State (UN COMMITTEE, 2017b).

Such a provision is aimed at preventing base erosion and profit shifting in the source State through the deductibility of services fees paid to non-residents (UN COMMITTEE, 2017a). It is abundantly clear that developing countries are large importers of technical, managerial and consultancy services. Up to now, fees for technical,

[24] Australia, New Zealand and Norway have adopted the optional service PE clause of the OECD Commentary. By contrast, other countries such as Denmark, Italy, Mexico, the Netherlands, Portugal or the UK decided not to include the service PE concept in their tax treaties, at least at the moment (DESAI & GORADIA, 2014).

managerial and consultancy services in the State of the payer of the fee may be used to shift profits from a profitable group company member to another group member in a low-tax jurisdiction. The payer could deduct the service fee in the source State, reducing its taxable base. And the company receiving the fee will increase its profits, which may only be subject to a low or no tax rate. The new Article 12A will help to address these issues by allowing the source State to levy a WHT on the service fees falling within the scope of this provision (i.e., those involving the application of specialised knowledge, skill or expertise by the service provider in the field of technical, managerial or consultancy services –excluding routine, standardised services-).

All in all, Article 12A UN Model is not introduced to specifically address the issue of base erosion and profit shifting in the digital economy, but it definitely plays a part in counteracting certain cases of tax avoidance in the source State by using digital means. It must be noted that the new article for technical services in the UN Model provides specific advantages compared with the services PE provision included in the UN Model (BÁEZ, 2015):

(1) While the current wording of the services PE contains threshold requirements, the new technical services article does not include any threshold at all. However, in some cases this advantage turns into a disadvantage, due to problems of enforceability.

(2) The existence of a time threshold in the services PE may give rise to an artificial avoidance of the service PE. By contrast, since there is no threshold in the new technical services article, there are not problems regarding avoidance of source taxation.

(3) Important difficulties exist for attributing profits to a service PE; by contrast, the new technical services article grants the source State the right to tax the gross amount of services fees by means of a simple withholding tax. A final WHT on a gross

basis removes the need for source and computational rules; the WHT will be imposed on the full amount of the service fee paid to the non-resident service provider without the deduction of any expenses, at the time the service fee is paid or soon afterwards. In favour of simplicity and certainty, a final WHT on fees for technical, managerial and consultancy services rendered with the use of digital means is presented as a better choice than a non-final WHT on fees for technical services on a net basis, at least from the perspective of the source State. Developing countries usually do not have enough administrative capacity to administer a non-final WHT, which requires levying a non-final WHT at a first stage, creditable against the tax payable by the non-resident in the source State; later, at a second stage, the taxpayer would have to file a tax return to receive a refund for the excessive WHT paid. It is precisely for this reason that the proposed tax rate should be anywhere between 10 and 15%, in order to reach a balanced attribution of taxing rights between the residence and the source States. So, a final withholding tax on fees for technical, managerial and consultancy services rendered with the use of digital means is suggested, keeping in mind that the State of residence would grant a credit for the tax paid in the source State. In this vein, the State in which fees for technical, managerial and consultancy services arise –i.e., the residence State of the payer of the fees- has the primary right to tax those payments, and the residence State of the payee is obliged to eliminate double taxation of those fees either by granting a credit or an exemption for taxes paid in the source State (Articles 23A and 23B of the OECD/UN Models).

Anyhow, to avoid problems of characterisation in relation to other distributive rules –such as the royalties' article, business profits' article or the service PE provision- and in order to respect the principle of neutrality, it would be advisable to delete the words "technical, managerial or consultancy" from the new services article on the UN Model, so that the new provision should be applied to services in general.

In short, a new provision on technical services (or services in general) is more desirable than a service PE approach, because the absence of thresholds and the lack of issues in the attribution of profits facilitate its enforcement.

D. A common reform of the EU's corporate tax rules for digital activities: a new nexus based on the concept of significant digital presence

The European Commission is aware that the current corporate tax rules are not fit for the modern global economy. Corporate taxation aims to tax profits where value is created, but today's international tax framework is not suitable to take into account new ways of value creation in the digital economy.

The tax challenges raised by digitalisation of the global economy were identified in the Communication of the European Commission on *'A Fair and Efficient Tax system in the European Union for the Digital Single Market',* dated 21 September 2017. Soon thereafter, the conclusions adopted on 19 October 2017 by the European Council highlighted the need for an effective and fair taxation system suitable for the digital era, and invited the Commission to develop appropriate proposals by 2018. Likewise, the ECOFIN Council adopted the conclusions *'Responding to the challenges of taxation of profits of the digital economy'* on 5 December 2017, emphasising the need for action *"taking into account relevant developments in ongoing OECD work and following an assessment of the legal and technical feasibility as well as economic impact of the possible responses to the challenges of taxation of profits of the digital economy".* Obviously, the final goal is to adopt a comprehensive solution within the corporate tax system, which should be agreed at the international level. However, action is required at EU level until international consensus is reached on this matter.

In this context, the European Commission has just launched a new package of proposals to ensure that digital business activities are taxed in a fair way within the EU.

The Commission states in its Communication *'Time to establish a modern, fair and efficient taxation standard for the digital economy'* (2018), dated 21 March 2018, that the EU Digital Single Market needs a stable tax framework that is consistent with the current digital business models. To this end the Commission proposes a comprehensive solution that includes three key elements: (1) a new Directive on corporate taxation of a significant digital presence; (2) integrating the provisions in the proposed Directive into the proposals for a Common Consolidated Corporate Tax Base (CCCTB); and (3) extending the solution to the global level (non-EU jurisdictions) through Member States' tax treaties.

The *'Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence'* provides rules expanding the concept of a PE. This is done by establishing a taxable nexus for digital businesses that are active across borders with no physical commercial presence. Once the significant digital presence (i.e. the virtual PE) is determined, the proposal sets out principles for attributing profits to a digital business. This initiative aims to protect the integrity and proper functioning of the single market, ensuring that domestic corporate tax bases are not eroded by digitalisation. Therefore, this proposal was also designed to make sure that Member States' finances are sustainable. Finally, the initiative will contribute to preserving social fairness and a level playing field between all businesses.

As will be seen further on, this Directive is part of a major package that includes a Recommendation to Member States for including rules on a significant digital presence and profit allocation in their tax treaties with third countries, a proposal for a Directive including an interim solution (the Digital Services Tax, DTS) and the abovementioned Communication setting the context and explaining the articulation between the proposals.

As regards the proposal for a Directive on corporate taxation of a significant

digital presence, it is important to note that it affects corporate taxpayers that are established in the EU, as well as enterprises that are established in a non-EU jurisdiction with which there is no double taxation convention with the Member State where the significant digital presence of the taxpayer is identified (Article 2). That is, in order to avoid a contravention of those tax treaties, the proposal does not affect enterprises that are established in a non-EU jurisdiction with which there is a tax treaty in force with the Member State of the significant digital presence. Anyway, there is an exception to this rule if the applicable tax treaty with a non-EU jurisdiction contains a similar provision on a significant digital presence which creates similar rights and obligations in relation to that non-EU jurisdiction.

The concept of significant digital presence is developed to establish a taxable nexus in a jurisdiction, expanding the existing concept of a PE. The three user-based factors proposed for establishing a taxable nexus of a digital business in a Member State are the following: revenues from supplying digital services, the number of users of digital services and the number of contracts for a digital service (Article 4). It is therefore obvious the influence of Action 1 Final Report conclusions on the Commission proposal on significant digital presence. The proxies for determining the digital footprint of a business in a jurisdiction are based on the same indicators of economic activity, which reveals that both the OECD and the EU are perfectly in tune with each other.

