

STUDY

Requested by the TAX3 Committee



Impact of Digitalisation on International Tax Matters

Challenges and Remedies



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Abstract

This paper was prepared by Policy Department A at the request of the Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3) to discuss tax challenges posed by digitalisation, especially regarding new business models and value creation process, the impact of Base Erosion and Profit Shifting (BEPS) actions, unilateral measures and recent tax developments in the European Union (EU) and the United States (US) while evaluating alternative approaches to reform the international tax system and highlighting difficulties and opportunities presented by Blockchain and collaborative economy for international taxation.

This document was requested by the European Parliament's Committee on Financial Crimes, Tax Evasion and Tax Avoidance.

AUTHOR

Eli HADZHIEVA, Dialogue for Europe

ADMINISTRATOR RESPONSIBLE

Dirk VERBEKEN

EDITORIAL ASSISTANT

Janetta Cujkova

LINGUISTIC VERSIONS

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ABOUT THE EDITOR

Policy departments provide in-house and external expertise to support EP committees and other parliamentary bodies in shaping legislation and exercising democratic scrutiny over EU internal policies.

To contact the Policy Department or to subscribe for updates, please write to:

Policy Department for Economic, Scientific and Quality of Life Policies

European Parliament

L-2929 - Luxembourg

Email: Poldep-Economy-Science@ep.europa.eu

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LIST OF ABBREVIATIONS

AI	Artificial Intelligence
AML	Anti-Money Laundering
AOA	Authorised OECD Approach
APA	Advance Pricing Agreements
ATAD	Anti-Tax Avoidance Directive
BEAT	Base Erosion and Anti-Abuse Tax
BEPS	Base Erosion and Profit Shifting
Bots	Software robots
BRICs	Brazil, Russia, India and China
B2B	Business to Business
B2C	Business to Consumer
CbCR	Country-by-Country Reporting
CCCTB	Common Consolidated Corporate Tax Base
CFC	Controlled Foreign Corporation
CIT	Corporate Income Tax
CJEU	Court of Justice of the European Union
CRS	Common Reporting Standard
DBCFT	Destination Based Cash Flow Tax
DEMPE	Development, Enhancement, Maintenance, Protection and Exploitation
DPT	Diverted Profits Tax
DST	Digital Services Tax
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortisation
EC	European Commission

ECOFIN	Economic and Financial Affairs Council
E-commerce	Electronic commerce
EU	European Union
EUR	Euro
FATCA	Foreign Account Tax Compliance Act
FATF	Financial Action Task Force
FDII	Foreign-Derived Intangible Income
GAAR	General Anti-Abuse Rule
GAFA	Google, Apple, Facebook, Amazon
GATS	General Agreement on Trade in Services
GBP	Great Britain Pound
GDP	Gross Domestic Product
GDPR	General Data Protection Regulation
GILTI	Global Intangible Low-Taxed Income
GNI	Gross National Income
GST	Goods and Services Tax
G-20	Group of Twenty
HMRC	Her Majesty's Revenue and Customs
HUF	Hungarian Forint
ICAEW	The Institute of Chartered Accountants in England and Wales
ICTs	Information and Communication Technologies
ID	Identification
IMF	International Monetary Fund
IoT	Internet of Things

IP	Intellectual Property
IT	Information Technology
LOB	Limitations-on-Benefits
LuxLeaks	Luxembourg Leaks
MAAL	Multinational Anti-Avoidance Law
MLI	Multilateral Instrument
MNEs	Multinational Enterprises
MOSS	Mini One-Stop-Shop
MTEC	Missing Trader Extra-Community Fraud
MTIC	Missing Trader Intra-Community Fraud
OECD	Organisation for Economic Co-operation and Development
OSS	One-Stop-Shop
PE	Permanent Establishment
PPT	Principle Purposes Test
R&D	Research & Development
SAF-T	Standard Audit File for Tax
SEP	Significant Economic Presence
SMEs	Small-and Medium Enterprises
QMV	Qualified Majority Voting
TAX3	Tax Evasion and Tax Avoidance
TCJA	Tax Cuts and Jobs Act
TP	Transfer Pricing
UK	United Kingdom
UN	United Nations

US	United States
USD	US Dollar
VAT	Value-Added Tax
VI	Virtual Intelligence
VIES	VAT Information Exchange System
VPN	Virtual Private Networks
WEF	World Economic Forum
WHT	Withholding Tax
WTO	World Trade Organisation
WWW	World Wide Web
3D	Three-dimensional

EXECUTIVE SUMMARY

The scale of and pace of digitalisation coupled with aggressive tax planning schemes to shift profits to low-tax jurisdictions by Multinational Enterprises (MNEs), which was put under the spotlight by Luxembourg Leaks (LuxLeaks), Panama Leaks and Paradise Papers, is exerting pressure on tax administrations to ensure fair taxation.

Business models are rapidly evolving and new business models are emerging due to Internet of Things (IoT), Artificial Intelligence (AI), Blockchain, collaborative economy and other technological advancements. With many established digital companies having multiple business lines, the differentiation between multi-sided platforms and other digitalised businesses becomes challenging.

With the **digital goods being highly mobile or intangible**, the physical presence of a company in the market country is often not needed, which is at odds with the outdated international tax system based on the condition of a connecting link to assert jurisdiction for taxation purposes. However, any departure from the nexus principle, which ‘forms part of general international law of income tax jurisdiction’, may question the very essence of statehood and state sovereignty.¹

The key features of digital companies such as **tendency towards monopoly, reliance on network effects, user participation and user-generated content** exacerbate broader tax challenges. These challenges remain unaddressed, even following the new Transfer Pricing (TP) Guidelines aiming to bring transfer pricing outcomes in line with value creation and the modifications to the Permanent Establishment (PE) threshold in the OECD Model Convention. Moreover, some **features specific to the digital sector may be further exacerbated by new technologies**, as smart data is likely to encourage the emergence of other business models, which are currently ‘unforeseeable’.²

The extensive use of data and user-generated content, which is particularly relevant for multi-sided businesses³, raises the question on whether the users contribute to **value creation** by providing their data to platforms in exchange for free access. Especially developing countries with big consumer markets are advancing the benefits theory principle to account for demand-side factors, such as sales, for value creation. On the contrary, others believe that supply-side factors, such as risks, intangibles and human capital, are the main income-generating elements.

The **OECD’s BEPS Actions** were effective at setting minimum standards, which are subject to peer review in the framework of the Multilateral Instrument (MLI). The impact of some BEPS measures can already be observed, with the modified nexus approach linking Intellectual Property (IP) regimes to Research & Development (R&D) activities. Some progress has been made on Controlled Foreign Company (CFC) rules with the adoption of the US Tax Cuts and Jobs Act (TCJA), the EU’s Anti-Tax Avoidance Directive (ATAD) and similar measures in Japan, Chile and Colombia. However, these legislations are set to eliminate high returns to cash-boxes but not the cash-boxes themselves.

Overall, the **effects of the most relevant Action Points** to digitalisation, such as Action 7 on Permanent Establishment and Action 8-10 on transfer pricing, are rather limited. They do not ‘adequately address taxation of digital platforms and businesses providing goods and services in countries without, or with limited PE presence.’ What is worse is that BEPS measures can lead to economic distortion while enhancing tax competition if MNEs decide to move their real economic

¹ Gadzo (2018).

² KPMG (2016) Comments with respect to the request for input with respect to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

³ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

activity to low-tax jurisdictions. Conversely, in late January 2019, the OECD renewed its commitment to reaching a consensus-based, long-term solution in 2020, with an update to be presented to the G20 during 2019.

Meanwhile, many countries introduced **unilateral measures**, including France's new GAFA tax, Hungary's advertisement tax, the United Kingdom's Diverted Profit Tax (DPT) and India's equalisation levy. These measures represent the following risks: Negative impact on investment, negative impact on innovation, growth and welfare, potential to shift economic incidence of taxation onto consumers, possibility of over-taxation and difficulties in implementation and compliance.

The OECD acknowledges that business models with high levels of scale without mass and business models relying on user participation and network effects '**constitute the highest risk**'⁴ but does not recommend any uncoordinated action prone to ring-fence the digital economy. Nevertheless, in March 2018, the European Commission proposed a Digital Services Tax (DST) in the short term and a Digital PE in the long term while declaring that it 'preferred rules agreed at the global level, including at the OECD'⁵.

Several **technical and political problems** surrounding the proposal put into question its adoption prospects. The difficulty to implement uniform measures to different digital business models without double taxation, the risk of putting some traditional industries in the process of digitalisation in the crossfire of policies meant for the tech giants, logistical problems related to tracking the localisation of the users, compliance and administrative burdens, possible impediment to growth and technological progress and fear of a US backlash are amongst arguments voiced against the Commission's digital tax reform. Moreover, Member States have diverging positions on the proposal due to different levels of technological advancement and distinct tax policies.

The problems and distortions in the formulary apportionment model in the US as well as the CCCTB in the EU led to discussions on **destination-based models**,⁶ which promise a structural solution as opposed to sheer avoidance measures, regardless of their being 'more or less legitimate than origin-based taxation or the CCCTB'.⁷ One example is the Destination-Based Cash Flow Tax (DBCFT), focusing on immobile factors in order to eliminate real economic distortions, profit-shifting and tax competition among countries. However, in a similar way to new taxes, doubts were raised about double taxation risks in the absence of its global application.

Concerning the **Value-Added-Tax (VAT)**, the destination principle started to be largely applied, with the EU's simplified compliance regime resulting in an excess of EUR 3 billion. Yet, these reforms are seen as insufficient to address compliance and enforcement issues and to eliminate tax fraud stemming from the expansion of electronic commerce (e-commerce). Currently, a definitive VAT regime proposal based on the destination principle, reverse charge mechanism and deeming provision is on the EU's agenda.⁸ The changes are expected to cut down fraud, simplify procedures and ensure equal treatment of inter-community and national purchases of goods⁹ but the vendor model has also its disadvantages.

⁴ OECD Interim Report (2018) Tax Challenges Arising from Digitalisation, p.184.

⁵ European Commission Press Release (2018) Digital Taxation: Commission proposes new measures to ensure that all companies pay fair tax in the EU.

⁶ Andrus and Oosterhuis (2017).

⁷ Schippers and Verhaeren (2018).

⁸ Lamensch (2018)

([https://wwwfr.uni.lu/content/download/108620/1284581/file/Tax%20and%20the%20Digital%20Economy_Slides_20180420%20\(downsampling\).pdf](https://wwwfr.uni.lu/content/download/108620/1284581/file/Tax%20and%20the%20Digital%20Economy_Slides_20180420%20(downsampling).pdf), p.101).

⁹ Lexology (2018) New EU-VAT system for the trade of goods by 2022? (<https://www.lexology.com/library/detail.aspx?g=2de24431-1595-4ade-ad0f-51494ffe57c3>).

As the OECD's 117-Member Inclusive Framework is extremely divided on the issue of digital taxation, reaching international consensus on nexus and profit allocation rules by 2020 seems to be ambitious, albeit still the objective. If it misses this window of opportunity to build global consensus, the Organisation may lose its appeal as a standard-setting body, paving the way for further fragmentation of international rules through uncoordinated and complex unilateral rules.

The consequences of the EU's promptness to assume a leading role in digital taxation matters are unclear: It may put some pressure to reach agreement in the international arena or could lead to retaliatory unilateral measures, for example, by the US. At the same time, policymakers shall be aware of the fact that unilateral measures, even at a regional level, could hamper international efforts. Such temporary measures are generally known to be perpetuated, one example being the UK's Corporate Income Tax (CIT), which was introduced as an interim measure during the Napoleonic Wars and has remained in place until present day.

1. SPECIFIC FEATURES OF THE DIGITAL ECONOMY AND THEIR IMPLICATIONS FOR TAXATION

KEY FINDINGS

- The digital economy is growing exponentially while the whole economy is going digital. Digitalisation transforms entire industries by changing the nature of innovation, product development and producer-consumer interactions.
- Digital businesses have a tendency towards monopolisation due to network effects, scale effects, restrictions of use, potential to differentiate and multi-sided platforms. Yet, they are volatile and easily contestable by disruptive newcomers, as barriers of entry and exit are low.
- The Fourth Industrial Revolution marked by 'a range of new technologies that are fusing the physical, digital and biological worlds, impacting all disciplines, economies and industries' fundamentally changed the way of doing business.
- The intensity, magnitude, speed and transformational power of the digital economy puts pressure on governments to design and address modern and innovative policies fit for the digital age.
- LuxLeaks, Panama Papers and Paradise Papers as well as the EU investigations on digital tech giants shed light on a wide range of tax evasion schemes used by large businesses triggering a heated public debate on the need for fair taxation.
- The main tax challenges of the digital economy include lack of nexus, reliance on intangibles, data and user-generated content, income characterisation, spread of new business models, in which the buyer and seller are in different jurisdictions and the expansion of e-commerce.
- New digital business models are emerging and expanding as a consequence of AI, IoT, adaptive manufacturing and autonomous supply chains.
- The European Commission (EC) divides digital businesses into online retailer model, social media model, subscription model and collaborative platform model while the OECD defines them as multi-sided platforms, resellers, vertically integrated firms and input suppliers.
- Some traditional industries, such as automotive manufacturing, have begun to digitise their processes and services.
- The digital transformation puts into question the existing taxation framework and the role of new technologies as well as high-skill jobs for value creation, with market jurisdictions highlighting the income-generating contribution of data and user interaction. According to the Commission, in some digital business models, including social media, distant sales, platforms and advertising, value is not linked to taxation.
- The OECD discusses three value creation processes: value chain, value shop and value network, the latter of which represents the strongest case for value creation in the market and accounts for online advertising and intermediation services.
- There is no strong consensus within the OECD on whether or not user contribution shall be taken into consideration to determine how value is created for taxation purposes.
- Although user data are in the centre of discussion at present time, the digitalisation of the economy underpins that broad spectrums of data could be turned into smart data in the near future.

1.1. Key Features of the Digital Economy

1.1.1. Rapid Digitalisation of the Economy

There is no agreed definition on the digital economy but according to the International Monetary Fund (IMF), ‘the “digital economy” is sometimes defined narrowly as online platforms, and activities that owe their existence to such platforms, yet, in a broad sense, **all activities that use digitised data are part of the digital economy**: in modern economies, the entire economy.’¹⁰ Those in favour of targeted measures regarding the digital sector tend to use the narrow definition whereas others opposing the ring-fencing the digital economy refer to the broad definition.

The digital economy is **growing exponentially** with the rapid diffusion of digital technologies at an unprecedented proportion, while the **entire economy is going digital**. The **massive increase of volumes of data** gathered from digital platforms, sensors and smart phones is accompanied by increasing storage capacity, stronger computing power and more sophisticated algorithms.¹¹ These factors as well as innovations, such as machine learning, are increasingly **transforming and ‘digitalising’ traditional sectors** such as retail, manufacturing, publishing, health care and car industry (as well as trucking and banking in the near future).¹²

The phenomenon of digitalisation, which emerged with the World Wide Web (WWW) only some 25 years ago, is causing a tremendous transformation to the existing industries by changing the nature of **innovation, product development as well as interactions between producers and consumers**. By 2020, the number of overall connected devices worldwide is expected to reach 30 billion.¹³ According to the World Economic Forum (WEF), the estimated value of this digital transformation will amount to USD 100 trillion by 2025.¹⁴ The EU is expected to reap the benefits of this transformation given its strategic connectivity objectives for 2025 in the framework of its Digital Single Market Strategy.¹⁵ **With the adoption of 5G and the EU data market exceeding EUR 106 billion in 2020**, European industries, such as manufacturing, energy, automobile and health care, could significantly evolve and adapt their infrastructures and services further to the era of IoT.¹⁶

While embracing the opportunities generated by the digital (or digitalised) economy, the EU will also have to face new challenges caused by it. Whereas only one tech company qualified for the top 20 list in Europe by market capitalisation in 2006 with a share of 7%, **9 digital companies, led by US tech giants**, were in the top 20 with a 54 % portion of the market in 2017.¹⁷ Alarmingly, only 1 EU company is found in top 25 tech companies according to Forbes.

¹⁰ IMF (2018) Measuring the Digital Economy (<https://www.imf.org/~media/Files/Publications/PP/2018/022818MeasuringDigitalEconomy.ashx>).

¹¹ McKinsey Global Institute (2016) The Age of Analytics: Competing in a Data-Driven World’ (<https://www.mckinsey.com/~media/McKinsey/Business%20Functions/McKinsey%20Analytics/Our%20Insights/The%20age%20of%20Analytics%20Competing%20in%20a%20data%20driven%20world/MGI-The-Age-of-Analytics-Full-report.ashx>).

¹² Mühleisen (2018) (<http://www.imf.org/external/pubs/ft/fandd/2018/06/impact-of-digital-technology-on-economic-growth/muhleisen.htm>).

¹³ European Parliamentary Research Service (2017) Free flow of non-personal data in the European Union.

¹⁴ World Economic Forum (2016) \$100 Trillion by 2025: The Digital Dividend for Society and Business’ (<https://www.weforum.org/press/2016/01/100-trillion-by-2025-the-digital-dividend-for-society-and-business/>).

¹⁵ European Commission (2018) Broadband Europe promotes European Commission’s vision and policy action to turn Europe into a Gigabit Society by 2025 (<https://ec.europa.eu/digital-single-market/en/broadband-europe>).

¹⁶ European Parliamentary Research Service (2018) Adapting to new digital realities-Main issues and policy responses ([http://www.europarl.europa.eu/RegData/etudes/BRIE/2018/614734/EPRS_BRI\(2018\)614734_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/BRIE/2018/614734/EPRS_BRI(2018)614734_EN.pdf)).

¹⁷ Brookings Institution (2017) Taxing the digital economy-it’s complicated, p.1 (<https://www.brookings.edu/blog/future-development/2017/12/13/taxing-the-digital-economy-its-complicated/>).

Only after some 20 years of their inception, the **ever-increasing prominence of tech companies** is unstoppable. Given that the cumulated turnover of GAFAs (Google, Apple, Facebook, Amazon) corresponds to the average Gross Domestic Product (GDP) of a State¹⁸, it is not surprising that Denmark appointed a Digital Ambassador to deal with large Multi-National Enterprises (MNEs) in the digital sector last year.¹⁹

The intensity, magnitude, speed and transformational power of the digital economy puts pressure on governments to design and address modern and innovative policies fit for the digital age, which will be marked by automated cars, personalised medicine and robotics.

1.1.2. Distinguishing Characteristics of the Digital Sector

Digitalisation renders operations of companies more efficient and faster while permitting time and cost savings for the product and service development processes.²⁰ It is also said to improve the corporate decision-making process, as enterprises following the path of data-driven-decision-making can enjoy 5-6% output and productivity gains.²¹ This occurs thanks to dropping prices of **Information and Communication Technologies (ICTs), big data and analytics, and a constant drive for innovation.**²²

Digital businesses, such as e-commerce, online advertising and cloud computing, have a tendency towards monopolisation due to network effects, scale effects, restrictions of use, potential to differentiate and multi-sided platforms. Yet, they are volatile and **easily contestable** by disruptive newcomers, as **barriers of entry and exit are low**. Hence, early success is no guarantee as many of the pioneers of the digital economy in the 1990s failed to keep their market domination (i.e. Cisco) while online shopping companies, such as Boo.com, and communication companies, such as WorldCom, got swept away in the dotcom crash of 2000.

The **Fourth Industrial Revolution** is the most important development in the world economy since the industrial revolution. Distinguished by 'a range of new technologies that are fusing the physical, digital and biological worlds, impacting all disciplines, economies and industries'²³, it has radically changed the way of doing business, by blurring boundaries between consumers and producers, among other things.

In addition, **AI, Virtual Intelligence (VI) and automation** altered the division of labour in the economy, human labour shifting to more creative and strategic tasks while **digital labour** is increasingly used in areas 'susceptible to full automation'.²⁴

¹⁸ Le Figaro, La toute-puissance des Gafa commence à inquiéter, 2 February 2018 (<http://www.lefigaro.fr/secteur/high-tech/2018/02/02/32001-20180202ARTFIG00351-la-toute-puissance-des-gafa-commence-a-inquieter.php>).

¹⁹ Le Figaro, Les GAFAs élevés au rang de puissance diplomatique ou la tyrannie des géants du Web, 2 February 2017. (<http://www.lefigaro.fr/vox/monde/2017/02/02/31002-20170202ARTFIG00113-les-gafa-eleves-au-rang-de-puissance-diplomatique-ou-la-tyrannie-des-geants-du-web.php>).

²⁰ KPMG (2017) Comments with respect to the Request for Input to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of the Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers, p.5.

²¹ European Parliamentary Research Service Briefing (2017) Free flow of non-personal data in the EU.

²² ICAEW (2018), Fair Taxation of the Digital Economy European Commission Questionnaire, p. 1.

²³ World Economic Forum (2017) Navigating the Fourth Industrial Revolution (<https://www.weforum.org/agenda/2017/08/fourth-industrial-revolution-990fcaa6-9298-471d-a45e-e6ed9238dde9/>).

²⁴ KPMG (2017) Comments with respect to the Request for Input to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of the Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers, p.5.

As **digital goods** are highly **mobile, the physical presence** of a company in the market country **is often not needed**. This renders digital businesses (or so-called click-and-mortar businesses)²⁵ substantially different from traditional businesses.

Digital business models generally rely on **intangible** property (licenses, brands, trademarks, copyrights) and place greater importance on use of technology (cloud, analytics, algorithms, smart machines). Although brick-and mortar businesses are likely to catch up and bring themselves into the digital age in the future, these developments put huge competitive constraints on these more traditional sectors.²⁶ To give an example, while top 5 e-retailers expanded approximately by 32% per year between 2008 and 2016, the entire EU retail sector registered only around 1% annual growth.²⁷

1.1.3. Why is the Digital Economy Posing Challenges for Taxation?

LuxLeaks, Panama Papers and Paradise Papers as well EU investigations on major MNEs, including digital tech giants, shed light on a wide range of tax evasion schemes used by large businesses triggering a heated public debate on the need for fair taxation. A recent survey shows that 74 % of the people believe that current taxation rules allow digital business models to benefit from specific taxation regimes and to **pay lower taxes**. 82% believe that action to address this should be taken.²⁸ Against this backdrop, the **EU governments, experiencing political and media pressure** felt compelled to ensure that digital companies pay their fair share of tax where their profits are generated.²⁹ The quest for fairness was justified by the EU Tax Commissioner Pierre Moscovici as he highlighted that **digital companies pay an average of 9% effective tax rate** in the EU compared to other firms that pay 21%.³⁰ However, this view is contested by recent studies, which do 'not support conclusions that the digital sector is undertaxed'.³¹

The specific features of the digital economy **exacerbate BEPS risks** and cause challenges for tax policy. These challenges are neither new nor unique to the digital sector as cross-border transactions of delivery companies posed similar questions regarding the determination of the taxing jurisdiction. Yet, the scale of these transactions and their ever-expanding nature induce tax policymakers to find appropriate and timely solutions to address them.³²

The main tax challenges of the digital economy include lack of nexus (or taxable presence in a jurisdiction), reliance of intangibles, data and user-generated content, income characterisation, spread of new business models, in which the buyer and seller are in different jurisdictions, and the expansion of e-commerce.³³

²⁵ Cockfield (2014).

²⁶ KPMG (2016) Comments with respect to the request for input with respect to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

²⁷ European Commission Communication from the Commission to the European Parliament and Council, A Fair and Efficient Tax System in the European Union for the Digital Single Market, 21 September 2017 (https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_taxation_digital_single_market_en.pdf).

²⁸ European Commission, Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market, 21 March 2018.

²⁹ Jones, Seabrook, Sciliberto and Jones Tax Journal (2018) Taxing the digital economy-The Unilateral Approach <https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>.

³⁰ European Commission, Keynote Speech by Commissioner Moscovici at the 'Masters of Digital' event, Brussels, 20 February 2018 (http://europa.eu/rapid/press-release_SPEECH-18-981_en.htm).

³¹ PwC (2018) Understanding the ZEW PwC Report 'Digital Tax Index, 2017' (<https://www.pwc.com/us/en/press-releases/2018/understanding-the-zew-pwc-report.html>).

³² Vella (2018) (<http://business-taxation.sbsblogs.co.uk/2018/02/21/taxing-digital-business-a-plea-for-holistic-thinking/>).

³³ OECD Observer (2017), Tax challenges, disruption and digital economy, p. 2.

The OECD identified three main challenges – scale without mass, reliance on intangibles and user participation. First, the fact that a business can be virtually conducted **without any physical presence** poses one of the main policy challenges. It is more and more difficult to determine the jurisdiction eligible for taxation under the existing rules, as assets and activities of digital businesses can easily move across jurisdictions to avoid taxable presence in a high-tax jurisdiction. Finally, the **expansion of e-commerce** poses difficulties as to determine the responsible jurisdiction for taxation, with many sellers avoiding registration in third states, where they conclude transactions via platforms. This makes **tax enforcement, collection and identification of business tax functions** (the people and systems required and the use of financial data) difficult, especially concerning cross-border trade in services and intangibles. At the same time, growing technology uptake by tax administrations could ameliorate taxpayer services and alleviate compliance burdens.³⁴

Second, **reliance on intangibles** increases the ability of companies to structure themselves to minimise their tax liabilities and makes it more cumbersome for tax authorities to assess how income from such assets should be identified, valued and allocated amongst different parts of multinational groups.

Third, **extensive use of data and user-generated content**, which is particularly relevant for multi-sided businesses³⁵, raises the question on whether the users contribute to value creation by providing their data to platforms in exchange for free access (which is then sold to online advertisers by platforms) in addition to enlarging the user base of the platform and enhancing its reputation through network effects.

In addition, the **characterisation of income** (between business income subject to corporate tax on net income and royalties/technical services subject to withholding tax on gross income) becomes extremely difficult.³⁶

Furthermore, new delivery channels³⁷ and new business models, such as service-oriented models using software or hardware³⁸, cloud computing, 3D printing³⁹, collaborative platforms and Blockchain, pose legal uncertainty for both taxpayers and administrations, as they are hardly matched by existing rules. The sheer diversity of the digital businesses and digital businesses using multiple business lines are further tax challenges, which shall be addressed by robust measures that would last in face of rapid digital evolution.⁴⁰

1.2. New Business Models

A digital business model can be defined as ‘the global network of economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks’.⁴¹

New digital business models are emerging and expanding as a consequence of AI, IoT, adaptive manufacturing and autonomous supply chains. With increasingly blurred lines between sectors, the

³⁴ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

³⁵ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

³⁶ Basak (2016).

³⁷ BBVA Digital Economy Outlook (2016) Tax Challenges of the Digital Economy.

³⁸ European Commission Directorate-General Communications Networks (2015) Digital Sector Based Own Resource-conclusions reached by the EC Expert Group and OECD-BEPS Action Plan on taxation and the digital economy (Presentation).

³⁹ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

⁴⁰ Jones, Seabrook, Sciliberto and Jones (2018) Taxing the digital economy-The Unilateral Approach (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

⁴¹ European Parliamentary Research Service Briefing (2017) Effective Corporate Tax Rate and Digital Business Establishment in the Corporate Tax Base Proposals.

emergence of innovative pricing models and diversification of revenue streams, these models are transforming the economy all by challenging basic economic notions.⁴²

Even the categorisation of the digital business models is a challenge in itself. The European Commission in its Communication of September 2017 uses the following categories: **Online retailer model, social media model, subscription model and collaborative platform model.**

The OECD, on the other hand, identifies four business models in its Interim Report on Tax Challenges Arising from Digitalisation of 16 March 2018: **Multi-sided platforms, resellers, vertically integrated firms and input suppliers.** Multi-sided platforms include platforms, such as Uber and Facebook, that ‘allow end-users to exchange and transact while leaving control rights and liabilities towards customers mostly with the supplier’. Resellers cover businesses, such as Amazon and Alibaba, that purchase products from suppliers and ‘resell them to buyers’. Vertically integrated firms refer to businesses, such as Huawei and Amazon, which integrate ‘the supply side of the market within their business’. Input sellers encompass businesses, such as Intel, which supply ‘intermediary inputs required for a production process of goods and services in another firm’.⁴³

Due to the rapid evolution of business models, many established digital companies have **multiple business lines.** For example, Amazon Marketplace is a multi-sided platform whereas Amazon e-commerce is a reseller and Amazon e-commerce (warehousing and logistics) can be defined as a vertically integrated firm. Another example is Netflix, which was a pure reseller but later integrated film production into its business model, acquiring characteristics of integrated firms. In the same vein, the Chinese e-retail giant Alibaba owns a bank and applies its data skills to finance by providing loans to its customers.⁴⁴ As illustrated by these examples, the differentiation between multi-sided platforms and other digitalised businesses is almost impossible.⁴⁵

Some traditional industries, such as automotive manufacturing, have begun to digitise their processes and services. The innovation centre of the German healthcare company Merck KGaA and the digital vending solutions of Coca Cola Enterprises Inc. are some examples.⁴⁶

Smart data (i.e. AI, machine learning) together with large data volumes enabled through IoT is likely to encourage the emergence of other innovative business models, which are currently ‘unforeseeable’.⁴⁷

1.2.1. Value Creation in the Digital Era and its Relevance for International Taxation

The digital transformation brought by the digital sector is **putting into question the existing taxation framework and, the role of new technologies and high-skill jobs for value creation.**⁴⁸ What is more, with the new products brought by digitalisation, the transformation of traditional industries and high mobility of MNEs, it is hard to determine where value is created and which factors contribute to value creation.

⁴² EY (2018) Don’t miss the BEAT on US tax reform ([https://www.ey.com/Publication/vwLUAssets/ey-tax-reform-eight-impact-areas-that-will-shape-tomorrows-operating-models/\\$FILE/ey-tax-reform-eight-impact-areas-that-will-shape-tomorrows-operating-models.pdf](https://www.ey.com/Publication/vwLUAssets/ey-tax-reform-eight-impact-areas-that-will-shape-tomorrows-operating-models/$FILE/ey-tax-reform-eight-impact-areas-that-will-shape-tomorrows-operating-models.pdf)).

⁴³ OECD (2018) Tax Challenges Arising from Digitalisation – Interim Report 2018, pp.30-31.

⁴⁴ Mühleisen, M. (2018) (<http://www.imf.org/external/pubs/ft/fandd/2018/06/impact-of-digital-technology-on-economic-growth/muhleisen.htm>).

⁴⁵ OECD (2018) Tax Challenges Arising from Digitalisation – Interim Report 2018, pp.30-31.

⁴⁶ Olbert and Spengel (2017).

⁴⁷ KPMG (2016) Comments with respect to the request for input with respect to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

⁴⁸ Dourado (2018), p. 567.

While some (including EU Commission, UK Treasury, OECD etc.) argue that the existing system is based on the **principle of value creation**, others support the view that the existing system does not actually follow this principle. Moreover, it is not clear that the international tax system *should* follow the principle that profits are taxed where value is created, bringing into question the choice of this principle as a guide to the allocation of profit among countries.⁴⁹

From a business point of view, value is created 'through development and exploitation of intangibles, effective risk management and operational excellence'. Digital networks introduce significant security, reputational and financial risks as 'companies must manage, maintain and protect customer and user data'.⁵⁰ Some scholars argue that 'added value is ultimately created in all cases by the intellectual element of a human being', as raw data does not create value and needs to be processed and analysed to be incorporated into the value creation process. This is made possible thanks to the intellectual use of tools, such as algorithms and software, by the individual (i.e. programmer).⁵¹ The supporters of this view are convinced that added value originates in the place where the individual adds the intellectual element and could be attributed according to the current system based on the arm's length principle and people functions.⁵² It is also underscored that human capital in its specific form of knowledge-based capital is becoming a predominant value driver of businesses, particularly in the digital age and that such capital should have substantial weight in the functional analysis of purposes of profit allocation.⁵³ Some even suggest taking into account the number of days that an individual works in a country.⁵⁴

However, these claims seem to raise doubts, especially in the aftermath of the Cambridge Analytica scandal, among the critics who believe that **without users there would be no markets and no profits**, especially for new business models, which are based on user participation. This group argues that following the digital revolution, the value of an enterprise is driven by external factors increasingly found in the users associated with the enterprise (demand-side factors), which are 'no longer at the end of the value chain but right in the middle of it'.⁵⁵

In effect, the **personal information** on user's behavioural patterns, preferences, opinions and shopping habits are being aggregated and processed by use of **cookies and algorithms**, which is then **monetised as 'market knowledge and marketing intangibles'**.⁵⁶ Nonetheless, the question of user contribution is not unique to the digital sector, as traditional businesses, such as car and aircraft engine manufacturers, also collect real-time data from their customers to improve their products.⁵⁷

In line with the **benefits theory**, market countries claim that by providing infrastructure and legal protection, consumers/users create value considering the fact that producers could not make profit without the existence of a market.⁵⁸ Nevertheless, it is not clear whether technological infrastructure

⁴⁹ Devereux and Vella (forthcoming).

⁵⁰ KPMG (2016) Comments with respect to the request for input with respect to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

⁵¹ Kemmeren (2018)

⁵² Kemmeren (2018)

⁵³ Olbert and Spengel (2017)

⁵⁴ Kemmeren (2018), p.73.

⁵⁵ Schippers and Verhaeren (2018), p.64.

⁵⁶ De Wilde (2018).

⁵⁷ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p. 16.

⁵⁸ Turina (2018).

relates to value creation, as demonstrated by the much-debated but abandoned idea of a bandwidth tax based on the volume of bandwidth used by MNEs' websites.⁵⁹

A middle ground argument is also proposed, which reconciles value created by the digital enterprise through Research & Development (R&D) and that by the customers and users in the market.⁶⁰

Value creation and margins under various business models may be very different,⁶¹ which is why new business models further complicate the situation. Like business models, value chains are undergoing a transformation, making **value creation more independent of physical presence** in the market country.⁶²

The OECD Interim Report elaborates three concepts of value creation: **Value chain** (brick-and mortar businesses creating value by converting inputs into outputs in a systemic way), **value shop** (cloud computing using intensive technology) and **value network** (multi-sided platforms creating value relying on a mediating technology, user contribution and network effects).

The **strongest case for value creation** in the market can be made for value network, covering **online advertising and intermediation services**,⁶³ which takes into account the role of data and user participation. Nevertheless, it is important to note that some prominent proponents of the view that taxing rights should be allocated the country where users are located, are not in favour of allocating taxing rights to the market country, as it is important to distinguish between users and consumers in their view.⁶⁴

User participation could occur through **social networks, collaborative consumption, e-commerce (tangibles and intangibles), cloud and manufacturing**. A distinction is made between active (i.e. posting) and passive participation (i.e. downloading an app) in the OECD's Interim Report. Moreover, ratings and reviews contribute to establishing a trust mechanism, attracting traffic and enhancing the reputation of the platform.⁶⁵

According to the report, the following characteristics are typical for digitalised businesses: **Reliance on intangibles, scale without mass (minimal or no need for personnel or physical establishment to operate in market jurisdiction) and user value creation**. Yet, there is no consensus on the relevance of these key features, their importance to the location of value creation and the identity of value creator.⁶⁶

There are three diverging views within the OECD's 117-Member Inclusive Framework on BEPS regarding the contribution of users to value creation. The first group, including the EU, believes that user value creation allows businesses to collect large amounts of data and contributes to network effects, which justifies taxation in the country where users are located.⁶⁷

The second group, including the United States, does not interpret the user-generated value relevant for taxation.

⁵⁹ Olbert and Spengel (2017).

⁶⁰ Baumann (2017).

⁶¹ Turina (2018).

⁶² PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

⁶³ KPMG (2018), OECD Task Force on the Digital Economy release Interim Report.

⁶⁴ HM Treasury (2017) Corporate Tax and The Digital Economy: Position Paper

(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661458/corporate_tax_and_the_digital_economy_position_paper.pdf).

⁶⁵ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy, OECD Interim report.

⁶⁶ OECD (2018) Tax Challenges Arising from Digitalisation – Interim Report 2018, p.24.

⁶⁷ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

The third group accepts that user data may be recognised as contributing to valuable intangible assets but would like to discuss the issue within the framework of the broader challenges posed by intangibles.⁶⁸

Unlike the OECD, the European Commission has a more precise understanding of value creation in the digital economy, as it concludes that value occurs as ‘a combination of algorithms, user data, sales functions and knowledge’.⁶⁹

In its public consultation on Fair Taxation and Digital Economy of 19 March 2018, the Commission identified four business models in which **value creation** is not linked to taxation according to existing rules.