In any case, different thresholds apply to any of the three user-based criteria. So, a digital platform will be deemed to have a taxable digital presence (or a virtual PE) in a Member State if it fulfils one of the following criteria: (1) it exceeds a threshold of 7 million euros in annual revenues in a Member State; (2) it has more than 100,000 users in a Member State in a taxable year; or (3) over 3,000 business contracts for digital services are created between the company and business users in a taxable year. As we

argued before, the thresholds should be high enough to exclude small cases where profits attributable to a digital presence would not cover the tax compliance cost for a PE.

Besides that, the proposal sets out rules for attributing profits to a significant digital presence (Article 5). In this regard, the proposal supports *"the principle whereby a significant digital presence should be attributed the profits that it would have earned through certain significant economic activities performed via a digital interface, in particular in its dealings with other parts of the enterprise, if it had been a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the* ***assets used****,* ***functions performed*** *and* ***risks assumed****"*. Therefore, the proposed rules for attributing profits to digital businesses are based on the current transfer pricing principles and make it clear that the attribution of profits to a digital business should reflect the particular ways in which digital activities lead to value creation, through use of criteria such as data and users.

This solution is aimed at improving the perception of fairness for EU citizens by ensuring that large companies with significant digital activities do not escape taxation in the EU. The new rules would remove distortions of competition, so businesses would benefit from a more level playing field. On the other hand, this option would also have a positive impact on national tax administrations public finances. Conversely, the implementation of this option would lead to an increase in the compliance costs of businesses falling under the scope of this solution. Concurrently, national tax administrations would also incur costs for implementing the new tax nexus. In any case, this solution would contribute to the long-run sustainability of the corporate tax system and to a fairer distribution of tax revenues.

2. The introduction of an equalisation levy and other defensive measures implemented by some countries

A. Introduction

The fourth option mentioned by the TFDE to address the broader direct tax challenges of the digital economy is the introduction of an **equalisation levy**, although the Task Force does not recommend its implementation on BEPS Action 1 Final Report for the time being –exactly the same way as in the PE nexus-based approach based on significant economic presence and the introduction of a withholding tax on digital transactions- leaving flexibility for countries to act unilaterally.

Indeed, the nexus-based approach and the withholding-based solution are seen as proposals with a relative long-term impact as compared to the equalisation levy, which is seen as an interim measure. Further still, the former seems to require modifying the double taxation conventions, while the equalisation levy does not require treaty modification since it is a new tax (AVI-YONAH, 2016).

An equalisation levy is aimed at achieving tax neutrality between foreign and domestic suppliers. In this context, the levy is used as a tool to tax a foreign enterprise that earns significant income from a jurisdiction and erodes its tax base. The TFDE maintains that it would be most appropriate if the levy were applied only when a foreign company had a significant economic presence in the market jurisdiction, excluding its application to small and medium-sized enterprises to avoid any undue burden on them. Depending on the objectives pursued, the equalisation levy could be structured in different ways: an excise tax[25], a levy imposed on all remote sales transactions entered

[25] In this case, the tax would be applied when the existence of a significant economic presence is determined. However, excise taxes are frequently passed on to customers, as enterprises need to increase prices to compensate for the resulting erosion of gross profit margins.

into with customers in the market jurisdiction[26] or a levy imposed on data and other contributions gathered from in-country customers and users[27].

Other reform options may include suggestions to introduce levies by reference to online advertising revenues, online advertising space, likes, search-engine results… In this vein, the 2014 interim report on Action 1 referred to a *bit tax* or bandwidth tax as one of the five options to address tax challenges of digital economy in relation to direct taxation (together with the amendment to the current PE definition, the creation of a new nexus based on significant digital presence, different virtual PE possibilities and the introduction of a final withholding tax for digital transactions).

It must be recognised that the TFDE was not the first to come up with this proposal. Actually, over two decades ago, CORDELL (1997) suggested the inclusion of a new tax as a turnover tax on interactive digital traffic. According to CORDELL, this new tax would subject to taxation the digital traffic on the information highway. Interconnectivity creates a value for companies that want to be a part of it and use the information available over the Internet. In this sense, the bit tax would be a measure that takes into account the value of interconnectivity a person receives for using the Internet. So, the bit tax would be based on the number of bytes used by the website; it would be a progressive tax, so different tax levels would apply depending on the enterprise size or the turnover. A minimum threshold of annual bandwidth used would be established, and the tax would be creditable against corporate income tax. However, this new tax –as laid down in the 2014 interim report- may contravene the EU Law. Also, the bit tax does not

[26] In this context, the equalisation levy looks more like a tax on a transaction than a tax on profit. Such a tax would be levied from (digital) companies as a percentage on their turnover in the respective market.
[27] In this case, the TFDE suggests two tests: one based on monthly active users (MAU) in the country and the other based on the volume of data collected from in-country customers and users. However, such a levy would be disconnected from the results of the analysis of the value creation within the company concerned. Additionally, the suggested tests would be difficult to apply in practice because measuring either of these items may be challenging.

have a taxable event that effectively expresses some form of ability to pay, which is a necessary prerequisite that several constitutions require. That is precisely why the 2015 Final Report explores different options when it refers to the equalisation levy.

Alternatively, URICCHIO (2016) suggests the implementation of other levies such as taxes on the recording of Internet domains, on the licensing of IP addresses, on online advertising and on Internet accesses (the so-called hit tax).

In this context, BACACHE et al. (2015) stated that “any specific tax on Internet activity requires a precise measure of the activity of Internet platforms. To measure this activity, tax and regulatory authorities must have access to data on users, numbers of clicks and advertisers”. Therefore, the authors recommend developing a statistical apparatus to measure the activity of Internet platforms. Subsequently, they suggest that entities should be taxed by the jurisdictions wherein tax sharing should be based on: (1) preferably, a sharing rule for corporate profits reflecting the number of users in the jurisdiction of the tax authority; in the absence of a fair sharing rule on corporate profits, (2) a specific tax based on revenues (sales advertising) generated in the market jurisdiction; and, in the absence of any of these, (3) a specific tax base on activity (number of users, flow of data or number of advertisers), calibrated at very low rates.

Moreover, potential trade issues an inconsistency with EU Law would arise if a levy were applied only to non-resident enterprises. In order to ensure equal treatment of domestic and non-resident companies, it is suggested that the potential levy could be imposed on both domestic and foreign entities. Another problem arises regarding the fact that if an equalisation levy were imposed, the same income would be subject to both corporate income tax in the State of residence of the enterprise and the levy in the market jurisdiction. In this case, the levy would not likely be creditable against that tax, which exacerbates the potential for double taxation. So, taking into account that the levy would

be applied on a gross basis, it should be either structured to apply only to situations in which the income would otherwise be untaxed, or subject to a very low rate to mitigate the negative impacts of gross basis taxation.

Finally, one must take into account that EU Law prevents the creation of taxes on turnover other than VAT. In this context, the Court of Justice of the European Union (CJEU) established the conditions that need to be present to consider that a turnover tax displays the essential characteristics of VAT, even if it is not identical to it in every way[28]. To that effect, the following four characteristics of VAT would have to be met[29]: (1) the tax applies generally to transactions relating to goods or services; (2) the tax is proportional to the price charged by the taxable person in return for the goods and services which it has supplied; (3) the tax is charged at each stage of the production and distribution process, irrespective of the number of operations which have previously taken place; and (4) the amount paid during the preceding stages of the process are deducted from the tax payable by a taxable person, with the result that the tax applies, at any given stage, only to the value added at that stage, and the final burden of the tax lies ultimately on the consumer.