- the digital platform model, granting access to a marketplace, where users offer services among themselves in exchange for either a fee on transactions or a subscription;
- the digital platform model, granting access to content for users in exchange for a fee;
- the social media and advertising model, which typically involves a platform offering access to users for free and advertising and other companies to whom the platform sells user’s data; and
- the distant sales model, where goods are sold via a website and then physically delivered.⁷⁰

On a final note, many value chains with a great potential to reduce information asymmetries exist alongside **wealth chains** that operate in multiple jurisdictions and multiple fields, including accounting, law, tax and supply chain management, to protect and create wealth through mostly opaque structures and secrecy. Seabrook and Wigan illustrate how global wealth chain governance is evolving according to regulations put in place. For instance, in response to the 2003 European Savings Directive, EU Member States and European offshore havens were forced to change their tactics. As the Directive targeted individuals and not companies and trusts, accountancy firms based in Liechtenstein modified their strategies to provide corporate entities to clients that required little coordination between clients and their consultants. More recent attempts to improve information exchange through the Liechtenstein Disclosure Facility has seen a switch back to wealth chains based on strong trust relationships.⁷¹

1.2.2. The Role Data Plays in the Value Creation Process as the New Oil of the Economy

According to the Economist, data is ‘the world’s most valuable resource’, which is referred to as the new oil of the economy. In this sense, tech giants thriving in the data economy today are what Standard Oil was in the 20th century.⁷² The value of data economy in the EU will increase to EUR 739 billion by 2020, representing 4% of the EU’s GDP.⁷³ Data collection is doubling every year and data analytics and technology are flourishing, with narrow artificial intelligence being used more and more and broad AI to arrive in the near future.⁷⁴

⁶⁸ Dourado (2018), p. 568.

⁶⁹ European Commission (2018) Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market. 21 March.

⁷⁰ ICAEW (2018), Fair Taxation of the Digital Economy European Commission Questionnaire.

⁷¹ Seabrook and Wigan (2017).

⁷² Economist (2017), The world’s most valuable resource is no longer oil, but data, May (<https://www.economist.com/leaders/2017/05/06/the-worlds-most-valuable-resource-is-no-longer-oil-but-data>).

⁷³ European Commission (2018) Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market, 21 March.

⁷⁴ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

At the end of May, German Chancellor Angela Merkel called on concerted efforts to determine **the value of data in order to tax it like a tangible product**.⁷⁵ In this context, there are diverging views on whether it is raw data or processed data that contributes to value creation, if it does at all.

Data is collected through various ways:

- Collected data whereby data is entered by tracking the user via third-party ad-serving cookies (Location, address, name, email, phone, shopping habits etc.);
- Submitted data entered by a user through a search engine; and
- Inferred data compiled by pooling together data strands from a variety of sources.⁷⁶

80% of data comes from untapped or unstructured data, called dark data. According to the KPMG, raw data has relatively low value, processed data has more value and smart data (actionable data that is available in real time) that informs business decisions has greater value. Although customer and user data are in the centre of discussion at present time, the digitalisation of the economy underpins that broad spectrums of data could be turned into smart data in the near future.⁷⁷

⁷⁵ Deutsche Welle (2018), Taxes coming to big data in Germany?, 29 May.

⁷⁶ Singh (2017).

⁷⁷ KPMG (2016) Comments with respect to the request for input with respect to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

2. RECENT BEPS REPORTS AND ACTIONS

KEY FINDINGS

- The 2015 OECD Action 1 Report acknowledged that the digital economy raises more systemic and broader challenges, summarised as characterisation, nexus and data, for tax policymakers. It discussed possible solutions, such as new nexus, equalisation levy, withholding tax without recommending any.
- The OECD 2018 Interim Report highlighted progress achieved regarding minimum standards (Action 5 on harmful tax practices, Action 6 on treaty abuse, Action 13 on CbCR, Action 14 on dispute settlement), which are subject to peer review within the MLI. It welcomed the onshoring of IP by some MNEs as a result of BEPS Action 5 as well as the wide acceptance of the CbCR standards. Changes under Action 6 of the OECD Model include an anti-abuse rule for permanent establishments situated in third States and a principle purposes rule, which were both criticised for lack of precision, complexity and subjectivity.
- The most relevant actions to the digital sector, such as Action 7, Action 8-10 and Action 3, are inadequate to tackle more fundamental long-term issues, as they fail to address key problems of nexus, profit allocation and separate group entities.
- Action 7 on PE: The revised OECD Model Tax Convention of 2017 introduced changes to the PE to tackle problems related to commissionaire arrangements, preparatory and auxiliary activities and fragmentation of group activities. However, it did not alter the physical presence condition, which permits highly mobile MNEs to continue their tax avoidance activities. An important development in this context is the Service PE, endorsed by the UN, which differs from the OECD approach because it is less focused on physical presence.
- Action 8-10 on Transfer Pricing: The new OECD Transfer Pricing Guidelines of 2017 aim at aligning transfer pricing outcomes with value creation by allocation of profits to jurisdictions where significant functions are assumed yet it does not alter the arm's length rule based on the separate legal entity principle. This is problematic as MNEs could still book profits in low-tax jurisdictions by relocating their senior employees.
- Action 3 on CFC Rules: Following BEPS amendments, CFCs will be entitled to residual income if they perform important functions or assume substantial risks. While the new rules are likely to prevent low level of taxation on passive income earned through CFCs, they do not completely eliminate structures, such as cash-boxes, allowing to shift MNEs parts of their income in subsidiaries corresponding at least to the risk-free return.
- The OECD's 117-Member Inclusive Framework is aiming at finding consensus on digital taxation, some countries demanding targeted solutions, others calling for a general reform without ring-fencing the digital sector and a third group seeing no need for further reform following BEPS. An OECD policy note on these issues: Addressing the Tax Challenges of the Digitalisation of the Economy was published on 23 January 2019.

2.1. OECD's Reports on Digital Economy

2.1.1. 2015 OECD Report on Addressing the Challenges of the Digital Economy (Action 1)

As part of its 15-point Action Plan to address BEPS, the OECD published its first report entitled 'Addressing the Challenges of the Digital Economy: Action 1' on 5 October 2015. Its aim was to address challenges of the digital economy with a particular focus on the concept of Permanent Establishment.

The report acknowledged that the **digital economy raises more systemic and broader challenges, summarised as characterisation, nexus and data**, for tax policy makers. These challenges lead to:

- The difficulty of collecting VAT in the destination country where goods, services and intangibles are acquired by private consumers from remotely based suppliers with no physical presence in the tax jurisdiction;
- The ability of some businesses to earn income from sales from a country with a less significant physical presence; and
- The ability of some businesses to utilise the contribution of users in their value chain for digital products and services, including through collection and monitoring of data and the difficulty to attribute value to user contribution.⁷⁸

While not suggesting any specific measures targeting the digital economy and warning against its 'ring-fencing', the report discussed three options to address direct tax challenges raised by digital economy: Creation of new nexus through significant economic presence, withholding tax on certain digital transactions, and excise tax or levy.

The report made the following recommendations, which concerned other BEPS Action Points, such as Action 7 on Permanent Establishment, Action 8-10 on Transfer Pricing and Action 3 on CFC rules⁷⁹:

- Reconsidering the list of exceptions to the definition of PE regarding preparatory or auxiliary activities;
- Altering the definition of PE to address artificial arrangements through certain 'conclusion of contracts' arrangements;
- An update to the Transfer Pricing Guidelines; and
- Changes to the CFC rules to address certain challenges posed by the digital economy.

The report also discussed indirect tax challenges generated by e-commerce, recommending that countries apply the principles of the OECD's International Value Added Tax and Goods and Services Tax (VAT/GST) Guidelines.⁸⁰

Although the report said that work on this action would continue, with another report to be produced by 2020, many criticised the outcomes of the Action 1 report as it sought a solution within the context of the existing international tax framework. Some even commented that the failure of BEPS report to address the shortcomings of the PE standard was 'a step back to the 19th century'.⁸¹

⁷⁸ OECD Observer (2017), Tax challenges, disruption and the digital economy, p. 2.

⁷⁹ OECD Interim Report 2018 Tax Challenges Arising from Digitalisation (Also see: EY Tax Insights (2015) BEPS Action 1: digital economy tax challenges (<https://taxinsights.ey.com/archive/archive-articles/beps-action-1--digital-economy-tax-challenges.aspx>).

⁸⁰ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

⁸¹ Avi-Yonah (2016).

2.1.2. The Inclusive Framework of BEPS and its 2018 Interim Report and 2019 Policy Note on Taxation of the Digital Sector

A Multilateral Convention comprised of more than 100 jurisdictions approved the Multilateral Instrument on 24-25 November 2016 under BEPS Action 15. The major objective of the instrument is to fight against base erosion by conveying the results of the Convention into more than 2000 bilateral tax treaties globally. The MLI contains material provisions on hybrid mismatches, treaty abuse, the use of artificial structures to avoid PE, improvements in corresponding transfer pricing adjustments and binding arbitration. Four of these measures were rendered minimum standards, which are monitored through peer review.⁸²

In order to achieve the implementation of the four minimum standards, the OECD decided in January 2016 to establish the 117-Member Inclusive Framework on BEPS, a system of monitoring and peer review. It will also monitor the rest of the BEPS package, including the two common approaches and the two best practice guidelines. It will further develop the action points that have not resulted in agreement on minimum standards and joint approaches, such as deductibility of interest payments and transfer pricing. In particular, it was tasked with devising control mechanisms to gain more insight into developments in the digital economy (Action 1).⁸³

The OECD published **an Interim Report** on taxation of the digital sector on 16 March 2018 and its Policy Note on 23 January 2019. The Inclusive Framework, which is studying international nexus and profit allocation concepts for taxing the digital economy, will produce a final report in 2020, with an update to the Group of Twenty (G-20) in 2019.

While providing a thorough analysis on new business models and value creation, the Interim Report flags the progress in countering some aggressive tax planning schemes (i.e. MNEs, such as Amazon, eBay, Facebook, changing their cooperative structures and moving to local distributor models referred to as 'on-shoring' of IP).

Acknowledging that more time is needed to evaluate the impact of the BEPS Actions, the report discusses the progress made with the rollout of the OECD recommendations, especially BEPS Action Points, which are the most relevant to the digital sector. These include⁸⁴:

- Action 7 on PE: Rather slow adoption rate of BEPS measures related to the PE, which are currently implemented by the Multilateral Convention;
- Action 5 on Harmful Tax Practices: Almost all OECD/G20 countries aligned with the new nexus approach linking IP regimes to R&D activities;
- Actions 8-10 on Transfer Pricing: New transfer pricing rules aimed at ensuring that transfer pricing outcomes are in line with value creation;
- Action 3 on CFC Rules: Relevant measures taken with the introduction of the US Tax Cuts and Jobs Act, the EU's ATAD and similar legislations in Japan, Chile, Taiwan and Colombia;
- Action 6 on Treaty Abuse: Most Inclusive Framework Members update their treaties through the MLI; and

⁸² De Graaf and Visser (2018), p.43.

⁸³ De Graaf and Visser (2018), p.45.

⁸⁴ EY Global Tax Alert (2018) The OECD's Interim Report on Tax Challenges arising from digitalisation: An Overview ([https://www.ey.com/Publication/vwLUAssets/The_OECDs_interim_report_on_tax_challenges_arising_from_digitalisation_-_An_overview/\\$FILE/2018G_01610-181Gbl_OECD%20-%20An%20overview%20on%20tax%20challenges%20arising%20from%20digitalisation.pdf](https://www.ey.com/Publication/vwLUAssets/The_OECDs_interim_report_on_tax_challenges_arising_from_digitalisation_-_An_overview/$FILE/2018G_01610-181Gbl_OECD%20-%20An%20overview%20on%20tax%20challenges%20arising%20from%20digitalisation.pdf)).

- New Guidelines and Implementation Mechanisms relating to VAT: The Guidelines were adopted by 50 jurisdictions.

The report welcomes the introduction of the **four non-binding minimum standards** (Action 5 on harmful tax practices, Action 6 on treaty abuse, Action 13 on CbCR, Action 14 on dispute settlement).⁸⁵ It notes that most Inclusive Framework countries implement standardised Country-by-Country reporting on transfer pricing that would affect around 95% of MNEs.⁸⁶ The spontaneous information exchange on tax rulings, the proper implementation of Mutual Agreement Procedure (MAP) to guarantee effective dispute resolution and the development of Limitation-on-Benefits (LOB) and a Principal Purposes Test (PPT) to prevent treaty shopping are also underlined.⁸⁷

However, the report itself considers BEPS measures inadequate to tackle more fundamental long-term issues related to digitalisation and business model change.⁸⁸ Among the 117 Members of the OECD's Inclusive Framework Members, **three distinctive opinions can be observed when it comes to digital taxation**.

The first group believes that 'user participation may lead to misalignments between where profits are taxed and where value is created', calling for targeted changes instead of a reform of the international taxation system. The second group acknowledges the challenges presented by digitalisation for taxation matters but is not convinced that they are exclusive to the digital sector.

The third group does not support a reform of the international taxation reforms, claiming that BEPS measures are sufficient to address double non-taxation issues and more time is needed to assess their outcomes.⁸⁹

Although the current debate on digital taxation partly relates to stopping certain forms of tax planning, the main issue at stake is how to allocate taxing rights among countries in a digitalised world, which makes consensus extremely difficult.⁹⁰

2.2. OECD's BEPS Actions

2.2.1. BEPS Action 7: Permanent Establishment

a. Recent Developments

Article 5 of the OECD'S Model Tax Convention makes a '**fixed place of business**' (premise, facilities or installations, which do not cover securities, bank accounts, patents, software of websites) a prerequisite for the existence of PE, without which companies cannot be taxed in a state of residence under Article 7.⁹¹ 'Fixity' refers both to physical presence and permanence whereas business activity could be entirely or partially undertaken at the fixed place.⁹²

⁸⁵ OECD (2018) About the Inclusive Framework on BEPS (<http://www.oecd.org/tax/beps/beps-about.htm>).

⁸⁶ EY Global Tax Alert (2018) The OECD's Interim Report on Tax Challenges arising from digitalisation: An Overview ([https://www.ey.com/Publication/vwLUAssets/The_OECDs_interim_report_on_tax_challenges_arising_from_digitalisation_-_An_overview/\\$FILE/2018G_01610-181Gbl_OECD%20-%20An%20overview%20on%20tax%20challenges%20arising%20from%20digitalisation.pdf](https://www.ey.com/Publication/vwLUAssets/The_OECDs_interim_report_on_tax_challenges_arising_from_digitalisation_-_An_overview/$FILE/2018G_01610-181Gbl_OECD%20-%20An%20overview%20on%20tax%20challenges%20arising%20from%20digitalisation.pdf)).

⁸⁷ Pearse Trust (2017) The OECD's Minimum Standards – A Progress Update (<https://www.pearse-trust.ie/blog/the-oecd-s-minimum-standards-a-progress-update-part-1>).

⁸⁸ KPMG (2018) OECD Task Force on the Digital Economy release Interim Report.

⁸⁹ OECD Centre for Tax Policy and Administration Presentation (2018) OECD Tax Talks (<https://www.oecd.org/tax/beps/OECD-Tax-Talks-presentation-16-March-2018.pdf>).

⁹⁰ Devereux and Vella (forthcoming).

⁹¹ Baumann (2017), p.12.

⁹² Requena and Gonzalez (2017), p. 734.

On 18 December 2017, the OECD Model Tax Convention was updated to address BEPS. It reflects in part the outcomes of Action 7 on Artificial Avoidance of PE. The modifications to Article 5 include changes to the PE threshold with the objective of preventing the avoidance of PE status through the replacement of subsidiaries that traditionally acted as distributors by commissionaire arrangements, exploitation of specific exceptions for preparatory and auxiliary activities and restriction of anti-fragmentation rules.⁹³

- **Commissionaire agreements:**

Accordingly, an **agency PE** would be triggered when the agent plays the principle role leading to the conclusion of contracts, when a service provider concludes the contract for the transfer of the ownership or when a closely related person concludes the contract on behalf of the company.⁹⁴

As a result of these changes, **PE thresholds were reduced** by treating subsidiaries as agents of their parent corporations and thus deeming the parent as having a PE through its subsidiary.

However, the fact that **an agent has to be a person** raises questions about virtual spaces, such as websites, allowing for the conclusion of contracts online, which would not qualify for a PE status.⁹⁵ Due to the subjectivity and lack of clarity of the thresholds, it is dubious whether marketing services companies would be covered by the OECD's updated definition.⁹⁶ While the proposed changes to the commissionaire structure might push businesses to restructure their business models or to accept an increased number of PEs, they might still be able to avoid PE status through the use of **Low-Risk Distributers** that take ownership of the goods before selling them to third parties.⁹⁷ It is also feared that the changes may lead to an aggressive use of Agency PE.⁹⁸

The OECD Commentary acknowledges that **a server could be deemed a PE** if the company is in possession of the server in the tax residence.⁹⁹ This provision is perceived as inadequate considering that MNEs would still be able to function via websites, smart phone applications or from servers located outside the jurisdiction to remotely sell products or to engage in advertising activities.¹⁰⁰

Moreover, there is no agreement on how to attribute profits to a Server PE and **how the server contributes to the value chain**. Some argue that it is the website (software)¹⁰¹ hosted by the server (hardware) that should be attributed profits, without which a digital company could not perform essential communications, advertising and information functions.¹⁰² Others are of the opinion that specific business models relying on Information Technology (IT) infrastructure, such as servers that are remotely controlled and serve to host data and computing power, are not tax-driven and represent the result of technological progress.¹⁰³

⁹³ OECD (2017) Tax treaties: update to OECD Model Tax Convention released.

⁹⁴ Merx (2017), p. 39.

⁹⁵ Baumann (2017), p. 736.

⁹⁶ Eisenbeiss (2016).

⁹⁷ Baumann 2017, p. 736.

⁹⁸ Eisenboss (2016).

⁹⁹ Hidalgo (2017), p.737.

¹⁰⁰ PwC (2017) Unequal Taxation in a Digital World-A Challenge for the Nordic Media Industry.

¹⁰¹ Cockfield (2014).

¹⁰² Baumann (2017), p.17.

¹⁰³ Olbert and Spengel (2017).

- **Exemptions:**

Article 5 was modified to make the list of exempted activities subject to a **‘preparatory or auxiliary’ test**. This would grant warehouses, storage and delivery places, used by remote sellers in market jurisdictions, a PE status.

The change involves creating PE for some models based on **indirect e-commerce** (based on payments done by digital means followed by conventional delivery, as in the case of Amazon)¹⁰⁴ but does not provide a framework enabling the source taxation of digital profits derived by fully dematerialised digital activities, such as direct e-commerce (based on product delivery through digital means, as in the case of iTunes) or multisided business models.

Moreover, online retailers operating within an indirect e-commerce model would not need a local warehouse in each jurisdiction and **could serve an entire region from one warehouse** in the proximity of the customer, thus avoiding PE in other jurisdictions.¹⁰⁵

- **Anti-fragmentation:**

An anti-fragmentation rule is established to avoid situations where different exempted activities are performed by different but closely related legal entities to avoid PE.

The changes to Article 5 stipulate that closely related parties engaging in business activity, which constitutes a cohesive business operation in the state, could lead to PE even if the individual activity of each legal entity is of auxiliary or preparatory nature.