Notwithstanding that, the European Commission states in its Communication *'A fair and efficient tax system in the European Union for the Digital Single Market'* that *"the EU needs a modern tax framework to seize digital opportunities, while also ensuring fair taxation"* (EUROPEAN COMMISSION, 2017). The Commission makes clear that the current international tax system is not appropriate for the case. The Communication refers to the main policy challenges that need to be addressed. On the one hand, the issue of 'where to tax digital companies?' (nexus), i.e., how to establish and protect taxing rights in a country where businesses can provide services digitally with little or no physical

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[28] Dansk Denkavit and Poulsen Trading, 31 March 1992 (C-200/90).
[29] *Erna Peltz and Others,* 8 June 1999 (C-338/97), *Banca Popolare di Cremona*, 3 Ocboer 2006 (C-475/03).

presence despite having a commercial presence. On the other hand, the issue of 'what to tax? (value creation), i.e., how to attribute profit in new digitalised business models driven by intangible assets, data and knowledge. In order to tackle these problems, a reference to the OECD work on Action 1 is made. At the same time, it is specified that, at the EU level, the Common Consolidated Corporate Tax Base (CCCTB) proposal offers a basis to address these key challenges. But, as long as a formal agreement on the long-term strategy is not reached, the Commission lists some alternative options for shorter-term solutions, including the following: (1) *"an equalisation tax on turnover of digitalised companies –a tax on all untaxed or insufficiently taxed income generated from all internet-based business activities, including business-to-business and business-to-consumer, creditable against the corporate income tax or as a separate tax";* (2) a *"withholding tax on digital transactions –a standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online";* or (3) a *"levy on revenues generated from the provision of digital services or advertising activity – a separate levy could be applied to all transactions concluded remotely with in-country customers where a non-resident entity has a significant economic presence".* In such a way, the Commission set out the main issues and objectives regarding the taxation of digital economy.

So, after the publication of the Communication adopted on 21 September 2017, it became clear that the European Commission considers an equalisation levy on the digital economy as a tax charged on the turnover of enterprises operating in this sector, with the objective of allowing the jurisdiction where value is created to exercise its taxing powers over businesses connected with the digital economy, equalising the tax burden applicable to traditional businesses with physical presence within that country. The Commission was aware that further work was also needed in this area, since questions about the

compatibility of such approaches with the tax treaties, State aid rules, fundamental freedoms and international commitments under the free trade agreements and WTO rules would arise. At that time, it was indicated that a re-examination of the current legislation would be necessary to address the problem, emphasising that the appropriate level of action is the EU.

The truth is that the ECOFIN Council conclusions presented on 5 December 2017 *'Responding to the challenges of taxation of profits of the digital economy – Council conclusions'* invite the Commission to adopt proposals responding to the challenges of taxing profits in the digital economy, *"taking note of the interest of many Member States for temporary measures, such as for example an equalisation levy based on revenues from digital activities in the EU that would remain outside the scope of double tax conventions concluded by Member States"*. After referring to the unilateral measures introduced by some countries to address the broader tax challenges of digital economy, reference will be made to the recent Communication of 21 March 2018 and the European Commission proposal for a *'Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services'*.

B. Unilateral and defensive measures introduced by certain countries: a short-term solution

UK and Australia have moved forward independently of BEPS Action 1, and specifically, to deal with arrangements aimed at avoiding the PE status. Likewise, India introduced an equalisation levy on online advertising revenue earned in India by non-resident digital companies. Italy, for its part, has developed a voluntary disclosure procedure; also, the Italian Parliament has just decided to create a new tax on digital transactions that will come into force in 2019. These are just some examples of the way in which countries adopt short-term unilateral defensive measures to address the broader

direct challenges of digital economy until international community reaches consensus.

These uncoordinated and unilateral measures can be grouped into four categories: *alternative applications of the PE threshold*[30], *withholding taxes*[31], *turnover taxes*[32] and *specific regimes targeting large MNEs*[33]. Some of these uncoordinated and unilateral measures introduced by certain countries are analysed below.

a) UK Diverted Profits Tax

The Diverted Profits Tax (DPT) was introduced in the UK domestic law in March 2015 as an anti-avoidance measure with the objective of dealing with artificial tax structures employed by MNEs[34]. In this context, the DPT is aimed at MNEs entering into arrangements to divert profits from the UK either by arranging their affairs so as to avoid having a UK PE, or by making payments that lack economic substance –or end up in a low-tax company that lacks economic substance-. In fact, the introduction of the UK DPT was announced before the publication of BEPS Actions Final Reports as a tool targeting digital companies that "go to extraordinary lengths to pay little or no tax" in the UK (OSBORNE, 2014), although it is not limited to digital businesses. As the Chancellor of the

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[30] Israel introduced a significant economic presence test in 2006. In 2017, the Slovak Republic expanded the definition of a 'fixed place of business' for certain digital platforms (intermediation services for transportation and accommodation). And in 2019, a new nexus rule based on the concept of significant economic presence is expected to come into effect in India.

[31] Some countries expanded their domestic definition of royalties, subject to a WHT on a gross basis, by including into that category elements of income traditionally characterised as business profits in double tax treaties. Also, an important number of countries created an exception to the PE threshold for certain service fees, including in their tax treaties a WHT on a gross basis in the source country when the payer is resident in that jurisdiction.

[32] Through these measures some countries try to "improve neutrality restoring a level playing field between foreign suppliers of certain digital goods and services and similar domestic suppliers, as well as between suppliers of certain digital goods and services and more conventional, brick and mortar suppliers of competing goods and services". In practice, these actions are usually combined with broad nexus rules focused on the destination of the supplies, and generally apply both to resident and non-resident enterprises irrespective of their location (OECD, 2018). Examples of these measures are the Indian equalisation levy, the Italian levy on digital transactions, the Hungarian advertisement tax, the French tax on online and physical distribution of audio-visual content or the recently proposed European Digital Services Tax.

[33] This is the case of the Diverted Profits Tax in the UK and Australia, the enhanced procedure for cooperation and collaboration for PE in Italy or the base erosion and anti-abuse tax (BEAT) in the United States.

[34] Generally, multinational groups based in the US using the so-called "Double Irish" structures.

Exchequer said in his 2014 Autumn Statement, the introduction of the DPT would be a vital instrument in order to make sure that big multinational businesses –including those in the tech sector- pay their fair share of taxes. Indeed, the UK DPT is widely known as the "Google Tax".

In this sense, the Diverted Profits Tax Guidance (2015) highlights that its primary aim is ensuring that the profits taxed in the UK fully reflect the economic activity within the country, which is consistent with the objectives of the OECD BEPS Project. The DPT is designed to attack the following scenarios: (a) *lack of economic substance*[35] and (b) *avoidance of a UK PE*[36].

Regarding ***entities or transactions lacking economic substance*** (Finance Act 2015, section 80) the DPT is charged to a company (C) if: C is resident in the UK in a certain accounting period (or a foreign company carrying on business through a UK PE) and there is a material provision imposed between C and another person (P) by means of a transaction or series of transactions; the participation condition is met in relation to C and P (i.e., they are related entities); the material provision results in an "effective tax mismatch outcome" between C and P, which is not an excepted loan relationship outcome; the "insufficient economic substance" condition is met; and C and P are not small or medium-sized enterprises for that period.

So, four conditions need to be met: the participation condition[37]; the mismatch

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[35] Where a UK resident company –or a UK PE of a foreign entity- erodes its tax base by transacting with an affiliate in circumstances where the arrangement or affiliate lacks economic substance, even if the arrangement is at arm's length. In other words, a UK company or a foreign company with a UK PE uses entities or transactions that lack economic substance to exploit tax mismatches. This provision is intended to cover transactions such as those involving sale and re-licensing of IP. These types of transactions usually involve the transfer of IP by a UK entity to another entity set-up at a low or no-tax jurisdiction, which would then license the IP back to the British entity. With this type of transactions, the UK entity would get deduction of royalty payments while the foreign entity would be subjected to very low (or no) tax rate on the royalty receipts.

[36] Where a foreign company carries on a business in connection with which there is activity carried on in the UK, but the foreign entity's affairs are designed in such a way as to avoid a UK PE arising.