In sum, the anti-fragmenting amendment is akin to an anti-avoidance rule, sealing a loophole, rather than addressing the challenges of e-commerce. Hence, its contribution to digital taxation seems ‘negligible’.¹⁰⁶

b. Effects of BEPS Action 7

Under the existing system, taxing rights are allocated to the country where the ‘supply side’ activities take place. Amendments to PE to expand its scope so that storage and delivery places could also be deemed PE take into account some demand-side activities. However, they are still regarded as **insufficient** by many commentators.¹⁰⁷

The **recent changes to the PE** status as a result of BEPS Actions will reduce the thresholds for taxing activities conducted through commissionaire agreements while making it simpler to establish the existence of a PE with the agency test and tightening the standards regarding preparatory and auxiliary activities. Nevertheless, the actual source revenue effects are likely to be minimal because the MLI will modify characteristics that are not relevant to the digital economy as it is conditional on physical presence.¹⁰⁸ Even if Dependent PE is found under the dependent agent MLI, with the current attribution rules, the only taxable amount would be the earnings of the Dependent Agent PE according to the arm’s length principle.¹⁰⁹

Reducing the PE threshold may help preventing the **worst cases of BEPS** but the failure to thoroughly address BEPS challenges may have given some countries enough flexibility to act unilaterally.¹¹⁰ For

¹⁰⁴ Singh (2017).

¹⁰⁵ Baumann (2017), p.736.

¹⁰⁶ Merckx (2017), p.38.

¹⁰⁷ Dourado (2018), p. 567.

¹⁰⁸ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

¹⁰⁹ Committee of Experts on International Cooperation in Tax Matters Fifteenth Session (2017) Tax Challenges in the Digitalised Economy.

¹¹⁰ Avi-Yonah (2016).

example, taxes introduced by the UK, Australia, India etc. aimed specifically at structures that seek to exploit the domestic market while avoiding PE.¹¹¹

According to **Article 7 of the OECD's Model Tax Convention**, companies can only be taxed at the state of residency if the business is conducted through a PE. **This outdated concept is no longer valid due to the emergence of the digital economy**, which is increasingly based on trade of goods and services electronically, without the need for a physical presence in a jurisdiction.

To give a few examples, Airbnb does not possess real estates, Alibaba does not carry inventory, Booking.com does not own any hotels and Twitter and Facebook do not produce content. Airbnb and Booking.com provide intermediary services, whereas Twitter and Facebook acquire revenues through advertising services. All these business models operate without a physical entity (building, factory etc.).¹¹² Therefore, **the existing nexus and profit allocation rules rooted in physical presence cannot capture these new realities**, falling short of tackling core problems regarding the conditions for deemed PE and the difficulty to define the place of effective management, with MNEs spreading their business functions all over the world depending on favourable tax conditions.¹¹³

Even after a Public Discussion Draft on Additional Guidance on the Attribution of Profits to PEs under Action 7 was released in 2016 (followed by new guidance published on 22 March 2018) to provide more clarity, many found the outcome 'disappointing' after 13 years of work.¹¹⁴ By contrast, the UN has made some progress to catch up with the new realities of the economy by inventing the service PE, which makes it easier to subject service providers to tax without much physical presence.¹¹⁵ The **Service PE is less focused on physical presence**, as a nexus can be established by a mere presence in a country for 183 days in a twelve-month period.¹¹⁶

According to the **current Authorised OECD Approach (AOA)**, a two-step functional analysis to determine the role that the PE and the head office play in a specific transaction following the separate identity principle,¹¹⁷ significant people functions shall be performed at the level of PE. If not, these functions would be attributed minimum profits. As the role of the market contribution is likely to be ignored in such a profit allocation system, other attribution rules, such as split profits method and formulary apportionment methods are being considered. While BEPS project explicitly rejects formulary apportionment, agreement seems more likely where its application is limited to the residual profits of Dependent Agency PEs. Nevertheless, the current AOA is both theoretically and practically flawed and unable to attribute significant profits to a Dependent Agency PE.¹¹⁸ In addition, there is a need for more guidance regarding the choice of various OECD methods, including the profit split method.¹¹⁹

A major concern is that a group can structure itself by creating **regional hubs** from which online advertisement campaigns targeting the whole region could be orchestrated. If no entities are in various market jurisdictions, one cannot even apply a profit split approach. Even if there is PE, the lack of significant people functions would not attribute income to it. This could continue to be the case in the

¹¹¹ Avi-Yonah (2016).

¹¹² Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, pp.29-30.

¹¹³ Schmidt (2016), p.6.

¹¹⁴ Andrus and Oosterhuis (2017).

¹¹⁵ Avi-Yonah (2016).

¹¹⁶ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

¹¹⁷ Baldi (2017) (<http://www.diva-portal.se/smash/get/diva2:1098901/FULLTEXT01.pdf>).

¹¹⁸ Baumann (2017).

¹¹⁹ Edesten and Almling (2016).

aftermath of a restructuring such that announced by Facebook, where advertisement profits would no longer be booked at the headquarters but rather at the head local offices.¹²⁰

2.2.2. BEPS Actions 8-10 on Transfer Pricing

a. Recent Developments

It is often argued that addressing transfer pricing issues would be more adequate rather than dealing with individual aspects of the digital economy by including the use of warehouses in the definition of PE.¹²¹ Some refer to transfer pricing between companies within the same group as the **most important problem in international taxation**¹²², with intra-firm trade making up for 30% of trade.¹²³

BEPS Actions 8-10 deal with transfer pricing problems **permitting a separation of income** from relevant economic activity by facilitating the transfer of intangibles and other mobile assets through use of methods such as under-valuation, over-capitalisation of and contractual arrangements to entities based in low-tax jurisdictions.

The **revised OECD Transfer Pricing Guidelines** of 10 July 2017 have the goal of aligning transfer pricing outcomes with value creation by allocation of profits to jurisdictions where significant functions are assumed and in particular, control functions related to risks are performed.¹²⁴ As a consequence, **less emphasis is given to legal ownership of IP and management of financial risks** when residual profits are allocated. An entrepreneurial risk taker is expected to employ the resources and knowledge required to control the associated risks. The functional analysis DEMPE (Development, Enhancement, Maintenance, Protection and Exploitation), compared by some to a soft form of formulary apportionment¹²⁵, is conducted in order to attribute profits according to the value adding functions performed by separate entities, thus preserving the arm's length principle.

At the same time, there is a lot of controversy around the **arm's length principle**, which remains intact since several decades, with some questioning whether or not it is a principle due to its 'vague and uncertain' nature and its use 'in such a wide variety of contexts' that necessitates constant explanation and clarification.¹²⁶

On a positive note, BEPS Actions 8-10 brought the **possibility for tax administration to adjust ex-post transfer prices** in case intangibles, which are hard to value due to the information asymmetries between companies and tax administrations (i.e. when granting a license).¹²⁷

b. Effects of the BEPS Actions 8-10

BEPS will most likely result in **prevention of very aggressive cases of tax planning** including the use of cash boxes but this was already happening before the BEPS reports were finalised. According to the

¹²⁰ Turina (2018).

¹²¹ Olbert and Spengel (2017).

¹²² LexisNexis Legal Newsroom (2014) 'Tax Law Transfer Pricing and International Taxation: A Continuing Problem for Taxing Authorities' (<https://www.lexisnexis.com/legalnewsroom/tax-law/b/internationaltaxation/archive/2014/11/17/transfer-pricing-and-international-taxation-a-continuing-problem-for-taxing-authorities.aspx>).

¹²³ Deloitte (2017) Blockchain technology and its potential in taxes.

¹²⁴ Edesten and Almling (2016)

¹²⁵ Majdowski and Bronzewska (2018)

¹²⁶ Collier (2018)

(<http://business-taxation.sbsblogs.co.uk/2018/03/26/the-arms-length-principle-alp-is-it-a-principle-and-is-it-arms-length/>).

¹²⁷ Majdowski and Bronzewska (2018).

revised Guidelines, a cash box entity (used for group financing or for owning and receiving income from intangibles) will receive only a minimal return on funding given that it does not assume any risk.¹²⁸

Legal ownership in itself will not imply an unconditioned right to profits connected to the assets and such rights will depend on functions. This should make it more difficult for global players to stream large parts of the profits related to IP from high tax jurisdictions to low tax jurisdictions. The assumption behind these BEPS measures was that inversions could be combated by adopting a managed and controlled definition of corporate residency because the top management would likely be located in major urban hubs having financial transport and communications networks rather than tax havens on remote islands.¹²⁹

Following this rationale, some companies may adapt their practices to the requirements of the revised OECD Transfer Pricing Guidelines on control of risk and performance of DEMPE functions.¹³⁰ The OECD notes that some MNEs are reconsidering their transfer pricing positions via on-shoring of assets while much will depend on domestic implementation of the measures. Yet, some scholars believe that **voluntary payments** made by a few MNEs is not a valid argument that would produce a structural solution.¹³¹

The **separate entity principle**, enabling MNEs to easily reallocate functions, assets and risks to low-tax jurisdictions, where sales, revenue and profit are reported **remains intact** even after the changes. Hence, global players could reassess their structures to meet new rules and requirements and continue to minimise the group's tax burden,¹³² as shifting functions to a special purpose company residing in a low-tax jurisdiction would technically still be possible (i.e. via relocation of senior employees).¹³³ Tax planning potential would not diminish because one allocation criterion (contractual risk allocation) has been replaced by another (people functions) that is also subject to manipulation.¹³⁴

It is not clear how many and which companies would move their top management due to lack of evidence on tax sensitivities of digital business models¹³⁵ and other factors that may affect the choice of MNE location (labour productivity, trade barriers, import duties, transport costs and the proximity of suppliers and customers). However, it is evident that the **'current stopping point in the arm's length principle is unstable'**¹³⁶, as the administration's ability to verify taxpayer transactions with foreign entities is complex and demanding,¹³⁷ leading to uncertainty and lack of efficiency.

Furthermore, **post-BEPS transfer pricing** may undermine or contradict the arm's length principle, as 'there are many cases where risks are clearly born by third parties even though they exercise no meaningful control over those risks'. Hence, the new control requirement may lead to litigation.¹³⁸ Other outstanding post-BEPS issues include the unfulfilled promise of controlling tax-driven capital

¹²⁸ Edesten and Almling (2016).

¹²⁹ De Graaf and Visser (2018), p.36.

¹³⁰ Andrus and Oosterhuis (2017).

¹³¹ Schippers and Verhaeren (2018), p.64.

¹³² PwC (2017) Unequal Taxation in a Digital World-A Challenge for the Nordic Media Industry.

¹³³ Majdowski and Bronzewska (2018).

¹³⁴ Majdowski and Bronzewska (2018).

¹³⁵ Olbert and Spengel (2017).

¹³⁶ Hearson (2017).

¹³⁷ Majdowski and Bronzewska (2018).

¹³⁸ Collier (2018) (<http://business-taxation.sbsblogs.co.uk/2018/03/26/the-arms-length-principle-arp-is-it-a-principle-and-is-it-arms-length/>). Also see: Collier and Andrus (2018) (<https://global.oup.com/academic/product/transfer-pricing-and-the-arms-length-principle-after-beps-9780198802914?cc=gb&lang=en&>).

shifts within the group, on which no new rules have yet been proposed. Moreover, the cost and complexity of the BEPS reform are highlighted as major problems.¹³⁹

More importantly, the **transfer pricing measures did not ‘resolve the dilemma of source vs. residence as connecting links when it comes to cross-border trade’**.¹⁴⁰ Their objective of aligning transfer pricing rules with value creation and levelling the playing field between residence and source was not attained as they still rely on the supply-side factors of value creation (production factors, such as capital, labour and risk) while ignoring the demand-side of the equation.¹⁴¹

1977 Transfer Pricing Guidelines provided three **methods for determining a commercial or arm’s length price** for intra group transactions: Comparable uncontrolled price, cost plus, resale minus. As these methods were inadequate as a result of the fact that no comparable transactions between non-affiliated parties could be identified, the OECD introduced two new methods in 1995: The transactional net margin method and the transactional profit split. The latter is seen as a move in the direction of the global formulary apportionment method.¹⁴²

BEPS outcomes **‘create new difficulties like the assessment of arm’s length behaviour and the (expected) increasing usage of the transactional based profit split method’**.¹⁴³ The application of the profit split method is limited to companies sharing economically significant risks (i.e. highly integrated operations) but its use may be broadened according to the Guidelines. Disappointingly, such a transfer pricing system to decide whether or not prices are in accordance with the arm’s length principle does not match the realities of the digital age because of the difficulty to analyse the entire value chain, hard-to-value intangibles and lack of economic justification to avoid arbitrary allocation of profits.¹⁴⁴

2.2.3. BEPS Action 3 on CFC Rules

a. Recent Developments

G20/OECD countries couldn’t agree on CFC rules during the BEPS project. For this reason, different options were proposed. OECD BEPS Action 3 aimed at **strengthening CFC rules and made recommendations to design minimum standards** for the definition of CFC, CFC exemptions and thresholds, definition and calculation of income, attribution of income, and prevention of double taxation.¹⁴⁵

Accordingly, **taxes will be imposed on the part of the actual economic substance of CFCs**. The passive income arising in CFCs, acting as title holding entities to provide the asset with no decision-making power, would be aggregated with the income of the parent company.

The Japanese CFC rules, which were based on a 20% effective tax rate threshold for a foreign subsidiary to be treated as a tax haven, were amended to be in line with these new standards in 2017, for

¹³⁹ Collier and Andrus (2018) (<https://blog.oup.com/2017/09/taxing-multinationals-international-tax-system/>).

¹⁴⁰ Dourado (2018).

¹⁴¹ Dourado (2018).

¹⁴² Eisenboss (2016).

¹⁴³ Greil (2017), p. 624.

¹⁴⁴ Greil (2017), p.627.

¹⁴⁵ EY (2017), The latest on BEPS-2017 in review-A review of OECD and country actions in 2017 ([https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/\\$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf](https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf)).

instance.¹⁴⁶ Like Japan, many countries, including Colombia, Chile, Taiwan, South Africa and the United States followed the OECD's recommendations and modified their CFC rules to combat BEPS.

b. Effects of the of BEPS Action 3

Following BEPS amendments, CFCs will be entitled to residual income if they perform important functions or assume substantial risks **as opposed to legal title and contractually attributed risks** that entitled CFCs to residual income before the changes.¹⁴⁷

Some question the redundancy of the CFC rules following the new Transfer Pricing Guidelines that adopted a similar substance criterion to the CFC regulations.¹⁴⁸ In the OECD's view, CFC rules are complementary to transfer pricing as the former apply to income whose value is determined according to the Transfer Pricing Guidelines. TP regulations are closely linked to CFC rules where, for example, they render structures using **cash-box companies, shell companies, money companies, ineffective**.¹⁴⁹ While the new rules would allow states to neutralise low level of taxation on passive income earned through CFCs, **they do not completely eliminate such structures** still allowing to shift parts of their income in subsidiaries corresponding at least to the **risk-free return income**.¹⁵⁰ Critics also stress that reliance on the active business clause could lead to the **non-taxation of the controlling person** for the purpose of CFC regulations.¹⁵¹

The old **CFC rules in the US** were much criticised for lacking robustness to reduce low-taxed income of US multinationals.¹⁵² This criticism was taken on board by the new US tax reform, which strengthens CFC rules. At the **EU level**, CFC rules were included in the ATAD measures that have to be adopted by EU Member States as a minimum standard to fight against non-genuine arrangements put in place for the main purpose of tax benefits. For instance, CFC rules were modified in Belgium so that 'non-distributed profits realised by a CFC that constitutes an artificial construction are added to the tax base of the Belgian parent if the CFC is held for at least 50% and is subject to tax at a rate below 12.5%'.¹⁵³

2.2.4. BEPS Action 5 on Harmful Tax Practices

a. Recent Developments

The purpose of Action 5 is to **limit beneficial treatment from IP regimes** to substantial activities resulting from R&D activities by adopting a modified nexus approach while ensuring spontaneous automatic exchange on tax rulings. In October 2017, the OECD released a progress report on preferential regimes, which was updated on 9 May 2018.¹⁵⁴

According to the report among **175 tax regimes, 31 have been modified and 81 undergo legislative amendments**. While the review of some regimes is continuing, it was highlighted that 4

¹⁴⁶ Deloitte (2017) Japanese Anti-Tax Haven Rules-Japan Reform Proposals 2017 (https://www2.deloitte.com/content/dam/Deloitte/jp/Documents/tax/it/jp-bt-japan-tax-newsletter-12december2016-international_en.pdf).

¹⁴⁷ Majdowski and Bronzewska (2018).

¹⁴⁸ Edesten and Almling (2016).

¹⁴⁹ Edesten and Almling (2016).

¹⁵⁰ Majdowski and Bronzewska (2018).

¹⁵¹ Majdowski and Bronzewska (2018).

¹⁵² Avi-Yonah (2016).

¹⁵³ EY (2017) The latest on BEPS-2017 in review ([https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/\\$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf](https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf)).

¹⁵⁴ OECD Harmful Tax Practices -2017 Progress Report on Preferential Regimes (<http://www.oecd.org/tax/beps/update-harmful-tax-practices-2017-progress-report-on-preferential-regimes.pdf>).

measures are potentially harmful.¹⁵⁵ To give an example, Israel adopted a modified nexus approach in 2017, which makes IP tax incentives at the rate of 6% conditional to R&D activities. Other countries, including Luxembourg, Singapore, Italy, Germany and Andorra, are in the process of updating their IP regimes. On tax rulings, the OECD released updated IT tools to support their exchange of information. Simultaneously, the OECD published a peer review on 4 December 2017 to monitor the transparency of 10,000 tax rulings.¹⁵⁶

b. Effects of BEPS Action 5

The OECD minimum standards, including Action 5 on harmful practices, are of the order of **soft law and non-binding**. Perhaps for this reason, France and Italy are two non-compliant EU Member States, which reportedly **maintain harmful IP regimes** not in line with the modified nexus approach. Turkey's technology development tax was also criticised for its potential harmfulness.¹⁵⁷ In parallel, many question whether the modified nexus approach would be fully compatible with the EU state aid law.¹⁵⁸

Although some argue that the location of R&D activities is not sensitive to reduced tax rates but depends on the availability of qualified researches and public knowledge infrastructure,¹⁵⁹ BEPS actions, aimed at addressing harmful tax practices with a focus on patent box regime, could lead to **economic distortions and tax competition**. Post-BEPS, MNEs would have to move their R&D activities to the jurisdiction offering a favourable patent box. Given the fact that attracting R&D is more beneficial to the economy than merely attracting IP, states may compete more intensely over real economic activity.¹⁶⁰

Even in the aftermath of BEPS, Ireland that has been subject to a fair share of naming and shaming for its Double Irish Dutch Sandwich schemes, remains an **attractive location**. Although from January 2015, the country enacted laws to treat all companies incorporated in Ireland as a resident, the **grandfathering clause** allows these companies to keep their existing arrangements until the end of 2020. Besides, Ireland put in place a knowledge development box in line with the OECD's modified nexus approach for IP tax regimes, providing for a 6,25% effective rate of corporation tax on qualifying profits related to qualifying IP assets. This favourable regime together with generous R&D tax credits continue to attract MNEs.¹⁶¹

2.2.5. Action 6

a. Recent Developments

Action 6 was designed to **prevent treaty abuse by a greater emphasis on economic substance with business purpose**. On 18 December 2017, the OECD Model Tax Convention was updated to address the outcomes of Action 6 on treaty abuse. Changes in line with Action 6 of the OECD Model include a

¹⁵⁵ MNE Tax (2018) Turkey's IP regime is harmful, new Singapore, Luxembourg, Lithuania, Slovakia laws meet standards, OECD report concludes.

¹⁵⁶ EY (2017), The latest on BEPS-2017 in review ([https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/\\$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf](https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf)).

¹⁵⁷ MNE Tax (2018) Turkey's IP regime is harmful, new Singapore, Luxembourg, Lithuania, Slovakia laws meet standards, OECD report concludes.

¹⁵⁸ Kardachaki and Van Hulten (2017), p.287.

¹⁵⁹ Olbert and Spengel (2017).

¹⁶⁰ Devereux and Vella (2018).

¹⁶¹ International Tax Review (2016) Ireland-An attractive location in a post-BEPS world, 1 February.

LOB rule, an anti-abuse rule for permanent establishments situated in third States and a PPT rule.¹⁶²

Action 6 was also **integrated in the MLI** as a minimum standard, whose implementation is monitored by peer review to be published in January 2019.¹⁶³ The PPT, which would be introduced in all tax treaties by the MLI, is a general anti-abuse rule to be applied by all jurisdictions having signed the multilateral instrument. The OECD notes that only 12% of the jurisdictions chose to adopt the PPT as an interim measure.¹⁶⁴

b. Effects of BEPS Action 6

In January 2017, the OECD released a Public Discussion Draft regarding the application of the PPT to non-collective investment vehicles. The examples given by the OECD were perceived as ‘vague and controversial’, with many lamenting the **lack of precision and subjectivity of the PPT and highlighting the risk of denial of treaty benefits** regarding cross-border investments by tax authorities.¹⁶⁵

The PPT’s threshold of abuse based on double subjective and objective test is also considered as a problem as it is **open to interpretation**. The experience with General Anti-Abuse Rule (GAAR) shows that national courts may interpret PPT in different ways.¹⁶⁶

Furthermore, the **design of the legal consequences of the PPT** runs against the logic of conventional anti-abuse provisions and the Constitutional requirements of several jurisdictions. The differences with EU’s GAARs raise compatibility questions with the EU law.¹⁶⁷

While the **LOB clause is similarly denounced for its turns**, the link between the PPT and the LOB clause in the OECD Model is regarded as ‘complex’. It remains to be seen whether the MLI will succeed in ensuring implementation and uniformity regarding treaty abuse.

2.2.6. General Evaluation of BEPS Actions

Perhaps the **greatest achievement of the BEPS** project was the introduction of the four **minimum standards**, whose implementation is subject to peer review. (Action 5 on harmful tax practices, Action 6 on treaty abuse, Action 13 on CbCR, Action 14 on dispute settlement).¹⁶⁸ However, among the four, which were classified as minimum standards, the dispute resolution system was not even aimed at combatting BEPS. Moreover, it shall be noted that not all of BEPS actions, especially the most relevant ones to the digital sector, became minimum standards.

According to some, the **OECD’s peer review system** is not an optimum implementation mechanism for the reason that government’s compliance with it depends on local political climate. There is no OECD provision for procedures where a commitment was given and later withdrawn or where

¹⁶² OECD (2017) OECD Council approves the 2017 update to the OECD Model Tax Convention.

¹⁶³ EY (2017), The latest on BEPS-2017 in review-A review of OECD and country actions in 2017 ([https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/\\$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf](https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf)).

¹⁶⁴ EY (2017) The latest on BEPS-2017 in review-A review of OECD and country actions in 2017 ([https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/\\$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf](https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf)).

¹⁶⁵ EY (2017) The latest on BEPS-2017 in review-A review of OECD and country actions in 2017 ([https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/\\$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf](https://www.ey.com/Publication/vwLUAssets/EY-the-latest-on-BEPS-2017-in-review/$FILE/EY-the-latest-on-BEPS-2017-in-review.pdf)).

¹⁶⁶ Bravo, Govind, Julien and Schoueri (2017).

¹⁶⁷ Moreno (2017).

¹⁶⁸ OECD (2018), About the Inclusive Framework on BEPS (<http://www.oecd.org/tax/beps/beps-about.htm>).

legislation was not implemented in time or in a correct manner. Moreover, a uniform implementation of BEPS seems difficult to achieve as interpretations vary.¹⁶⁹

There is even the risk that **some countries may choose to opt out**, 'turning the implementation to a process of cherry picking'¹⁷⁰ due to the soft law approach of the OECD and the non-binding nature of the BEPS measures. A good example to this is the US, choosing not to comply with the minimum standard agreed within the Transparency Forum, and as a result, did not to participate in the automatic exchange of information on savings due to its own legislative constraints.¹⁷¹ The fact that in most countries including in the US, the treaty ratifying bodies are not bound by the negotiation of their respective Finance Ministers raises the question on how the MLI will deal with States only willing to adopt certain measures.

According to some, the **yet to be completed MLI** is 'the new international paradigm' of tax matters while others do not acknowledge its significance as a multilateral agreement due to its 'flexible' structure. Paradoxically, its flexibility was the main factor, which convinced so many signatories to adopt the instrument.¹⁷² Although the instrument is designed to address the remaining BEPS actions, some scholars express dissatisfaction with the absence of clear definitions and its incapability to solve the problem of the non-homogenous tax bases arising from distinct economic realities in each country.¹⁷³

In general, **BEPS was instrumental in drawing attention to international tax issues**, which is per se difficult due to their technical nature. Although the OECD Interim Report acknowledges that it is still early days to evaluate the impacts of BEPS section, the report states that double non-taxation concerns have been addressed through the implementation of the BEPS package both regarding direct and indirect taxation. As a result, the ability of MNEs to achieve stateless income or even single digit local effective tax rates may be diminishing.¹⁷⁴

BEPS measures, such as lower threshold for PE, amendments to the OECD Transfer Pricing Guidelines, more limited possibilities to rely on favourable regimes, tightened anti-abuse rules and other changes may influence the way MNEs organise their business activities. One effect could be that businesses would be structured as a single entity rather than separate legal entities.¹⁷⁵ On the other hand, a shift towards more centralised business models could already be observed over the last few decades as there is no longer a need to make on-spot business decisions.¹⁷⁶

Nevertheless, there is no evidence whether the **broader tax challenges** mentioned in Action 1, such as nexus, data and characterisation, have been tackled despite a change of tax planning practices. Overall, little progress was achieved in Action Points, which are most relevant to the digitalisation. There seems to be a certain inaction concerning the residence-source dilemma and the digital economy.¹⁷⁷ According to Baez and Brauner, it is apparent that BEPS package (Action 3, 6, 7, 8-10) does not address BEPS issues created by digitalisation or a number of broader tax challenges related to it.¹⁷⁸

¹⁶⁹ Monsenego (2016), p.46.

¹⁷⁰ Eisenboss (2016).

¹⁷¹ De Graaf and Visser (2018), p. 46.

¹⁷² Hidalgo (2017), p.717.

¹⁷³ Hidalgo (2017), p. 718.

¹⁷⁴ Andrus and Oosterhuis (2017).

¹⁷⁵ Monsenego (2016).

¹⁷⁶ Edesten and Almling (2016).

¹⁷⁷ Monsenego (2016).

¹⁷⁸ Baez and Brauner (2018).

Similarly, Andersson argues that the changes following Action Point 7 on PE and Action Points 8-10 on intangibles **do not 'adequately address taxation of digital platforms and businesses providing goods and services in countries without, or with limited, PE presence.'**¹⁷⁹

It is equally important to note that BEPS Action 12, aiming at introducing disincentives for intermediaries, who assist in tax evasion schemes, failed to introduce minimum standards and to tackle one of the main challenges faced by the tax authorities, which is lack of timely, comprehensive and relevant information on the aggressive tax planning strategies.¹⁸⁰

When it comes to PE, the changes introduced to Article 5 'entails limited changes to the taxation of digital business operations.'¹⁸¹ In order to constitute a PE, an entrepreneur would still need to have human and technical resources and there should be a place of business with a certain degree of permanence. Hence, the **actual source-revenue effects are likely to be minimal** because BEPS measures focus on measures based on physical presence, which are not relevant to the digital economy.¹⁸²

The **source-residence duality** as criteria for taxation is an outdated concept, as online businesses can relocate their income through their subsidiaries allowing them to function remotely from their customers without being taxed either at the source or at the residence state, and thus depriving states of significant tax revenues.¹⁸³ The territoriality and non-discrimination principles enshrined in Article 24 of the OECD Model Tax Convention are no longer fit to adapt to today's economic realities.¹⁸⁴

In conclusion, the OECD failed to address the **'troika of threshold requirement, separate legal entity principle and attribution of profit** to arrive at a coherent globally supported solution'.¹⁸⁵ Some even question whether BEPS project 'is all more for political effect than substantial reform'.¹⁸⁶ BEPS was primarily meant to close loopholes. Those who call for fundamental reform view it as a very limited exercise, which did not face up to the broader problems troubling the system, including economic inefficiency and instability due to tax competition. In fact, both of these problems might have worsened.¹⁸⁷ However, the OECD Policy Note - published on 23 January 2019 -emphasizes that tailored and effective solutions can be found by 2020.

¹⁷⁹ Moreno (2018).

¹⁸⁰ Cachia (2018).

¹⁸¹ Baumann (2017), p.37.

¹⁸² Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

¹⁸³ Hidalgo (2017), p.715.

¹⁸⁴ Hidalgo (2017), p.720.

¹⁸⁵ Eisenboss (2016).

¹⁸⁶ Gomes (2018).

¹⁸⁷ Devereux and Vella (2018).

3. RECENTLY INTRODUCED UNILATERAL TAX MEASURES

KEY FINDINGS

- Despite the pitfalls of unilateral actions, political and revenue needs are too high and pressing for some countries in the absence of international consensus, various countries introduced specific measures in the form of new nexus, withholding taxes, turnover taxes or specific measures targeting large MNEs.
- The revenue-based equalisation levy represents the objective of tax neutrality between different businesses using distinct business models or residing within or outside the taxing jurisdiction. Such new taxes give rise to legal uncertainty and lead to arbitrary distinctions, as they combine elements of taxes on profits with elements of consumption taxes and defy clear classification for tax treaty purposes. The uncertainty extends to treaty overrides and tax treaty arbitration. While regarded as potentially harmful to the growth of SMEs and the development of new technologies, such 'quick fix' solutions may 'trigger counter-reaction by non-EU countries.'
- A new nexus alters the traditional PE threshold by establishing a taxable presence for businesses with a significant economic presence determined by preferably quantitative measures even in the absence of physical presence, reflecting the benefits principle. Yet, under the current rules relying on physical PE, only minimal profits could be attributed to such a nexus. Moreover, such sales taxes could be problematic due to multiple taxation, inequalities, market distortions, legal uncertainty, and red tape, both for tax authorities and taxpayers alike.
- A withholding tax at source on payments regarding digital products and services is typically applied in the territory where digital services are provided. While some find it more acceptable for the reason that it is in line with current tax treaties, the downside of this measure could be double taxation 'in the state of residence of the online selling company, 'desincentivisation' of electronic commerce in Business to Consumer (B2C) type activities and potential uncertainty caused by continuing contracts to determine the taxpayer.
- Anti-avoidance measures targeting the MNEs, such as the UK's DPT and the French GAFA Tax, also raise tax treaty compatibility, compliance, legal uncertainty, and double taxation issues.
- The proliferation of unilateral taxes gives rise to uncertainty regarding the scope of application of the tax treaties as they mark a departure from standard categories by showing a certain hybridization, in particular by combining elements of taxes on profits with elements of consumption taxes.
- According to the OECD, the potential target of unilateral measures shall be business models constituting the highest risk, combining high levels of scale without mass characterised by performance of a profit-generating income activity abroad for a relatively long period of time with reliance on user participation and network effects (i.e Internet advertising and intermediation services).
- Such measures shall be simple, temporary and targeted, minimising over-taxation, the impact on start-ups as well as cost and complexity. They shall also be in accordance with the international obligations and treaties.

Despite the pitfalls of unilateral actions¹⁸⁸, political and revenue needs are too high and pressing for some countries in the absence of international consensus, which went ahead acting unilaterally to address problems arising from the digital sector.¹⁸⁹ The majority of unilateral measures are based on new nexus, equalisation levy and withholding tax, which were already mentioned under BEPS Action 1 as possible policy options without any of them being recommended.

The OECD categorises these uncoordinated unilateral measures¹⁹⁰, which were enacted worldwide as follows¹⁹¹:

- Alternative applications of the **PE threshold** (Adjustment of PE definition or establishing tax rights according to digital presence, e.g. India, Israel);
- **Withholding taxes** (Broadening the categories of exception to the PE rule under which the taxing right is allocated to the source rule to include digital products and services);
- **Turnover taxes**, such as equalisation levies (Non-income tax measures to subject foreign-based suppliers of digital goods and services, e.g. India, Italy, France); and
- **Specific regimes targeting large MNEs** (e.g. UK, Australia, US).

3.1. Various Unilateral Measures Introduced across the EU

As many as 11 EU countries already introduced direct tax measures targeting digital activity, including the UK's Diverted Profits Tax, Italy's web tax and France's YouTube tax.

3.1.1. Italy's Web Tax

The Finance Law 2018 in Italy introduced a web tax, which will be applicable from January 2019 onwards. The **3% tax** is applicable to Internet services distinguished by minimum human intervention and use of technology, provided both by Italian resident and non-resident entities to local business recipients. The new tax will be settled by the buyers of the service. The minimum threshold is 3000 transactions per year. The special turnover tax does not take into account expenses and is not creditable against Italian income tax.¹⁹² The tax is intended to apply to intangible goods, such as online advertising and sponsored links, but not to online retail.¹⁹³

The Italian Income Tax Code has also introduced a Significant Economic Presence (SEP) test and amended the definition of PE. The SEP test shall apply where factors, such as revenues and numbers of customers, are located but physical presence is not necessarily needed to indicate a significant presence.¹⁹⁴

Italy has also passed a new transfer pricing rule that stipulates the use of valuation techniques other than cost-based indicators for determining the arm's length prices of digital transactions.¹⁹⁵

¹⁸⁸ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

¹⁸⁹ Avi-Yonah (2016).

¹⁹⁰ KPMG (2018) OECD Task Force on the Digital Economy release Interim Report.

¹⁹¹ Bloomberg Tax (2018) Special Report on 'Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation', p.14.

¹⁹² EY Global Tax Alert (2017), Italy enacts Web Tax and new PE definition.

¹⁹³ Financial Times, Italy pushes ahead with 3percent web tax, 19 December 2017.

¹⁹⁴ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p. 49.

¹⁹⁵ Olbert and Spengel (2017).

3.1.2. Austria's Online Advertisement Tax

Austria extended the scope of its national tax to include online advertising. With the new measures, which came into force in 2018, the government intends to reduce the advertisement tax while broadening the tax base to include online advertising.¹⁹⁶

3.1.3. Slovakia's Intermediation Tax

Slovakia introduced a tax on income derived from intermediation through websites and platforms. This targeted measure aims at expanding the fixed place of business condition for certain digital platforms.

3.1.4. France's YouTube and GAFA Tax

In France, a 2% tax levied on the advertising revenue by resident or non-resident platforms broadcasting free or paid videos online, such as YouTube or Netflix, came into effect in the beginning of 2018.¹⁹⁷ The tax complements tax mechanisms for online television platforms or video-on-demand services. Although the tax was found compatible with the EU laws, concerns arise as to its narrow scope and difficulties regarding collection from the platforms located abroad.¹⁹⁸ France also introduced its so-called "GAFA tax"—named after Google, Apple, Facebook and Amazon—to ensure the global internet giants pay a fair share of taxes on their huge business operations in Europe (applies as from 1 January 2019).

3.1.5. Belgium's Fairness Tax

The fairness tax is a 5,51% levy on profit distributions by Belgian companies or foreign companies with a PE in Belgium. The tax only applies to profits which have not already been subject to corporate tax due to the Belgian national interest deduction or due to a loss-carry forward. The tax is assessed separately from ordinary corporate tax. It is different than an income tax, as business expenses are not deductible. The subject of taxation is the payer of the distributions rather than the recipient.¹⁹⁹

3.1.6. Hungary's Advertisement Tax

Hungary's Advertisement Tax Act, introduced in 2014, targeted advertisement turnover of companies, which were subject to progressive tax rates ranging from 0% to 50%. A first amendment was made to the law following the launch of the European Commission investigation in July 2015 to limit targeting sales revenues over a smaller range of 0% and 5.3%. The upper threshold was applied to companies exceeding 100 million Hungarian Forints (HUF) in revenues. On 4 November 2016, the European Commission found that Hungary was in breach of EU state aid rules because its progressive tax rates granted a selective advantage to certain companies.²⁰⁰

Hungary amended its advertisement tax again in 2017 to comply with the EU rules, raising the upper threshold of the progressive tax rate to 7,5% for taxpayers with sales revenues from advertising over HUF 100 million.²⁰¹ The de minimis threshold at which the tax kicks in was retained despite the European Commission's warning that a low turnover could give unfair advantages over competitors.

¹⁹⁶ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

¹⁹⁷ Osborne Clarke (2016) France: Introduction of a new tax mainly targeting US leaders of the digital economy including Youtube? (<http://www.osborneclarke.com/insights/france-introduction-of-a-new-tax-mainly-targeting-us-leaders-of-the-digital-economy-including-youtube/>).

¹⁹⁸ Lavocat (2018) So-called "Youtube"/ "Netflix" tax comes into effect in France (<https://www.avocatl-en.com/single-post/2018/04/13/So-called-Youtube-Netflix-tax-comes-into-effect-in-France>).

¹⁹⁹ Ismer and Jescheck (2017).

²⁰⁰ European Commission Press Release (2016) State aid: Commission finds Hungarian advertisement tax in reach of EU rules.

²⁰¹ EY Tax Insights (2017) Hungary: advertisement tax amended.