[37] The *participation condition* demands that the parties to a transaction or series of transactions be related or connected, i.e., that one of the parties is directly or indirectly participating in the management, control or capital or the other.

condition[38]; the tax avoidance condition[39]; and the no economic substance condition[40]. Then, where companies or PEs lack economic substance, two tests need to be considered: "the insufficient economic substance condition" and "the effective tax mismatch condition". And, if either test is met, the diverted profits tax will be payable.

On the other hand, as regards the ***avoidance of a UK taxable presence*** (Finance Act 2015, section 86), the DPT will apply under the following conditions: (1) where there is a non-UK resident company that carries on a trade; (2) a person (the avoided PE, whether or not UK resident) is carrying on activities in the UK in connection with supplies of services, goods or other property by the foreign entity in the course of that trade; (3) it is reasonable to assume that the activity of the avoided PE or the foreign company (or both) is designed to ensure that the foreign company does not carry on that trade in the UK for corporation tax purposes; (4) the "mismatch condition"[41] or the "tax avoidance

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[38] The *mismatch condition* requires that the "material provision results in an effective tax mismatch outcome" between the UK and foreign parties. An effective tax mismatch outcome (i.e., base erosion) arises when the material provision results in an increase in expenses or deductions, or a reduction in income for one party and the reduction in that party's liability is higher than any resulting increase in the second party's total liability to corporate income tax, income tax or any non-UK tax. The reduction can be a consequence of the application of different tax rates, availability of a relief, exclusion of any amount from a charge to tax or otherwise. An 80% test shall apply, which provides that there will not be an effective tax mismatch outcome if the amount of tax paid by the second party is at least 80% of the corresponding reduction in the first party's tax liability. *A sensu contrario*, a tax mismatch outcome arises when the increased tax liability of the entity due to the arrangements is less than 80% of the corresponding reduction in liability of the other relevant party. Certain exclusions may prevent an effective tax mismatch outcome from arising; among them is the exclusion for excepted loan relationship outcomes. This exclusion applies if the increase in expenses or reduction in income arises wholly from something that would produce credits or debits under the loan relationships rules or, where is a hedging derivative, the derivative contract rules (NEIDLE, 2015).

[39] The *tax avoidance condition* is met if the main purpose of an arrangement is deemed to be the avoidance of a charge to tax in the UK.

[40] The *insufficient economic substance condition* is met if one of the following conditions applies: (1) it is reasonable to assume that the transaction was designed to secure the tax reduction arising from the effective tax mismatch outcome, unless at the time of making the material provision it was reasonable to assume that the overall non-tax financial benefits of the transaction would exceed the overall financial benefit of the tax reduction; (2) it is reasonable to assume that the involvement of a person who is a party to the transaction was designed to secure the tax reduction, unless, at the time of making the material provision, either it was reasonable to assume that the overall non-tax financial benefits of the transaction referable to the contribution of the person's staff would exceed the overall financial benefit of the tax reduction, or the income attributable to the contribution of that person's staff in an accounting period exceeds other income attributable to the transaction or transactions.

[41] The *mismatch condition* is met if: there is a material provision between the foreign entity and another person (A); the participation condition is met in relation to the foreign company and A; there is an effective tax mismatch outcome resulting from the material provision between the foreign entity and A which is not

condition[42]" is met or both of those conditions are met; and (5) the avoided PE is not excepted[43]. A *de minimis* exclusion is included for the section 86 charge whether sales related to UK business by the foreign entity and connected persons do not exceed £10 million, or expenses related to UK activity by the foreign entity and connected persons do not exceed £1 million.

So, basically, this rule is designed to target the following trade scheme. An overseas "billing company" helped by a local subsidiary or a branch is being used with the purpose of remotely supplying goods and services to final customers directly from the overseas billing company, instead of from the local subsidiary/branch carrying on the substantive sales activity. Local employees are usually engaged in the sale of products and services to local clients but the contracts are signed overseas. The final goal of this scheme is to supply goods and services to local customers with the support of personnel based locally without creating a dependent agent PE in the UK. Hence, if it is reasonable to assume that one of the main purposes of the arrangement is to avoid a PE in the UK, the structure will fall within the scope of the DPT.

If these conditions are satisfied, the Act creates a new PE fiction and a 25% DPT applies to the company's taxable diverted profits –i.e. profits that would have been taxable to the foreign company in the UK if it had a PE-. This rate is higher than corporate income tax –a 19% standard corporate tax rate in 2017-, to encourage taxpayers to change their structures and pay corporation tax on profits in line with economic activity. Therefore, the DPT establishes a nexus in the market jurisdiction. To calculate the taxable diverted

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an excepted loan relationship outcome; the insufficient economic substance condition is met; and both the foreign company and A are not small or medium-sized enterprises.

[42] The *tax avoidance condition* is met if, in connection with the supply of goods, services or property, arrangements are in place the main purpose or one of the main purposes of which is to avoid or reduce a charge to corporation tax.

[43] The *avoided PE is excepted* if the activity of the avoided PE is such that the foreign entity qualifies for one of a number of statutory exemptions from PE.

profits, it is necessary to consider the profits that would have arisen if the entity had made a full transfer pricing adjustment (in the context of section 80 charge); and also determine the profits that would have arisen from an alternative transaction that is reasonable to assume would have been entered into if a tax reduction had not been relevant to the parties (in the context of section 86 charge).

The DPT is not self-assessed, but the taxpayer initiates the administrative process. Companies have to notify Her Majesty's Revenue and Customs (HMRC) within three months after the end of the year if they are potentially within the scope of tax and do not satisfy any of the exemptions. After notification, if the HMRC officer understands that a company may be liable for the tax, he/she will issue a *preliminary notice* to the company with an estimate of the taxable diverted profits –precisely, with the best estimate that the HMRC officer considers can reasonably be made-. But, if there is a material provision or a mismatch condition, the officer can disallow up to 30% of the relevant tax-deductible expenses of the company it he/she considers that these expenses are higher than they would have been if the transaction had been carried out according to the arm's length principle. If the company is notified that it is potentially within the scope of the DPT, HMRC must issue the preliminary notice within 2 years of the end of the accounting period in which the DPT charge arose; but if the company has not notified its potential chargeability, HMRC has 4 years to issue a preliminary notice. A company that receives a preliminary notice has 30 days to contact the HMRC officer to make representations and, within 30 days following the termination of the 30-day period to make representations, the officer must either issue a *charging notice* or confirm that no charging notice will be issued. Once the payment is made, charging notices will be reviewed by HMRC within 12 months. It is important to note that suspension or deferral of the DPT payment is not possible, since the assessment process is characterised by the so-called

"pay first, argue later" approach. During the review period, both the taxpayer and HMRC can reach an agreement on the amount due. At this point, the initial best estimate can be replaced with the actual result of applying the legislation, and a balancing payment of additional tax or a tax refund shall be made (NEIDLE, 2015). The review period may also terminate after less than 12 months if both the taxpayer and HMRC agree.

Taking into account the design of the DPT, it is clear that it is relatively easy to satisfy its conditions. Although being announced as an anti-avoidance rule, the DPT does not only apply to cases in which the sole or main purpose of the taxpayer is to avoid taxation, which is a key feature of an anti-avoidance provision. Instead, the DPT enables taxation of any sales or services undertaken in the UK internal market, irrespective of the existence of a PE –the latter contrasts with the spirit of article 7 of the tax treaties signed by the UK-. Additionally, once the DPT is levied by the UK –i.e. the source State- there is no guarantee that the State of residence grants an exemption of a foreign tax credit. This could lead to double taxation of business profits, which would not be compatible with the UK's tax treaty obligations.