The tax does not target the digital sector but is considered to be influential in the operation of the digital market.²⁰²

3.1.7. UK's Diverted Profits Tax

The UK's diverted profits tax was conceived as a response to BEPS activities facilitated by digital businesses, circumventing PE status despite having significant economic presence through intragroup mismatch arrangements to shift profits.²⁰³ The measure is tied to the presence of PE standard, in the absence of which it could not apply.²⁰⁴

The Diverted Profit Tax aims at establishing a nexus between the entity producing the income and the place where the income originates. The tax is an upfront tax at 25 % (as opposed to the UK Corporate Income Tax of 19 %) of punitive character. The conditions are purposeful avoidance of PE and structures lacking economic substance and mismatch arrangements to shift profits.²⁰⁵ In case there is a tax mismatch in that the tax paid by a company abroad is less than 80 % of the tax avoided, tax reduction is perceived as one of the main purposes of the arrangement. If these conditions are satisfied, a 25 % applies to diverted profits.²⁰⁶

In April 2018, the UK proposed a targeted **royalty withholding tax applicable to IP royalties** paid by a non-UK resident entity to a related party in a low-tax jurisdiction. A withholding tax is a step towards taxing the digital economy by reference to nexus of consumer and user base rather than physical presence. The proposed tax requires no UK presence for the taxpayer beyond a UK customer base.²⁰⁷ The withholding tax would be waived if the non-resident has a PE or is subject to diverted profits tax. The UK-resident related parties to the non-resident supplier would be made jointly liable for the tax.²⁰⁸

3.2. Other Unilateral Measures Introduced Globally

3.2.1. Australia's Multinational Anti-Avoidance Law (MAAL)

Australia introduced a similar tax to the UK's DPT: The Multinational Anti-Avoidance Law. The tax, which is also dependent on PE condition, puts the burden of proof on the non-resident.

A draft guidance issued on May 2nd further clarified this tax, which will be subject to a low-threshold connection test between the company and its supply of a product or service. The connection test will be satisfied irrespective of whether the supply of a product or service has occurred. Examples to the included activities are: Attracting new customers (through local advertising campaigns), procuring demand for sales, supporting the execution of supply through supplier arrangements (telephone-based assistance to customers by local support staff), and relating to the ability to supply the goods or service.

²⁰² Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

²⁰³ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

²⁰⁴ Avi-Yonah (2016).

²⁰⁵ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

²⁰⁶ Avi-Yonah (2016).

²⁰⁷ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

²⁰⁸ Turina (2018).

3.2.2. New Zealand's Digital Services Tax

New Zealand extended its GST to digital remote services provided offshore. Although New Zealand remained reluctant about introducing a DPT-type tax, it remains open to potential anti-avoidance measures.²⁰⁹

3.2.3. Israel's New Nexus and Significant Economic Presence Test

In April 2016, Israel published guidelines on changes to income tax and VAT which expand the concept of the PE to include non-resident online businesses, which sell or provide services through Internet to Israeli residents. The proposals focus on instances in which income of foreign company could be attributed to a PE in Israel in the context of digital economy. A virtual PE would be established for companies with a significant presence, even if these activities are of preparatory and auxiliary nature. To countries with which no treaty has been concluded²¹⁰, **a significant digital presence** test will be applied taking into account the number of contracts concluded with local customers, adjustments to the online services for Israeli users (i.e. the use of Hebrew language and local currency), high web traffic by local users, a close correlation between the consideration paid to the foreign company and the level of Internet usage.²¹¹

3.2.4. India's New Nexus and Equalisation Levy

India introduced an equalisation levy of 6% in 2016. With the new levy, any Business to Business (B2B) payment made to a non-resident in respect of online advertising is withheld by the resident taxpayer. The gross value tax is aimed at digital business models, such as Google and Facebook. The equalisation levy does not apply when a non-resident service provider maintains a PE, in which case the income tax rate of 40% applies and expenses may be deducted from the tax base.

India may extend its Google tax to include streaming and marketing services like those offered by Facebook, Amazon.com and Netflix.Inc.²¹²

In addition, India amended the concept of 'business connection' to include a significant economic presence in its Finance Act of 2018. Such a move could impose a 40% tax on any foreign company rendering digital goods and services to India.²¹³

The Indian SEP test is divided into two limbs: The first limb is triggered if aggregate of payments arising from transactions are carried out by a non-resident in India, including the download of data or software exceeding a certain threshold in India.

The second limb is kicked off if such business activities are conducted in a systematic and continuous way in interaction with a certain number of users. The SEP applies even when there is no local agreement signed, independently of the existence of a fixed place of business of the non-resident who may or may not provide services to local customers.²¹⁴

²⁰⁹ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

²¹⁰ Turina (2018).

²¹¹ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

²¹² Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.41.

²¹³ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

²¹⁴ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.49.

3.2.5. Saudi Arabia and Kuwait's Virtual PE

Saudi Arabia and Kuwait introduced the virtual service PE, which can be triggered even in the absence of physical presence, when a non-resident provides services to local customers. Any services performed for more than 6 months under cross-border agreements between non-resident and local consumers create a virtual PE.²¹⁵ In this context, the OECD notes a minority view that physical presence is not required under the Article 12 of the UN Model Convention on fees for technical services adopted in 2017, but concludes this is at risk of taxpayer challenge and its efficiency is not known.²¹⁶ Like Saudi Arabia, other countries started re-interpreting the concept of the PE and creating a digital PE.²¹⁷ Recent discussions and actions start regarding websites as potential PEs and even consider them as a 'virtual PE'.²¹⁸

3.2.6. Taiwan's New Nexus

On 2 January 2018, Taiwan also introduced guidelines on changes to income tax rules for foreign companies without a fixed place of business that provide e-commerce services to local consumers in. Such income generated from services with an economic nexus in Taiwan would be deemed to be taxable.²¹⁹

3.2.7. Turkey's Withholding Tax on E-payments

In 2016, Turkey introduced monthly mandatory reporting obligations regarding transactions, including digital sales of service providers and advertisers acting as intermediaries in the country. In parallel, a withholding tax became applicable to e-business payments and similar online activities. The concept of an electronic PE was also put forward, which could make intermediaries as well as purchasers liable for the payment of withholding taxes.²²⁰

3.3. Evaluation of Specific Unilateral Measures

3.3.1. Equalisation Levy

An equalisation levy (e.g. Italy, India) constitutes a turnover tax on e-services if it is imposed on the supply itself and where it focuses exclusively on the expenditure side of the payment (nature and value of supply), if not charged at a fixed rate and if not creditable or eligible for any other type of relief against income tax imposed on the same payment. The equalisation levy **is meant to achieve tax neutrality** between different businesses using distinct business models or residing within or outside the taxing jurisdiction²²¹ in addition to providing greater clarity in respect of characterisation of payments for digital services. However, the structural weakness of the equalisation levy appears to be 'manifold and insurmountable'.²²²

The equalisation levy is revenue based and levied upon the gross value of payments exiting the source state. It could mean imposing a tax on loss-making businesses, which would be potentially in

²¹⁵ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

²¹⁶ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

²¹⁷ Committee of Experts on International Cooperatin in Tax Matters (2017), Tax consequences of the digitalised economy.

²¹⁸ Requena and Gonzalez (2017), p. 735.

²¹⁹ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

²²⁰ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

²²¹ Basak (2016).

²²² Baez and Brauner (2018).

violation of the ability to pay principle. Therefore, it could hamper the growth of SMEs and its global implementation could impede technological advancements.

The Indian equalisation levy, which was inspired by the OECD's 2015 Final Report, drew much criticism. The Indian levy is imposed just on transactions effectuated through a digital platform and it is applicable only when a non-resident enterprise has a significant economic presence, covering only cross-border B2B transactions.

However, it differs from the OECD proposal for the reason that it is collected by the service recipient and not by the foreign enterprise or local intermediary. In this sense, it is similar to an income tax.²²³ Although India defends the opposite view, chances are high for the tax to be covered by India's tax treaties.²²⁴ **Such new taxes give rise to legal uncertainty and lead to arbitrary distinctions**, as they combine elements of taxes on profits with elements of consumption taxes and defy clear classification for tax treaty purposes. The uncertainty extends to treaty overrides and tax treaty arbitration.²²⁵

The **nature of the Indian levy** is also questioned. While it shares common features with both income tax and turnover tax, some believe that it is neither an income tax nor a turnover tax and thus, should come on top of existing direct and indirect taxes. There are also uncertainties about the scope of the levy as to whether or not it covers all transactions concluded remotely or just those effectuated through a digital platform.²²⁶

The equalisation levy introduced in India was seen by some as **an attempt to engage in 'treaty dodging'** by delinking the taxation of digital transactions from tax treaties with the introduction of a new levy not covered therein. As the levy would be carved out of income taxation, it cannot be credited against tax paid by the foreign company in its residence country.²²⁷ Yet, the manner in which taxes are levied is of no relevance for their inclusion in the scope of application of tax treaties.

The levy is supposed to ensure equal treatment of foreign and domestic supplies but some question whether it fulfils this very purpose if it is imposed on both domestic and foreign entities.²²⁸ **In order to be compatible** with the General Agreement on Trade in Services (GATS), an equalisation levy could apply only to services in B2B situations. GATS includes an exception for difference in treatment aimed at ensuring the equitable or effective imposition or collection of direct taxes, which a priori covers the equalisation levy.

According to Kemmeren, such short-term measures, akin to turnover and use taxes, are already included in the VAT and, sales and use taxes.²²⁹ Hence, one should consider carefully the introduction of turnover taxes in addition to **VAT** because of their similarities.²³⁰ This view is supported by arguments that it is better to enforce existing tax claims, such as under VAT, than to create problematic new taxes.²³¹

Conversely, others emphasize that the potential for convergence between equalisation levies and VAT should be seized as an opportunity to find solutions within an indirect tax framework.²³²

²²³ Baez and Brauner (2018), p. 8.

²²⁴ Ismer and Jescheck (2017).

²²⁵ Hearson (2017).

²²⁶ Baez and Brauner (2018), p.8.

²²⁷ Turina (2018).

²²⁸ Baez and Brauner (2018), p.7.

²²⁹ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p. 10.

²³⁰ Turina (2018).

²³¹ Ismer and Jescheck (2017).

²³² Turina (2018).

3.3.2. Nexus-based Approaches

A company in the cyberspace alone is not sufficiently solid to be liable to taxation if it is not accompanied by significant digital and economic presence.²³³ A **new nexus alters the traditional PE threshold** by establishing a taxable presence allowing source taxation of business profits even in the absence of a fixed place of business, which would be conditional to a certain degree on significant economic presence via technology and other automated tools.

Such a new nexus reflects the benefits principle²³⁴ and assigns taxing rights to the jurisdiction where sales take place.²³⁵ One of its objectives is to reduce the existing bias differentiating tax treatment of digital and physical transactions by introducing consistency between the two.²³⁶ However, questions may arise on how to differentiate between business models based on both traditional and digital elements while respecting the principle of tax neutrality and avoiding the trigger of multiple PEs. Such sales taxes could be **problematic due to 'multiple taxation, inequalities, market distortions, legal uncertainty, and red tape, both for tax authorities and taxpayers alike'**.²³⁷

A significant economic presence could be determined by **quantitative thresholds**, as qualitative thresholds are likely to cause disputes, tax unpredictability and double taxation. Setting minimum thresholds could be an optimum way to provide for a level playing field for Small-and Medium Enterprises (SMEs).²³⁸

In addition, finding the **appropriate profit attribution rules** could be challenging in case of a new nexus. If the current Authorised OECD Approach would be applied, a significant people functions should be performed at the PE level. If these functions are not performed in the market jurisdictions, the income attributable to the PE would be negligible. Hence, other profit attribution rules, such as formulary apportionment and split profits method, shall be considered.²³⁹

In this context, the introduced nexus-based measures were subject to much criticism. With its new significant economic test, **Israel** has followed a 'standard-based rather than a rule-based approach' but the lack of hard thresholds could give rise to 'nudges susceptible to distort taxpayer behaviour'. Moreover, some argue that, a very low threshold would have been a better policy option to give a level playing field for SMEs.²⁴⁰

As for **India's SEP test**, concerns have been expressed regarding:

- The retrospective nature of the amendment;
- The wide amplitude of the 'provision of download of data or software' which could lead to different interpretations and litigations;
- The trigger of the first limb based on 'aggregate of payments', which is akin to a global formulary approach;
- Difficulty to identify deemed profits 'accruing or arising in India' for profit attribution; and

²³³ Hidalgo (2017), p.736.

²³⁴ Turina (2018).

²³⁵ Dourado (2018), p.565.

²³⁶ Turina (2018).

²³⁷ De Wilde (2018).

²³⁸ Baumann (2017), pp.38-40.

²³⁹ Turina (2018).

²⁴⁰ Turina (2018).

- The lack of definition regarding the ‘systematic and continuous soliciting of business’ condition in the second limb.²⁴¹

Such **‘vaguely worded and ‘not well articulated’** tax policy could lead to potential litigations. As with Israel’s case, detailed guidance would be needed regarding the Indian SEP test. Moreover, **double taxation** could arise where both countries have a SEP test even where there is no Double Taxation Avoidance Agreement (DTAA) with a country.²⁴²

3.3.3. Withholding Tax

A withholding tax at source on payments regarding digital products and services is typically applied in the **territory, where digital services are provided**, showing some similarities with the equalisation levy.

The OECD 2015 Final Report favours the use of withholding tax as a **backup mechanism**. Regarding the scope, transactions for goods or services ordered online or operations concluded remotely with non-residents are cited. It explores the possibility to require intermediaries processing payments to withhold on the payment in B2C contexts but it constrains WHT to B2B transactions. This measure limits deductions made by subsidiaries or existing PEs in the source jurisdiction for technical services provided by the parent company, making such fees subject to a withholding tax. Thus, it tackles BEPS by restricting the shift of profit from the source state through income deductions.

According to Article 7 of the OECD Model Tax Convention, a state **cannot levy a withholding tax on an item of business profits**.²⁴³ In spite of this, the new Service PE under the UN Model expanded withholding tax on services, giving the source state a right to tax outgoing payments for certain technical (managerial, technical or consulting) services, even in the absence of a PE.

Developing countries claim that they are the main source of tax revenue loss in the digital economy as providers of consumer and user base but with no possibility to host digital businesses.²⁴⁴ They argue that the paying capacity of the consumer is made possible due to the state’s contribution via public goods, law, order, market facilitation, infrastructure and redistribution.²⁴⁵ However, opinions vary as to whether or not companies benefit from the infrastructure in market jurisdictions as much as consumers do.²⁴⁶ Although the new provision in the UN Model might create a balancing effect for the developing countries and may lead to an increase in bilateral treaties attributing taxing rights to the source state for technical services²⁴⁷, some believe that it may culminate in a more complex international tax system, increasing compliance costs due to the difficulty of interpretation of the new rule for the taxpayers operating in multiple jurisdictions.²⁴⁸

On the other hand, it is proclaimed that **tax treaties create power asymmetries** via unequally distributed taxing rights by adjusting the PE definition and fixing a maximum rate for withholding taxes, which disfavours developing countries through special treatment of foreign residents. According

²⁴¹ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.50.

²⁴² Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.51.

²⁴³ Turina (2018).

²⁴⁴ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

²⁴⁵ Singh (2017).

²⁴⁶ Kemmeren (2018), p.73.

²⁴⁷ Baez and Brauner (2018)

²⁴⁸ Baumann (2017), p.45.

to Hearson, developing countries make revenue sacrifice in tax treaties in accordance to their size, their revenue base and their reliance on corporate tax.²⁴⁹

Withholding taxes represent a **partial shift of taxing rights**. Therefore, they are believed to be more acceptable. However, like virtual PE, the introduction of a withholding tax could necessitate changes to tax treaties.²⁵⁰ Moreover, the WHT could lead to double taxation 'in the state of residence of the online selling company', 'desincentivisation' of e-commerce in B2C type activities and potential uncertainty caused by continuing contracts to determine the taxpayer. Setting different withholding tax rates could also give rise to an unhealthy tax competition.²⁵¹

In addition, the withholding tax on gross revenues might not be a 'good proxy for net income' and should be fixed at a relatively low amount due to the World Trade Organisation (WTO) and EU law concerns.²⁵² In accordance with the WTO, foreign suppliers of goods and services shall not be taxed more favourably than domestic suppliers. However, exceptions are provided in case of direct taxation of services and withholding taxes on non-residents.²⁵³ When it comes to the EU law, the Court of Justice of the European Union (CJEU) does not allow gross withholding taxes levied from non-residents.²⁵⁴ Finally, if applied solely on revenue before expense deductions, the WHT could hamper cross-border trade while leading to increased compliance costs and impediments to the growth of start-ups.²⁵⁵

3.3.4. Measures targeting large MNEs

DPT-type measures have an **effect on how businesses organise their structure**. In March 2016, only months after the introduction of the DPT in the UK, Facebook announced that it would change its policy so that revenues generated from its largest advertisers displaying content on Facebook will be routed through the UK rather than Ireland. This will not result in the company's booking of all the revenues it generates from local consumers in the UK but will lead to some tax revenue increase. Facebook made similar changes in Australia. Snapchat also announced that it will pay taxes in the countries, where it sells digital advertising services.²⁵⁶

Despite these positive effects, many question the **compatibility of such measures with tax treaties** as the state of residence is not obliged to credit the tax against domestic income tax.²⁵⁷ Although it was introduced as a new tax, the DPT has been criticised for contradicting the UK tax treaties, deeming business profits to be taxed in the resident jurisdiction in the absence of PE. This may give rise to controversy between contracting states, creating a risk of double taxation.

The DPT consists of **complicated legal framework**, making it a burdensome procedure for the taxpayer to predict tax liability. If applied in every jurisdiction, it would lead to uncertainty and impair world trade.²⁵⁸ Businesses complain about tax uncertainty because of rather subjective rules put in place

²⁴⁹ Hearson (2018).

²⁵⁰ Avi-Yonah (2016).

²⁵¹ Requena and Gonzalez (2017), p. 736.

²⁵² Baez and Brauner (2018), p.7.

²⁵³ Moreno (2018).

²⁵⁴ Kemmeren (2017).

²⁵⁵ Baumann (2017), p.45.

²⁵⁶ PwC (2017) Unequal taxation in a digital World-a challenge for the Nordic media industry.

²⁵⁷ Ismer and Jescheck (2017).

²⁵⁸ International Tax Review (2017), Combining Technology and Talent for the digital tax future.

to counter BEPS.²⁵⁹ Moreover, as the nature of connection is broadly construed, it may lead to different interpretations.²⁶⁰

While some argue that the **tax is incompatible with the existing nexus rules** stemming from the fact that it is based on the principle of allegiance in spite of a feeble connection,²⁶¹ others are convinced that such anti-avoidance measures fail to address problems caused by distant digital providers, as they are deeply rooted in the existing PE rules.²⁶²

3.4. Design and Compliance Issues that arise from Unilateral Measures

Absence of consensus leads to unilateral measures, making multilateralism lose its appeal. **The effectiveness of such interim measures is doubtful.** Some scholars recognise the legitimacy of short-term approaches that may put pressure on international organisations to speed up their coordination efforts²⁶³ while others think that they would fall short of fixing the interests of source needs, calling for a serious reform.²⁶⁴ In parallel, many argue that ‘quick fix’ solutions, such as taxation of turnover proposed by France, Germany, Italy and Spain, are the wrong way forward as they will ‘trigger counter-reaction by non-EU countries’.²⁶⁵

At the OECD level, a group of countries is opposed to interim measures arguing that there is no sound conceptual basis for such action on the basis of possible negative consequences, including the risk of over-taxation and hindrance to growth. Other countries support the view that the current system cannot tax all value generated in a third jurisdiction and such measures would be justified in advance of a long-term solution as means to restore fairness, sustainability and public acceptability. The OECD does not recommend interim measures on digital taxation but accepts an excise tax on e-services if certain conditions regarding the design of the measures are respected.²⁶⁶

The OECD’s Interim Report sets out the **main criticism of interim measures** as follows: Impact on investment, innovation and growth, impact on welfare, potential economic incidence of taxation on consumers and businesses, possibility of over-taxation, possible difficulties in implementing a tax as an interim measure and compliance and administration costs.²⁶⁷

According to the OECD, the potential target of unilateral measures shall be businesses with high levels of **scale without mass** characterised by performance of a profit-generating income activity abroad for a relatively long period of time as well as business models relying on **user participation and network effects**. (i.e. **Internet advertising and intermediation services**). Moreover, such measures shall be simple, temporary and targeted, minimising over-taxation, the impact on start-ups as well as cost and complexity, while complying with international obligations.

²⁵⁹ KPMG (2016) Comments with respect to the request for input with respect to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

²⁶⁰ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, pp.17-18.

²⁶¹ Basak (2016).

²⁶² Baumann (2017).

²⁶³ Dourado (2018), p. 565

²⁶⁴ Dourado (2018).

²⁶⁵ Schippers and Verhaeren (2018), p.64.

²⁶⁶ Taxsutra (2018) Decoding OECD’s Interim Report on Digital Economy (<http://www.taxsutra.com/experts/column?sid=936>).

²⁶⁷ OECD Interim Report (2018) Tax Challenges Arising from Digitalisation, p.178-180.

The **proliferation of unilateral taxes** gives rise to uncertainty regarding the scope of application of the tax treaties as they mark a departure from standard categories by showing a certain **hybridization**, in particular by combining elements of taxes on profits with elements of consumption taxes.²⁶⁸

One major problem is that the concepts of **income and capital are not defined** in the OECD Model Convention. While income taxes are flow figures focusing on the recipient, turnover taxes seek to capture the spending power of the payer.²⁶⁹ However, the lines between the two can be blurred in practice, making it difficult to distinguish taxation at source from turnover taxation of specific supplies.

A possible solution to determine whether new taxes are covered by previous tax treaties may be obliging the contracting states to **enter into a Mutual Agreement Procedure (MAP)**.²⁷⁰ Yet, MAPs can be usurped by MNEs becoming principles with some home state acting as their agent, initiating a MAP and later arbitration, as a means of forcing the other state to change its behaviour when it comes to taxing them.²⁷¹ Such measures may increase tax certainty while limiting countries' source taxation rights.²⁷² Tax treaties could also be misused to impose norms by large states onto smaller ones. In order to be legitimate, they have to be binding and precise while delegating enforcement to independent courts or arbitrators.²⁷³

If tax measures are selective regarding the type of transaction and the location of businesses, tax policy might distort corporate behaviour and the location attractiveness of the respective jurisdiction might suffer. A prominent example is Hungary, which has already experienced a loss in location attractiveness for digital businesses on top of numerous EU investigations.²⁷⁴

²⁶⁸ Ismer and Jescheck (2017).

²⁶⁹ Ismer and Jescheck (2017).

²⁷⁰ Ismer and Jescheck (2017).

²⁷¹ Hearson (2017).

²⁷² Hearson (2017).

²⁷³ Hearson (2017).

²⁷⁴ Olbert and Spengel (2017).

4. RECENT TAX DEVELOPMENTS IN THE EU

KEY FINDINGS

- Some examples to MNEs' tax avoidance practices investigated by the EU include Apple Inc.'s income shifting from US to Ireland, McDonald's' use of CFCs, Starbucks' manipulation of inter-company transfer pricing, Fiat's extension of inter-company loans to its subsidiaries, Amazon's profit shifting among subsidiaries, Google's claim that its high-tech products are developed in the US and should be treated as US-sourced income, and Ikea's high royalty charges to its subsidiaries.
- The EU's response to BEPS came as the Anti-Tax Avoidance package, especially the ATAD, whose scope was extended in 2017. Given the inadequacy of international rules and the need for fair taxation, the Commission introduced a 3% interim tax on digital services as well as a long-term solution setting a Significant Economic Presence based on digital factors, including sales, users and contracts.
- The Commission's short-term proposal could mean the collection of EUR 5 billion annual revenue for the Member States. It is estimated to cover 120 to 150 companies, 50% of which are residing in the US, under the advertising and multilateral interface pillars.
- Business circles, practitioners and academics fiercely criticised the digital tax proposal as 'populist and flawed', highlighting the problems that this would cause for loss-making businesses, the possible deterrent effect it would have on start-ups, the risk of double taxation, potential retaliation of third countries, as well as technical difficulties, such as identification of the user location.
- Some believe that such unilateral measures are justified as they put pressure on the international community to act while others question their viability calling for fundamental reform to catch up with the digital revolution.
- Interim measures are known to be perpetuated and could possibly put international tax co-operation in peril. Despite the Commission's reassurances that an international solution is preferable, the target date to introduce the Digital Services Tax set for the end of 2018 in view of European elections seems too ambitious, as some Member States may choose to wait for the OECD outcome.
- The proposed long-term solution is the Commission's preferred option but it would necessitate the replacement of some 2000 tax treaties, which is highly dubious given the reluctance of US and other countries.
- EU Member States are divided over digital taxation, as their tax policies differ due to diverse national interests and varying levels of technological advancements. The lack of unanimity leads the Commission to seek for alternative ways, such as informal pressure, Qualified Majority Voting (QMV) and enhanced cooperation.
- The inclusion of a virtual PE to the CCCTB could provide an appropriate solution to stop a race to the bottom yet its adoption is far from guaranteed due to implementation difficulties and Member State opposition, fearing an EU-wide tax harmonisation.
- The European Parliament is putting pressure on the Council to reach agreement before the end of its mandate in April 2019. In December 2018, two proposals were supported by the EP that will see the threshold of minimum taxable revenues within the EU lowered to €40 million from the commission original proposal of €50 million, a 5% tax rate imposed rather than the Commission's 3%, and the inclusion of online streaming services under the scope of the plans.

4.1. State of Play of EU Tax Cases against MNEs

Since 2013, the **state aid instrument** was used against MNEs, exploiting differences in national tax systems and manipulating their tax strategies to circumvent the law. A Task Force on Tax Planning Practices was established in 2013 to investigate tax authorities signing Advance Pricing Agreements (APAs) in order to give MNEs selective advantages and a beneficial treatment.²⁷⁵

Many **US corporations moved their tax headquarters** to the EU in the past 10 years. These include digital companies (tech companies, online sellers etc.) as well as more traditional ones, such as fast-food chains, retailers and automobile industry. These corporation's tax strategies were regarded by the European Commission as tax subsidies, which is illegal according to the EU acquis. The tax disputes focus on source of income, royalties, transfer pricing and inter-company loans.

Some examples include Apple Inc.'s income shifting from US to Ireland, McDonald's' use of CFCs, Starbucks' manipulation of inter-company transfer pricing, Fiat's extension of inter-company loans to its subsidiaries, Amazon's profit shifting among subsidiaries, Google's claim that its high-tech products are developed in the US and should be treated as US-sourced income, and Ikea's high royalty charges to its subsidiaries.²⁷⁶

These cases have commonalities as many US multinationals struck agreements with EU governments, such as Ireland, Luxembourg and the Netherlands, to be recognised as a foreign corporation and used the discrepancy between the worldwide income tax system in the US and the territorial income tax system used in countries, such as Ireland, to avoid paying taxes both in the US and in the EU. In response to this, the EU asked some of these companies to repay the respective EU Member States the illegal tax subsidies that they received in the past few years. Most of the cases are pending.

Notwithstanding these investigations and the OECD's BEPS measures, **MNEs seem to continue to embark on aggressive tax planning schemes**. This is exemplified by recent disclosures about tax avoidance activities of Netflix and eBay.²⁷⁷

4.2. The EU's anti-BEPS Efforts

4.2.1. Recent EU Actions to Counter BEPS

Following the release of the final BEPS recommendations covering 15 Action Points in 2015, the EU responded by an Anti-Tax Avoidance package published on 28 January 2016, and in particular the Anti-Avoidance Tax Base or Anti-BEPS Directive, having the objective to design rules against tax avoidance practices which have a direct effect on the single market. With the adoption of **ATAD** on 12 July 2016, the EU introduced a restriction on interest deductibility in the form of an earnings-stripping provision (Action 4), established CFC rules (Action 3) and neutralised hybrid mismatches including certain qualification differences (Action 2). The Directive goes beyond BEPS actions by providing two additional provisions: Exit tax and general anti-abuse provision.²⁷⁸ On 21 February 2017, the ATAD's scope was broadened with regard to the neutralisation of qualification differences so as to include third

²⁷⁵ De Graaf and Visser (2018), p.41.

²⁷⁶ Watttel (2016).

²⁷⁷ Financial Times, Netflix and eBay find the holes in the UK tax net (<https://www.ft.com/content/b4b481de-af57-11e7-beba-5521c713abf4>) 13 October 2017.

²⁷⁸ KPMG (2017) OECD BEPS Action Plan- Moving from talk to action (<https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2017/09/ema-beps-report-2017.pdf>).

countries, while also extending its material scope of application by neutralising other qualification differences (ATAD 2).

Regarding cross-border tax disputes, a **Dispute Resolution Directive** was adopted in October 2017, bringing automatic and binding resolution to disputes.²⁷⁹

Moreover, the Code of Conduct Group reached agreements on **patent box regimes**.²⁸⁰ The Member States also agreed to spontaneously **exchange information on tax rulings** under the Directive on Automatic Exchange of Information (Action 5). With the amended Mutual Assistance Directive, the exchange on APAs is ensured while other information, such as financial income and account balances is set to be exchanged at the EU level.

Simultaneously, the EU signed the Foreign Account Tax Compliance Act (**FATCA**) and Common Reporting Standard (**CRS**) disclosure agreements. Moreover, the EU took measures to enhance **greater transparency** by introducing **Country-by-Country Reporting** for extractive and logging companies and revising the **Capital Requirements Directive 4** for banks and investment funds. In addition, the European Parliament voted in favour of more tax transparency requiring **public CbCR** for all multinational groups with a total consolidated revenue of EUR 750 million²⁸¹. However, political consensus on public CbCR was not yet reached in the Council.²⁸² If adopted, a maximalist CbCR demanding MNEs to publicly disclose labour costs, invested capital, payroll, employment, tax payments, sales and purchases, divided between intra-group transactions and external transactions in each jurisdiction, could confront the separate entity principle by exposing transfer pricing arguments.²⁸³

On 25 May 2018, the Council of the European Union introduced new rules with respect to mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements, which would oblige intermediaries to disclose certain potentially harmful tax structures to local tax authorities in line with BEPS Action 12 from 2019 onwards.²⁸⁴ The **EU's new rules on intermediaries** is meant to cover gaps in the CRS of the Global Forum, as it broadly applies within the Union under the Administrative Cooperation Directive. Due to increased transparency, the initiative creates disincentives for intermediaries (eg. consultants, lawyers, financial advisors, accountants²⁸⁵) to design and market new schemes while posing reputational risks in case of non-compliance with a reporting obligation.²⁸⁶

On 5 December 2017, the Economic and Financial Affairs Council (ECOFIN) approved the **EU list of non-cooperative jurisdictions** in taxation matters that includes 17 jurisdictions. In addition, it published a grey list consisting of 47 jurisdictions.

Separately, the EU has amended its **Anti-Money Laundering (AML)** legislation for cryptoasset beneficial ownership disclosure rules on 19 April 2018, which will be effective by January 2020.

²⁷⁹ Ismer and Jescheck (2017).

²⁸⁰ De Graaf and Visser (2018), p.41.

²⁸¹ EY (2017) European Parliament votes in favour of public Country-by-Country reporting in first reading (<https://www.ey.com/gl/en/services/tax/international-tax/alert-european-parliament-votes-in-favor-of-public-country-by-country-reporting-in-first-reading>).

²⁸² Accountancy Europe (2018) Tax Policy Update, 11-22 June (https://www.accountancyeurope.eu/wp-content/uploads/180622_Tax-Policy-Update_Accountancy-Europe.pdf).

²⁸³ Seabrook and Wigan (2016).

²⁸⁴ EY (2018) EU Mandatory Disclosure Regime (https://www.ey.com/gl/en/issues/webcast_2018-04-25-1400_eu-mandatory-disclosure-regime).

²⁸⁵ Cachia (2018).

²⁸⁶ Cachia (2018).

With the enactment of the EU's General Data Protection Regulation (**GDPR**) on 25 May 2018, a framework for the collection, use and storage of personal data that directly impacts on the capacity to use big data, (i.e. development of AI tools) was established. Some of its effects could already be seen with the use of the GDPR Shield to block European users from accessing their website and services in order to avoid compliance burden.²⁸⁷

Furthermore, the **e-privacy regulation and the regulation on free flow of non-personal data**, expected to be adopted in 2018 will further improve data regulation in the EU. The former will strengthen security and confidentiality of communication by requiring consent for any marketing and bring new rules on cookies. The latter will regulate storage and processing of data and prohibit any data localisation requirement unless it concerns public security.²⁸⁸

4.2.2. Reflections on Recent EU Actions

The hard law approach of the EU is generally seen more effective than the OECD's soft law approach. At the same time, some credit shall be given to the OECD's peer pressure method, which could accelerate implementation through informal pressure.²⁸⁹ Although the EU's ambition to counter BEPS is unquestionable and can be testified by measures, such as ATAD going beyond BEPS recommendations, the Directives which are the only means for EU action in the area of taxation, give Member States a lot of flexibility in terms of implementation. While the effects of BEPS will depend very much on the individual implementation of EU Member States, it is already possible to identify some shortcomings.

Kuzniacki demonstrates that following the **incorrect implementation of Articles 7-8 of the ATAD**, Polish CFC rules are not in line with the free movement of capital, especially when it comes to the Polish black lists regarding third countries. According to the new Polish legislation, the whole income of a CFC in a third country may be taxed in Poland.²⁹⁰

The **ATAD** closes many of the existing loopholes, where hybrid mismatches are used by allowing for implementation of primary and defensive rules but it is said to merely address the symptoms of mismatches and not the mismatches themselves. ATAD 2 only extends the scope of the measures while ensuring their application on third country situations. By doing so, it also focuses on neutralising the negative effects of hybrid mismatches instead of providing for solutions to their rootcauses. To completely eliminate hybrid mismatches, a uniform classification method is needed between Member States by mutually recognising the tax classification in the host country.²⁹¹ Generally, following a more unified approach could promote a level playing field and legal certainty.

On the other hand, **BEPS Action 6 in general and the peculiar design of the PPT** have raised suspicion in relation to its potential **contravention of EU law**. The reference under the PPT to obtaining of a treaty benefit as one of the principle purposes that might lead to the application of the GAAR has come under criticism. The fact that the majority of Member States have domestic GAARs in place may provoke a disparity. The broader scope of the PPT and its detrimental consequences for the taxpayers as compared to domestic GAARs may imply a different treatment of cross-border and domestic transactions. These different treatments could be considered disproportionate.

²⁸⁷ Disruptive Competition Project (2018) The EU's GDPR: Lessons fro US Policymakers (<http://www.project-disco.org/privacy/052518the-eus-gdpr-lessons-for-u-s-policymakers/#.W32AHZMzaT8>).

²⁸⁸ European Parliamentary Research Service (2018) Adapting to new digital realities.

²⁸⁹ De Graaf and Visser (2018), p.47.

²⁹⁰ Kuzniacki (2018).

²⁹¹ Fibbe and Stevens (2017).

Separately, Paradise Papers made it clear that certain taxpayers still use shell companies registered in tax havens and appoint nominee directors to conceal their wealth and income by hiding the identity of the real owners or the beneficial owners of the companies. According to the **new rules on intermediaries**, if the intermediary is not located in the EU or is bound by professional privilege or secrecy rules, the obligation to report the tax arrangement passes to the EU-based taxpayer. Although these rules do not set a minimum threshold for disclosure, the hallmarks for reporting usually point to high-risk situations that involve elaborate arrangements. Small companies and individuals would not normally have the sources to seek tax advice. Therefore, it can be assumed that the reporting obligation would mostly affect big corporate taxpayers. In any event, its effects are questionable as the UK, which has already such legislation for intermediaries in place, has the highest number of intermediaries in the EU.²⁹²

The **EU's tax haven** lists are also on the radar. In November 2017, Oxfam suggested that the EU tax haven blacklists should include at least 35 countries, covering four EU Member States: Ireland, Luxembourg, the Netherlands and Malta. The Oxfam list also mentions some UK crown dependencies, EU overseas territories and EU candidate states together with Switzerland, Singapore, Hong Kong and US Virgin Islands.²⁹³ The fact that some of the largest offshore provider states are European poses obstacles for policy action.²⁹⁴

The EU's new tax arbitration process is considered to increase states' accountability to an international community of tax experts at the expense of tax sovereignty. Additionally, it is not clear whether the Dispute Resolution Directive applies to cases of treaty overrides.²⁹⁵

Finally, calls for more transparency are made with regards to the **European Code of Conduct Group**, a political working group comprised of officials of the Ministries of Finance of the Member States, which monitors compliance with the European Code of Conduct that prohibits harmful tax competition and encourages a coordinated approach to combat tax avoidance.

It has become an important player in fighting tax avoidance by MNEs, as it was involved in the creation of common tax ruling policy, international hybrid mismatches, and disclosure of aggressive tax planning schemes. Its **informal assurance of political agreement** (soft law) may be a positive development but national parliaments and the European Parliament are kept in the dark about the pseudo-legislative practices of the group, which lacks democratic checks and balances. Transparency could be ensured through disclosure of background documents, room documents, meeting minutes etc., appointment of a political chairperson and equal representation by Member States.²⁹⁶

4.3. The EU's Plans regarding Digital Taxation

4.3.1. Background

The 2014 Report by the European Commission expert group **on taxation of the digital economy** advised against a special tax to avoid ring-fencing the digital economy. However, these conclusions seem to be no longer supported by the Commission following the adoption of ATAD1 and ATAD 2,

²⁹² Cachia (2018).