On the other hand, the UK DPT creates a new avoided-PE fiction similar than other PE fictions included in some of the UK tax treaties (for example, the offshore oil fictions included in the UK-Ireland tax treaty, that do not meet the traditional PE criteria but however are brought within the scope of a State's taxation through the PE fiction). That said, the latter is included in the tax treaties after agreement between the Contracting States, while the DPT is a unilateral action of the UK Parliament (MACLENNAN, 2016). At this point, HMRC emphasises that the DPT is compatible with **UK's obligations under tax treaties** basing its decision on the following arguments. First, HMRC defends the idea that the DPT is a new tax introduced outside the corporation tax legislation; it is applicable only to a specific part of the profits –as opposed to corporation tax- and

includes special provisions for avoiding misuse and circumventions of the tax system. The DPT and corporation tax differ with regard to taxpayers, calculation method, and tax collection procedure; also, the tax rate is different in both cases[44]. And second, HMRC insisted that the DPT is a new tax and, therefore, is not an extension of the scope of Income Tax, Corporation Tax or Capital Gains Tax, to conclude that the DPT is not subject to double taxation conventions. In this respect, it should be recalled that Article 2(1) OECD MC defines the substantive scope of a tax treaty in the following way: *"this convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied".* Then, paragraph 2 tries to clarify the meaning of taxes on income and capital, stating that these shall be *"all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation".* Article 2(3) OECD MC provides a non-exhaustive list of taxes to which the tax treaty applies. And finally, paragraph 4 includes a clause under which the substantive scope is extended to *"any identical or substantially similar taxes* [to taxes listed in paragraph 3] *that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes".* However, what happens in practice is that a significant number of tax treaties do not include paragraphs (1) and (2) of the OECD MC, and just insert a list of taxes covered as it is suggested in Article 2(3) OECD MC. In these cases, the treaty would cover new taxes implemented after the signing of the tax treaty if they are *identical or substantially*

[44] As HMRC states, "the entry conditions for the diverted profits tax [the mismatch condition and the tax avoidance condition] mean that it will only be applied to arrangements designed to exploit the provisions of tax treaties to avoid tax. Therefore, the arrangements it targets are the kind where there is no obligation to provide relief under international Law", so Contracting States would be free to extend whatever tax treatment they wish to such arrangements.

similar to taxes listed in paragraph 3. On this basis, some UK tax treaties include the Article 2(4) OECD MC provision. In this sense, if the DPT were considered a supplement to Corporation Tax, it would also have to be concluded that it is identical or substantially similar to Corporation Tax, and consequently the DPT would fall within the scope of the UK's tax treaties. In this regard, ISMER & JESCHECK (2017) defend that the same principles apply to the calculation of profits under corporation tax and under the DPT – actually, taxable profits of an avoided PE are the same profits that would have been taxable to the non-resident entity in the UK if it had a PE-, and the fact that the DPT tax rate is different is not in itself sufficient to conclude that it is not substantially similar to corporation tax. In a similar way, as MACLENNAN (2016) claims, "while HMRC maintains that the DPT is formally distinct from Corporation Tax, the only discernible differences between them appear to be the jurisdictional standard triggering the charge to tax, which is problematic with respect to the UK's tax treaty obligations; and the rate at which the tax is payable -25%, as opposed to [the current 19%] rate of Corporation Tax, which might also be problematic with respect to EU Law". Anyhow, the fact is that although the DPT appears substantially similar to corporation tax, the State of residence is not obliged to grant tax treaty benefits when there is a misuse of the treaty, which would mean that there is no guarantee that this country grants an exemption of a foreign tax credit, leading to double taxation of business profits (ISMER & JESCHECK, 2017). In other words, whether the DPT is creditable will vary by country. So, unless a country has made an explicit statement, there may be uncertainty in ascertaining whether a tax credit is available.

On a separate issue, some commentators consider that the DPT is contrary to **EU Law**, specifically the rules on *freedom of establishment* (SELF, 2015). The DPT becomes chargeable where a non-UK resident entity avoids a UK taxable presence and also either

the tax avoidance condition or the mismatch condition is satisfied. There are clear differences in treatment of UK entities that carry out trading activities in the UK –which are taxed at a 19% rate- and non-UK companies incorporated in another EU Member State carrying out the same activities –which are taxed at a higher rate, i.e. 25%-. As it is stated by the CJEU in *Cadbury Schweppes*, "a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned". Furthermore, "the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory"[45]. In this vein, NEIDLE (2015) points out that "the DPT is not specifically targeted at wholly artificial arrangements. In principle, it would seem to apply to a variety of commercial arrangements with a tax element, even if that tax element is incidental, and even if non-tax financial benefits are very substantial. […] Arrangements may be genuine with a very significant tax benefit, just as arrangements may be artificial with no tax benefit". This author also states that the DPT is *disproportionate* because it is based on estimates and shall be prepaid by the taxpayer, with little chance of challenging the charging notice.

By contrast, others defended its compatibility with EU Law. Regarding the potential disadvantage of cross-border arrangements that have been designed to achieve a tax mismatch outcome or to avoid a PE by comparison with wholly domestic situations where entities could pay corporation tax at a lower tax rate referred by NEIDLE, BAKER (2015) argues that "it is always open to the group concerned to dismantle their artificial arrangements and to pay corporation tax. [And adds that] the fundamental freedoms are

[45] Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC (C-196/04).

freedoms to establish oneself in another member country for genuine commercial purposes, or to supply and receive services for genuine purposes; they are not a freedom to continue artificially avoiding the tax normally due on profits arising in the UK". BAKER emphasises that the CJEU recognised in *Marks & Spencer* that a measure that is restrictive on a fundamental freedom may be admissible on the grounds of two or more justifications combined[46]. In this case, the two justifications would be "combating tax avoidance and the principle of territoriality" –i.e. profits arising in the UK should be taxable in the UK. The analysis of this author goes even further, reflecting that the DPT is consistent with the international approach to counteract base erosion and profit shifting, so in the current context such measures "are justifiable, even where they restrict a fundamental freedom". To admit the contrary would result in accepting that EU Member States have little to do to counter some of the major targets of the BEPS Project without falling foul of the CJEU. And with respect to the lack of proportionality, BAKER claims that the original charging notice must state the grounds on which it is based and the facts on which it relies, i.e. HMRC must explain why the DPT would apply and, in the case of alternative arrangements, it must specify why those arrangements are considered as such. After payment, the taxpayer can also appeal the HMRC decision and show that its arrangements are genuine.

b) The Indian Equalisation Tax and the recently proposed new nexus based on a concept of "significant economic presence"

The Indian e-commerce industry is the fastest growing in the world (AWASTHI, 2017). Where a foreign company obtains e-commerce revenues (business income) in India and in the absence of a PE within the country, such income shall not be taxable in India. The Indian Government was concerned about not receiving its piece of the pie on

[46] Marks & Spencer plc v Halsey (C-446/03).

digital transactions revenues, so they decided to take action[47].

Thereby the Finance Act 2016 (Chapter VIII) introduced a 6% **equalisation levy** on payments made for "specified services" to foreign sellers with the objective of equalising their tax burden with other businesses that are subjected to income tax in India. The Finance Act clarifies that "specified services" are defined as follows: "online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement, and any other service which may be notified later by the central government", i.e., online marketing and advertisements, cloud computing, website designing, hosting and maintenance, provision of digital space, digital platforms, advertising on radio or TV, services relating to online sales of goods and services, and online use or download of software and applications[48]. Based on the definition given of "specified services" and, particularly the reference made to "any other service which may be notified later by the central government", the scope of the levy may be expanded to cover a wider range of digital goods and services as time goes by and, at the same time,

[47] In this context, the Finance Minister of India noted in his 2016 Budget speech that "the typical direct tax issues relating to e-commerce are the difficulties of characterising the nature of payment and establishing a nexus or link between a taxable transaction, activity and a taxing jurisdiction, the difficulty of locating the transaction, activity and identifying the taxpayer for income tax purposes. The digital business fundamentally challenges physical presence-based permanent establishment rules. If permanent establishment principles are to remain effective in the new economy, the fundamental permanent establishment components developed for the old economy, i.e. place of business, location, and permanency must be reconciled with the new digital reality".

[48] Actually, the Indian Committee on Taxation of E-Commerce suggested the inclusion of the following services under the ambit of specified services: (i) online advertising or any services, rights or use of software for online advertising, including advertising on radio & television; (ii) digital advertising space; (iii) designing, creating, hosting or maintenance of website; (iv) digital space for website, advertising, e-mails, online computing, blogs, online content, online data or any other online facility; (v) any provision, facility or service for uploading, storing or distribution of digital content; (vi) online collection or processing of data related to online users in India; (vii) any facility or service for online sale of goods or services or collecting online payments; (viii) development or maintenance of participative online networks; (ix) use or right to use or download online music, online movies, online games, online books or online software, without a right to make and distribute any copies thereof; (x) online news, online search, online maps or global positioning system applications; (xi) online software applications accessed or downloaded through internet or telecommunication networks; (xii) online software computing facility of any kind for any purpose; and (xiii) reimbursement of expenses of a nature that are included in any of the above. As can be seen, the categories of payments suggested by the Committee were not restricted to online advertisement. But, at least for the present, the Indian government decided to include only the digital advertisement sector within the scope of the levy.

this could lead to a tax rate reduction. The measure was implemented as an interim tool until international community reaches a consensus on the application of international tax principles to digital economy.

This proposal followed an important loss of revenue by the Indian Tax Administration regarding the payments by *Right Florists*[49] to websites like Google (Ireland) and Yahoo (US) for advertising services rendered through their respective search engines[50]. So, as recommended by the Indian Committee on Taxation of E-Commerce (2016), the Indian Government introduced various measures such as the equalisation levy of 6% on the fees that Indian resident advertisers or Indian PEs of a non-resident entity pay to non-resident companies if the consideration exceeds INR 100,000 (around 1.400 euros) per annum from every advertiser. The recipient of such services should either be resident in India and carrying on business or profession in India or be a non-resident entity having a PE in India. By contrast, the levy would not be applicable to non-resident service providers having a PE in India since they will be subject to the PE-basis taxation. Actually, the introduction of the levy is an indirect way of taxing companies such as Google or Facebook for the income they make from local advertisers.

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[49] ITO v. Right Florist Pvt Ltd., ITA No. 1136/Kol/2011.

[50] In April 2013, the Income-Tax Appellate Tribunal (ITAT) in Kolkata held that these payments could not be taxed in India because they were business profits and the providers did not have a PE in India. Actually, the ITAT held that the website could neither be considered as a PE nor as taxable presence of foreign entities owned and maintained in India. Nor could the income be taxed in India as business profits because web servers were located outside this country. Thus, the income was taxable in the countries where the servers were located. On the other hand, since banner hosting does not involve the use of, or the right to use any industrial, scientific or commercial equipment, the income could not be taxed as royalties. Neither could it be taxed as fees for technical assistance because the service rendered by Google involved only generation of certain tests on the search engine through a wholly automated process, without human intervention (LAHIRI, et. al., 2017). Additionally, in *Yahoo India* (Yahoo India Pvt. Ltd. v. DCIT (2011) 140 TTJ 195 (Mum)) and *Pinstorm Technologies* (Pinstorm Technologies Pvt Ltd. v. ITO, (2012) 54 SOT 78 (Mum)) the ITAT in Mumbai rejected taxation of advertisement revenue from display of banner advertisement on portals as royalties. Returning to the *Right Florists* case, the Tribunal added: "clearly, conventional PE test fails in this virtual world even when a reasonable level of commercial activity is crossed by foreign enterprises. It is a policy decision that Government has to take whether it wants to reconcile to the fact that conventional PE model has outlived its utility as an instrument of invoking taxing rights upon reaching a reasonable level of commercial activity and that it does fringe neutrality as to the form of commercial presence, i.e., physical presence or virtual presence, or whether it wants to take suitable remedial measures to protect its revenue base. Any inertia in this exercise can only be at the cost of tax certainty".

According to some commentators, the experience of the Indian equalisation levy is that costs are passed on to the purchaser of advertising services under contractual agreements -i.e., the small and medium-sized enterprises and start-ups who sustain on digital advertising. This problem has been brought to light particularly by CBI members on its response to the OECD request for input on working regarding the tax challenges of the digitalised economy (OECD, 2017).

The levy is only charged on cross-border B2B transactions. On the contrary, B2C transactions are exempt because the collection cost may override the tax. Thus, the equalisation levy is a 6% withholding tax applied to the gross consideration paid by Indian service recipients engaged in a business to a non-resident that does not a have a PE in India for online advertisement and related services, if the total amount exceeds IRN 100,000. It must be noted that the tax base is the value of the covered transactions, not the income generated by them. Therefore, it is a turnover tax limited to revenues from online advertisement services supplied by non-residents. So, the legal liability of the equalisation tax is imposed on the non-resident payee, but the levy is collected by the local business in India (the payer), who is responsible for making the payment to the Indian tax administration. The compliance procedure is similar to withholding tax provisions; the Indian service recipient shall ask the non-resident service provider for a no-PE declaration in order to enable the recipient to decide on the applicability of the levy. Then, the service recipients are required to comply and file an annual statement in respect of services received. Payers collecting the equalisation levy are liable to deduct the levy from the amount paid or payable to the non-resident company in relation to the specified service. By contrast, no compliance requirements apply to the non-resident payee. Additionally, the payer is allowed to deduct that amount paid as expense for determining the taxable profits under the Income-tax Act 1961, in the year in which the

levy has been deposited. Non-compliance by service recipient results in the imposition of different penalties[51]:

It must be noted that the equalisation levy is a different tax, separate from the income tax. According to the Indian legislation, the equalisation tax is not classified as a tax on income, but rather as a transaction-based tax that applies to the amount of consideration received. Actually, the territorial scope of application in both taxes is different: whereas the income tax is applicable throughout the country, the Finance Act exempts from the application of the equalisation levy to Jammu and Kashmir (SINGH, 2017).

If we look at arguments contained in the 2016 Report of the Indian Committee on Taxation of E-Commerce, the equalisation levy is not a tax on income of the type covered by tax treaties –such as corporate income tax-, which means that tax credits would not be available, and this poses the threat of double taxation. It would be at the discretion of the State of residence to give credit under its domestic Law. Apart from that, some argue that the equalisation levy is a tax collected on the gross amount of payments made to non-residents, but also different from a "withholding tax", -such as the tax withheld on payments of dividends, interests, royalties or technical services fees- which is a tax on the income and covered under the tax treaties (BASAK, 2016). Even though, the Indian Committee on Taxation of E-Commerce (2016) suggested that the levy should be structured to apply only to situations in which the income would otherwise be untaxed, or subject to a very low rate in the country of residence of the service provider.

By contrast others defend that, although the Indian equalisation tax was not

[51] (1) Penalties for failure of payment, if the equalisation levy was not deducted or if it was deducted but not deposited. In the first case, a penalty equal to the amount of equalisation levy has to be paid by the assesse. In the second case, the penalty is equal to INR 1,000 for each day the failure continues but cannot exceed the amount of the equalisation levy; and (2) penalties for failure to file the statement of compliance: in this case, the penalty is equal to INR 100 for each day the non-compliance continues.

originally designed to fall under the scope of tax treaties –i.e., it was enacted outside the Indian income tax legislation and presented not as a tax on income but a tax on payments for digital transactions-, it is covered by Article 2 OECD MC since it is a tax on income and not a turnover tax (ISMER & JESCHECK, 2017). On this basis, the Indian equalisation levy would be covered by the respective tax treaty since it was determined that it was identical or at least substantially similar to the taxes listed in Article 2, i.e. taxes on income, capital and elements thereof. The authors base their conclusion on the following elements. First, the equalisation tax is levied on digital transactions. Payers are obliged to withhold the tax when making payments to the non-resident entity and, if they fail to withhold the tax, they are required by the tax office to do the payment, plus interest and penalties. Second, the payer has to deduct the amount of the equalisation levy and transfer the money to the Indian tax administration. In this context, the payer is the formal debtor of the equalisation tax, while the recipient of the payment is carrying the burden of the tax as this entity gets a 6% lower consideration for the service rendered. On the contrary, in the context of turnover taxes, the recipient of the payment is the formal debtor, while the payer carries the tax burden since he/she pays a higher price for the products and services purchased. Third, income subject to the equalisation levy shall be exempted from regular income tax in order to avoid double taxation. Double taxation is only possible if the equalisation levy is regarded as a tax on income or, at least, substantially similar if not identical to an income tax. But still, as ISMER & JESCHECK argue, "the result that a tax is covered by the convention may well result in a Pyrrhic victory for the taxpayer. Where the respective domestic legal order allows treaty overrides, the fact that the tax is covered by the convention will not effectively limit domestic taxation in the source state. Yet the State of residence may refuse to give credit for such tax levied in violation of the conventions". Against this background, the authors suggest that taxpayers affected by

treaty overrides might challenge it under Article 25(1)-(2) OECD MC, submitting the case to arbitration.

It should be noted that this levy would not affect the service tax levied at the rate of 15% on a reverse charge mechanism in the hands of the service recipient. In this sense, the service recipient shall collect and pay the service tax as well as collect the equalisation levy on the gross payment made to the non-resident service provider.

In comparison with the UK DPT, the Indian equalisation levy has a narrower scope since it is only applicable to the digital advertisement sector. But, as already mentioned, the scope of the levy may soon be expanded to cover a wider range of digital goods and services, encouraging non-resident enterprises to set up PEs within the Indian territory and to be taxed on their net income generated.

On the other hand, significant differences exist between the equalisation levy in the BEPS Plan and the Indian equalisation levy. The former is presented as an alternative to the expansion of profit attribution rules based on significant economic presence. However, Action 1 Final Report makes clear that it would be more convenient to apply the levy only when a foreign company had a significant economic presence in the market jurisdiction. The significant economic presence would be established either on the basis of revenue-based thresholds (high enough to minimise administrative burden for the tax authorities and the compliance burden on small and medium-sized businesses) or user-based thresholds (the average of number of monthly active users and the volume of data collected from in-country users). By contrast, the Indian equalisation levy does not focus on data generated or online contracts executed by users of websites to establish nexus, but on advertising, since advertising revenue seems to be a more effective way of establishing digital nexus instead of user-related data (VARANASI & NAGAPPAN, 2016). Additionally, the Indian levy does not follow the suggestion that an equalisation levy

should be imposed only in "situations in which the income would otherwise be untaxed or subject only to a very low rate of tax", which was recommended by the Indian Committee on Taxation of E-Commerce in its 2016 Report.

Conversely, the 2018 Budget introduced a **new nexus rule based on the concept of "significant economic presence"** for corporate income tax purposes that will become effective from 1 April 2019. This new rule extends the domestic concept of nexus for business income in two different situations that introduce two alternative thresholds: one based on local revenue, and the other based on the number of local users[52].

c) The French tax on online and physical distribution of audio visual content

France introduced an indirect tax in 2003 targeted at sales and rentals of videograms (videotapes, DVDs…) In 2004, the scope of the tax was extended to include online video-on-demand services where movies and audio-visual content are accessed through digital means in exchange for a payment. And, in 2016, the tax was expanded to include online video-on demand services provided for free but monetised through the advertisements displayed to the users. It is clear that the successive amendments were aimed at capturing all types of distribution models, regardless of their medium: sales and rentals of videograms and online video-on-demand services.

This tax, named **"tax on the online and physical distribution of audio-visual content"** (the so-called *Youtube tax* or *Netflix tax)* affects operators established in France or outside the country, offering access in France to audiovisual content, whether for a

[52] According to the 2018 Finance Act, a foreign company shall be said to have a significant economic presence in India if: (1) the aggregate of payments arising from any transaction in respect of any goods, services or property carried out by a non-resident in India, including a provision of download of data or software in India, during the previous financial year exceeds a yet-to-be determined amount *(threshold based on local revenue);* or (2) there is a systematic and continuous soliciting of its business activities or engaging in interaction with a yet-to-be determined number of users through digital means *(threshold based on number of local users).* Further rules are required to clarify the implementation of these thresholds, as well as an explanation of how profits will be attributed to a significant economic presence. However, the rule makes clear that in case of a conflict between the domestic concept of significant economic presence and a provision contained in a double taxation convention (i.e., the PE definition), the later would prevail over the domestic nexus rule.

consideration or free of charge.

The tax is imposed at a flat rate of 2% (10% in the case of movies and audiovisual content containing pornography or incitement to violence) when the sale and rental of videograms takes place in France or, in the case of online video-on-demand services, when the audience is located in that country. The tax base is composed of two elements: (1) the consideration paid for the purchase, rental or access to online audio-visual content (exclusive of VAT); and/or (2) the consideration paid for the display of advertisements and/or sponsorships linked to a particular online audio-visual content[53].

d) The Italian initiatives: the voluntary disclosure procedure and the levy on digital transactions *(web tax)*

Italy introduced a specific "procedure of enhanced cooperation and collaboration" (the so-called *web tax procedure*) by virtue of Decree Law No. 50 of 24th April 2017, converted into Law 96 of 21st June 2017. The aim of this measure was to intercept the income derived by foreign entities from the sale of goods and the provision of services in Italy, either directly or with the support of an Italian entity belonging to the same group, by means of a hidden PE in Italy.

Rather than a new tax, it is a **Voluntary Disclosure Procedure** addressed to MNEs fulfilling the following conditions: (1) the non-resident entities are part of multinational groups with a consolidated worldwide turnover over 1 billion euros per year; (2) the non-resident entities provide goods or services in Italy for an amount higher than 50 million euros per year; and (3) the provision of goods or services in Italy is effected using an Italian resident subject.

[53] In the latter case, the revenue generated by advertisement and sponsorship is reduced by a 4% tax allowance, increased to 66% when that revenue is generated by audiovisual content created by private users for the purpose of sharing and exchange within communities of interest. As regards the second element, a *de minimis* threshold of 100.000 euros is included, so only the remaining amount in excess of that sum is subject to the tax.

The voluntary disclosure procedure is not available when the relevant subjects have already received a notification of inspections, tax audits or any other administrative or criminal procedures by the competent authority regarding any potential hidden PE.

The procedure may be activated by the non-resident company by filing a specific application in case it sees a risk of potential existence of a PE in Italy in the past open tax periods, regarding the support activities rendered by the Italian service company. If a PE is indeed identified, the non-resident company will receive a tax settlement invitation in order to define the income attributable to the deemed PE. The tax debt is agreed between the tax authorities and the corporation. And, once the debt is agreed and paid, the non-resident may benefit from: (a) a reduction of the applicable administrative penalties (50%); (b) there will be no criminal pursuit against the violation for omitted income tax return; and (c) the foreign company can access to the Italian cooperative compliance program, which provides for a number of benefits on the basis of mutual transparency and cooperation.

On another level, the Italian Budget Law for 2018 includes new measures related to the digital economy, including a new **levy on digital transactions** (the so-called *web tax)*.

The new transaction-based tax was adopted by the Italian Parliament in 2017 and will enter into force on 1st January 2019. The *levy on digital transactions* is a 3% withholding tax on any digital transaction related to the performance of services carried out through electronic means, rendered both by resident and foreign enterprises to Italian businesses and other entities qualifying as withholding agents under Italian Tax Law, different from Italian PEs of non-residents, irrespective of their level of physical presence in Italy. So, the levy is aimed at restoring a level playing field between suppliers of digital services and suppliers of traditional services, ensuring that the value generated by users

and user-generated content is (at least in part) captured by taxation.

As can be seen, the levy will apply only to B2B transactions. E-commerce transactions are exempted; therefore, only services supplied through the Internet or an electronic network will be covered by the tax. The tax base will be the amount of consideration paid in exchange for the provision of digital services supplied digitally (net of VAT). It is expected that the Minister of the Economy and Finance will present a Decree in the first half of 2018 identifying the services subject to the levy. Additionally, only companies with over 3000 online transactions in a calendar year (minimum activity threshold) are subject to such levy. The web tax would be due by the enterprise rendering the digital services. The tax liability rests on the supplier of the taxable transactions. But the responsibility to collect the tax falls on the Italian customer, which would have to withhold the tax when the payment for the service is made and transfer it to the tax administration on the 16th day of the month that follows the payment. It is important to note that the final legislation approved by the Italian Parliament establishes that the levy is not creditable against any other Italian taxes due by the taxpayer, such as the corporate income tax, local taxes or wage taxes. To be more precise, domestic-based suppliers will be able to deduct the levy from their domestic corporate tax base; by contrast, deductibility for foreign suppliers will depend upon corporate tax rules of their countries.

C. The introduction of a Digital Services Tax as an interim measure at EU level

The European Commission has just launched a new package of proposals to ensure that digital business activities are taxed in a fair way within the EU. This way, the recent Communication from the Commission to the European Parliament and the Council *'Time to establish a modern, fair and efficient taxation standard for the digital economy'* (2018) suggests the introduction of a **Digital Services Tax** (DST) on revenues resulting from the supply of certain digital services by particular entities as an interim measure at

EU level. This tax should be applied on a provisional basis until a comprehensive solution within the corporate tax system has been agreed at the international level. As has been seen above, the preferred option is a Directive on digital PE and profit allocation principles, with adjustments to the CCCTB. But, in order to avoid the adoption of uncoordinated and unilateral measures by Member States, the Commission considered the Directive on a common system of a tax on certain digital activities as an interim solution.

After ascertaining that some EU Member States started to implement unilateral measures taxing the digital economy to protect revenues and to guarantee a level playing field, the Commission was well aware of the risks that further uncoordinated measures could cause in the EU, *"creating additional barriers and legal uncertainty for companies and distorting competition in the Single Market".*

For this reason, the Commission proposes a Digital Services Tax at EU level directed to activities where user participation and user contributions play an important role in value creation. To achieve that aim, a proposal for a *'Council Directive on the Common system of a Digital Services Tax on revenues resulting from the provision of certain digital services'* (2018) is presented. This equalisation tax would be applied at a rate of 3% on gross annual revenues in the EU coming from specific digital services and would be due in the country or countries where the users involved are located (i.e., where value is created).

Actually, revenues derived from activities where users play an important role in value creation are the most difficult to capture with the existing tax rules. It is clear that the Digital Services Tax is a tax with a targeted scope, which is levied on the revenues created from the supply of certain digital services characterised by user value creation. So, services falling within the scope of the tax *are "those where the participation of a*

user in a digital activity constitutes an essential input for the business carrying out that activity and which enable that business to obtain revenues therefrom". As a result, revenues included in the scope of the tax (taxable revenues) are the following (Article 3(1)): (1) revenues created from selling online advertising space; (2) revenues created from digital intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services between them; and (3) revenues created from the sale of data generated from user-provided information. It is quite clear that what is subject to taxation are the revenues obtained from the monetisation of the user input, and not the user participation in itself.

The Directive contains guidelines for the purposes of determining the proportion of taxable revenues that shall be allocated in a tax period to a particular Member State (Article 5). In the case of a taxable service consisting in the *placing of advertising on a digital interface,* it should be taken into account the number of times an advertisement was shown on user's devices in a tax period in that Member State. Regarding a taxable service consisting in *making available of multi-sided digital interfaces*, it is necessary to distinguish between cases where the interface facilitates underlying transactions directly between users and those where it does not. In the cases of the first premise, the factor that should be taken into account is the number of users who conclude such a transaction while using a device in that Member State. But if the intermediation service does not involve the facilitation of underlying transactions, the factor that should be taken into account is the number of users in that tax period holding an account which was opened using a device in that Member State, whether opened during that tax year or an earlier one. Finally, as regards a taxable service consisting in the *transmission of data collected about users*, it should be taken into account the number of users from whom data transmitted in that tax period has been generated as a result of such users having used a device in that

State. In any case, the taxable revenues should be equivalent to the total gross revenues received by a taxable person, net of VAT and other similar taxes (Article 3(2)).

To prevent eventual cases of double taxation where the same income is subject to the corporate income tax and DST, Member States should allow the deduction of the DST paid as a cost from the corporate income tax base in their territory, regardless of whether both taxes are paid in the same or in different Member States.

That said, if no revenues are obtained from the supply of the taxable services (the placing on a digital interface of advertising targeted at users of that interface; the making available of multi-sided digital interfaces which allow users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users; and the transmission of data collected about users and generated from such users' activities on digital interfaces), there should be no DST liability. Crowdfunding platforms, investment and lending based crowdfunding would be outside the scope of the DST because the providers of such services play the same role as that of trading venues and systematic internalisers; therefore, it is not intermediation (Articles 3(4) and 3(5)). But services provided by crowdfunding platforms that are not investment and lending based and constitute intermediation (i.e., donation or reward based crowdfunding, or services provided by such platforms consisting in the placing of advertising) would fall within the scope of the Directive.

In order to ensure that this interim proposal does not negatively impact on small or emerging businesses, and that its application is limited to cases where there is a significant digital footprint at EU level in relation to the type of revenues covered by the tax, two thresholds would apply (Article 4). Only large digital enterprises, i.e., those with total worldwide revenues of over 750 million euros[54] and EU digital revenues over 50

[54] And by the way, the same threshold has been suggested in Article 2 of the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB).

million euros, would qualify as taxable persons for the purposes of the DST, regardless they are established in a Member State or in a non-EU jurisdiction.

Additionally, the tax would be collected by the State where the users are located; at this point, a One Stop Shop (OSS) collection mechanism is suggested for taxable persons with DST liability in one or more Member States. In this latter case, the taxable persons would fulfil their tax obligations (identification, submission of the DST return and payment) at once. Under the OSS system, one Member State (the Member State of identification) should collect the information and the payment of the tax on behalf of the other Member States where the DST is due, and later that State should exchange that information and share the collected amounts with the other Member States.

In this regard, the implementation of the interim solution would improve the perception of fairness for EU citizens by ensuring a minimum level of taxation in the EU for companies that rely the most on user contributions and data. Additionally, only large companies above the thresholds would have to comply with reporting requirements to compute their tax base in the Member States in which they are active; by contrast, small and medium-sized enterprises would not be affected because their revenue would not reach the thresholds. On the other part, national tax administrations would have to cope with initial costs to implement this measure, although the expected additional revenue from the tax would cover the initial administrative costs.

It must be noted that the EU Digital Services Tax was designed following the guidelines included in the OECD Report '*Tax Challenges Arising from Digitalisation – Interim Report 2018'* (OECD, 2018) as well as some current EU Member States unilateral practices. Actually, the European Commission and the OECD are working closely on the development of an international comprehensive solution to taxing the digital economy. But, since reaching an international consensus may take time, action has been taken at

EU level to propose a harmonised approach on an interim solution that addresses this problem.

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