²⁹³ Oxfam (2017) Effective EU Tax Haven Black List must include at least 25 countries, Oxfam analysis finds. (<https://www.oxfam.org/en/pressroom/pressreleases/2017-11-27/effective-eu-tax-haven-blacklist-must-include-least-35-countries>).

²⁹⁴ Seabrook and Wigan (2017).

²⁹⁵ Ismer and Jescheck (2017)

²⁹⁶ Nouwen (2017).

which will come into effect by 2019 and 2020 respectively, as well as the progress made regarding the implementation of BEPS with the MLI.²⁹⁷

In September 2017, Finance Ministers of several EU Member States called on tech companies to 'pay their fair share of tax' in order to ensure economic efficiency, tax fairness and sovereignty and asked the Commission to come up with proposals akin to the equalisation tax.

In its Communication of 21 September 2017, the European Commission acknowledged that the existing tax system is no longer appropriate for the digital age and falls short of ensuring **fair taxation**. Although the lack of evidence to make a case for fair taxation is criticised by some²⁹⁸, the Commission is of the view that the inadequacy of the international rules leading to increasing tax avoidance and tax revenue drain are destabilising the level playing field for businesses.

In September 2017, the Estonian Presidency initiated discussions to find a working definition, recognising the need to change the OECD Transfer Pricing Guidelines regarding PE, as changes on Action 7 and Action 8-10 were considered to 'not adequately address taxation of digital platforms'.²⁹⁹ In December 2017, the European Council formally urged the OECD to find appropriate solutions and invited the Commission to prepare proposals for action at the EU level by early 2018.³⁰⁰

4.3.2. European Commission's Directives of 21 March 2018

The European Commission issued a communication on September 21st 2017 entitled '**A Fair and Efficient Tax System** in the European Union for the Digital Single Market'. On 21 March 2018, it proposed new rules for corporate taxation based on a significant digital presence.

The Commission proposed a short-term measure - **Digital Services Tax**, and a long-term measure - **Digital PE and Profit Allocation**, accompanied by a recommendation on double tax conventions, suggesting Member States to change the definition of PE to account for a situation where a company has a significant digital presence, and to include rules for profit attribution. When Member States have double tax treaties with third countries, the proposed new rules will not apply. Thus, tax treaties would need to be amended regarding tax residents outside the EU.

Before embarking on such an ambitious reform, the Commission sent a **multiple-choice questionnaire to its stakeholders**. While two-thirds agreed that international tax rules do not allow for fair competition between traditional and digital companies and over four-fifths supported action regarding taxation of the digital economy, more than half agreed that a digital tax would lead to an increase in tax disputes and only half of the correspondents were in favour of an interim solution. Respondents were also divided as to whether SMEs should be exempt from a digital tax and whether it would slow down the development of digital technologies in the EU.

a. Short-term Measure: Digital Services Tax

The short-term measure involves a **3% interim** tax which covers digital activities currently not being taxed in the EU. The tax is to be levied on **gross revenues** of a digital business, characterised by user value creation, and allows for no cost deduction from January 2020 onwards. A threshold is set at worldwide annual revenues from digital services above EUR 750 million and EU revenues above EUR 50 million. If the economic presence belongs to a consolidated group, then the thresholds shall be

²⁹⁷ Dourado (2018), p. 570.

²⁹⁸ EPICE (2018) (<http://ecipe.org/publications/digital-companies-and-their-fair-share-of-taxes/>).

²⁹⁹ Andersson (2017).

³⁰⁰ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

assessed on the group level. According to the Commission, the threshold would help smaller start-ups while in-built mechanisms would alleviate the possibility of double taxation.

The **equalisation levy** aims at preventing the adoption of unilateral measures in advance of a long-term solution, targeting the most acute mismatches between profit taxation and value creation, namely advertising, multi-sided digital interface and selling of user data.

The tax would apply **to cross-border transactions and domestically** to comply with international law. To minimise tax compliance burdens, the proposal envisages a **One-Stop Shop** system for declaring and collecting the web tax at the EU level in a similar way to VAT collection. Double taxation would be mitigated by allowing the tax to be deducted from the Corporate Income Tax (CIT) base, irrespective of whether or not taxes are paid in the same or different Member State(s).

The temporary tax could mean the **collection of EUR 5 billion annual revenue** for the Member States. It is estimated that 120 to 150 companies, 50 % of which are residing in the US, are covered within the scope of the Commission's proposal. These figures could be contested due to the lack of reliable data regarding the annual turnover of digital companies.³⁰¹

Digital services are described as being 'delivered over the Internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and possibility to ensure in the absence of information technology', using the examples of Google and Airbnb.³⁰²

Although Commissioner Moscovici denies that the Commission is targeting GAFAs, businesses based on the **advertising model**, including social networks and search engines (Facebook, Google, AdWords, Twitter, Instagram, free Spotify) will be within the scope of the new measure. Businesses based on the **agency model**, including online marketplaces (Airbnb and Uber), will also be affected, although revenues from the sale of their own goods and services will not be taxable.³⁰³ Companies providing content and services in return for a fee based on a subscription model and e-retailers will generally not be caught.

The Directive does not regard digital interface consisting in the supply of digital content, such as video, audio or text, as intermediation services, providing exemptions for electronically supplied media, streaming, online gaming, IT solutions, cloud computing solutions and fintech services that facilitate the granting of loans or crowdfunding service providers.

b. Long-term Stand-Alone Measure: Digital PE and Profit Allocation

The long-term measure aims to **reform corporate tax rules** by linking taxation to the location of value creation, especially where businesses have significant interaction with users through digital channels.

The long-term approach based on a 'significant digital presence' will focus on a **broad range of digital services**, such as the provision of films, music, software and cloud computing.³⁰⁴ A digital platform will be deemed to have a taxable 'digital presence' or a virtual permanent establishment according to a significant digital presence test.

³⁰¹ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.34.

³⁰² European Commission Press Release (2018) Digital Taxation: Commission proposes new measures to ensure that all companies pay fair tax in the EU, 21 March.

³⁰³ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.38.

³⁰⁴ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.29.

The Commission proposes a new threshold for creating a taxable presence based on digital factors including sales, users and contracts. The **Significant Digital Presence** will be deemed to exist when one or more of the following conditions are met:

- More than EUR 7 million annual turnover in one Member State in a tax period;
- More than 100,000 users in a Member State in a taxable year; and
- More than 3000 contracts for digital service supply in a taxable year.

The EC provides a **list of exemptions**, including radio and television broadcasting, telecommunications, delivered goods, professional services, such as lawyers and financial consultants. A consolidated group exemption is also foreseen. Accordingly, the groups could nominate a single company to pay on behalf of the whole group and to file returns.

The Directive includes **profit allocation rules** to be determined by the DEMPE functional analysis, usually related to intangibles. Profit split will 'often be considered as the most appropriate method to attribute profits'.

4.3.3. Evaluation of the Commission's Proposals

a. Reactions to the proposed Short-term Measure

Many tech companies, academics and others criticised the EU's digital services tax as a '**populist and flawed**' proposal.³⁰⁵ It shall be admitted that it was proposed in the midst of Brexit negotiations, the difficulties posed to the international cooperation under Trump presidency and the upcoming European elections.³⁰⁶

The **definition of digital services** in the proposed Directive is too broad and may lead to different interpretations and legal uncertainty. For instance, the broad scope of the tax charge on 'multilateral interfaces' as well as the lack of clear definition of digital services leaves room for interpretation (i.e. its possible application for financial services).³⁰⁷

Business models of tech giants are different, hence uniform measures would be impossible to implement. This is probably why the Commission chose to target large tech companies' advertisement revenues. As it is difficult to make a distinction between these tech companies having a wide range of activities and other businesses,³⁰⁸ the Commission faces the risk that some **traditional industries** in the process of digitalisation **are put in the crossfire** of policies meant for the tech giants.³⁰⁹

One major concern is that a **digital retail store** selling physical or digital products directly to consumers or businesses, such as Amazon and Alibaba, will not be caught by the DST.³¹⁰ Paradoxically, these are the businesses that received the most media and political attention.³¹¹ The Commission's

³⁰⁵ Becker and Englisch (2018) (<http://kluwertaxblog.com/2018/03/16/eu-digital-services-tax-populist-flawed-proposal/>).

³⁰⁶ GPLUS (2018) Going All In on Digital Tax.

³⁰⁷ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax (<https://talkingtech.cliffordchance.com/en/tech/missing-the-target.html>).

³⁰⁸ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax. (<https://talkingtech.cliffordchance.com/en/tech/missing-the-target.html>).

³⁰⁹ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax. (<https://talkingtech.cliffordchance.com/en/tech/missing-the-target.html>).

³¹⁰ MNE Tax (2018) EU proposes digital services tax on large tech companies.

³¹¹ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax. (<https://talkingtech.cliffordchance.com/en/tech/missing-the-target.html>).

justification is that the digital interface is simply used as a means of communication but it 'seems to understate the transformational nature of digital retail'.

Moreover, **specific exclusions** that exist for services, such as supply of digital content, communication, and payment services,³¹² lead to discontent in business circles, which complain about the fact that broadcast television and print newspapers carrying advertisements will not be subject for taxation, while the same services broadcast over the Internet would be taxed.

Serious **tax fairness issues** could arise if the same rate would be charged for intermediaries and for targeted online advertising sold by large Internet companies. The tax burden could be passed on to small companies using online platforms to buy and sell goods, putting them at competitive disadvantage vis-à-vis traditional sellers.³¹³ There is also a risk that big tech companies could use their bargaining power to force smaller companies to include the cost of equalisation levy in the amount of consideration paid to them, resulting in **arbitrary pricing of services**.³¹⁴

Another concern is that businesses, such as Airbnb, having gross profit margins closer to 2% may be pushed to **pass the tax burden to consumers**. In the past, gross revenue taxes in the EU, such as insurance premium tax and air passenger duty, were often passed on.³¹⁵

Taxing gross revenues could also affect loss-making businesses adversely while contradicting double tax treaties and potentially leading to profit shifting to reduce the net profit artificially.³¹⁶ Moreover, businesses with low margins, who are seeking to scale up, may be discouraged by the EUR 750 million global turnover and could decide to **stay small**.³¹⁷ Currently, there is **no impact assessment** on how the digital tax proposal will impact the EU's digital aspirations³¹⁸ but the DST could reward 'digital consumption over digital creation'³¹⁹ while hampering EU's attractiveness.³²⁰

While some argue that applying the measure to both residents and non-residents is counter to its equalisation objective,³²¹ business circles fear that the web tax could lead to **double taxation** for European businesses even more than foreign businesses³²², which already pay substantial taxes on their European profits, calling for a dispute resolution mechanism to ensure that 'multiple implementing countries do not seek to tax the same turnover.'³²³ Moreover, the package may lead to **discrimination** in that double taxation will arise mainly for businesses that are headed outside the EU. Double taxation could also result from the concept of users using services, which may or may not attract revenue. Thus, the proposed tax is considered be not tailored enough while being detached from the existing international tax framework.³²⁴

³¹² PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³¹³ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.10.

³¹⁴ Basak (2016).

³¹⁵ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax. (<https://talkingtech.cliffordchance.com/en/tech/missing-the-target.html>).

³¹⁶ Clifford Chance (2018) 'Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax' (<https://talkingtech.cliffordchance.com/en/tech/missing-the-target.html>).

³¹⁷ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³¹⁸ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³¹⁹ Disruptive Competition Project (2018) The Unintended Consequences of a European Digital Tax.

³²⁰ Euractiv (2018) OECD report stokes last-minute criticism of EU digital tax plan, 19 March.

³²¹ Turina (2018).

³²² Financial Times (2018) Bertelsmann chief warns of hit from EU 'digital tax', 27 March.

³²³ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³²⁴ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

The EU Tax Centre comments that the **possibility to deduct the DST as an expense** could only partially mitigate the risk of double taxation³²⁵, as credit mechanisms are seen to be more efficient to avoid such risks.³²⁶ If deductions are to be granted on a Member State by Member State basis, taxpayers could be encouraged to locate real investment where they expect to have the highest DST charge. This could shift investments from smaller Member States to bigger Member States.³²⁷

Moreover, the **compatibility of the DST with the tax treaties** is put into question, some qualifying it as an income tax if the person liable for the payment would be the service provider³²⁸ and others arguing that its imposition on a transaction may differentiate it from an income tax. According to the case law, the hybrid features of the tax could fall under the tax treaties due to the Article 2 of the OECD Model. By contrast, it could be argued that the OECD Model Convention would apply only to taxes imposed by contracting States and not to the EU as a whole.³²⁹ Similarly, the hybrid nature of the tax makes it unclear whether it is within the scope of the EU's competence over indirect tax³³⁰ or Member State competence over direct tax (except for distortions regarding the single market).³³¹

Although this **temporary** measure would not be desirable in the long-term, such measures are known to remain in place, as was the case for the income tax that was introduced as an interim step in the 19th century.³³² It is important to note that the Commission itself acknowledges a number of limitations, but says that political considerations etc. drove it to push this proposal forward. Indeed, if the proposal did not have these limitations, it would have been put forward as a permanent rather than an interim measure.

b. Technical Difficulties regarding the EU Digital Tax

The Commission's proposal suggests that the tax could be levied based on the **location** of the advert being displayed, the user who generated the data being transmitted, the user who concluded the transaction or the user of a multi-sided digital platform. Hence, the companies will have to report on the number of times an advert appeared on user's devices, the number of times the account is used, user's location etc. through IP address or other methods of geolocation.

However, **identifying the user location is a major logistical problem**, which brought the proposal under fire for 'lacking legal backing' due to the absence of a 'proper, legally tight definition of user ID'.³³³ In addition, identifying users when they have multiple devices each accessed over multiple sessions poses another difficulty, which could cause over-taxation.

ID location problems raised by VPN, fake IDs or bots were raised as potential risks for fraud³³⁴, as users could **obscure their IP address**.³³⁵ Anonymous payments could also be problematic in the absence of cooperation with financial institutions.³³⁶

³²⁵ KPMG (2018) EU Commission releases package on Fair and Effective Taxation of the Economy.

³²⁶ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³²⁷ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³²⁸ Baez and Brauner (2018).

³²⁹ Turina (2018).

³³⁰ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax.

³³¹ Cachia (2018)

³³² Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p. 10.

³³³ Bloomberg Tax (2018), Special Report 'Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation', p.9

³³⁴ Bloomberg Tax (2018), Special Report 'Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation', p.10.

³³⁵ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³³⁶ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, pp.42-43.

User identification through **geolocation** could be an easier option concerning marketplaces and other services where users identify themselves and log in. On the other hand, regarding advertising on search engines and newspapers, the use of geolocation would be problematic from technical and privacy perspectives. More importantly, geolocation could be falsified by users.³³⁷

Installing software to track the location of the users in order to file tax returns would place a **burden on industry** and administrations.³³⁸ All businesses may not track the metrics needed for tax reporting on a country by country basis, as their revenues are based on clicks.³³⁹ Moreover, some businesses operating across multiple domains cannot track users across those domains, as this requires third party cookies, which are usually blocked by browsers.

Requiring the MNEs to track users, viewing their advertisements across all their sessions, browsers, and devices, may be problematic from a **privacy** point of view.³⁴⁰ The user concept requires keeping extensive data on users and their location for many years, which is another privacy concern. Having such volumes of data could be misused by national authorities for surveillance. Finally, the use of geolocation and ad tracking data may be contrary to the GDPR Principles.³⁴¹

c. Evaluation of the Commission's proposed Long-term Proposal

The Commission's long-term proposal involves two steps – setting a new PE threshold and providing new profit attribution rules. The latter is much harder than the former, and the Commission's proposal acknowledges that the long-term proposal is not fully developed. This may be one of the greatest weaknesses of the proposal – as it is still not clear what these rules will really look like but one can assume that they will be extremely complex.³⁴²

According to the long-term measure, digital services supplied through a digital interface by the entity carrying on the business and any associated enterprises are to be considered when applying the test for PE. This reform recommendation does not require a **physical presence**, establishing a digital presence condition as sufficient for taxation purposes.

In this sense, the proposal is a **significant departure from the current taxation rules**. The long-term solution that the Commission proposes involves a change to the PE status, which requires amending Member States' double taxation treaties. This is particularly problematic as countries not having **double taxation agreements** in place and relying on OECD thresholds would be impacted from a change in domestic definitions of PEs in the EU. If Member States are encouraged to renegotiate their treaties, it would be a significant change in international taxing rights that would pose a low threshold for a foreign taxpayer to come within the charge to tax. In particular, the US is expected to be reluctant to such treaty changes given that it is where the most significant digital businesses are based, especially now that the Congress proved hesitant to ratify even uncontroversial tax treaties.³⁴³

A possible solution could be **bargaining with the US tech companies** in the EU, which could in turn convince the Congress, by offering to ease the regulatory burden and obstacles they face in Europe. It is argued that, simplifying compliance for large MNEs in the digital economy could capture 60-70% of

³³⁷ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³³⁸ International Tax, Merkel's Call to Tax Data Reveals Hurdles to Policing Tech Giants, 31 May 2018.

³³⁹ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³⁴⁰ MNE Tax (2018) EU proposes digital services tax on large tech companies, Julie Martin, 22 March.

³⁴¹ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax.

³⁴² Also see Escribano (2018) (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3191787).

³⁴³ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax.

the market, having a knock-on effect on the compliance of SMEs.³⁴⁴ Acknowledging that the optimal regulatory burden shall be imposed on these companies independently of tax policy developments, the informal nature of this negotiated solution as well as its compatibility with the EU state aid and WTO may be problematic.³⁴⁵

One concern is that the DST would be enough to wipe out many businesses' net profit margins. Hence, **a high DST rate could encourage parties to renegotiate treaties to accept the digital PE concept in the comprehensive proposal**, which covers a broader range of activities.³⁴⁶ DST would be payable by taxpayers whose country of residence has agreed to the comprehensive solution through amendments to double taxation treaties although it is unknown how this would work where multiple treaties are relied upon.³⁴⁷ It is also unclear if the DST charge will be higher than the corporate tax they would receive under the comprehensive proposal due to the different profit attribution methods.

Although some agree that **digital factors**, such as local domain names, local payment factors and user-based factors are important factors to constitute a virtual PE³⁴⁸, there is an on-going debate on whether supply-side (local domain name of a website, language of the platform, local payment options etc.), demand-side factors (active users, online contracts etc.) or their combination shall be used to determine significant economic presence.³⁴⁹

User value creation is acknowledged as the connecting element for taxation at the market jurisdiction by the European Commission to identify a digital establishment. However, the Commission interprets user value creation according to the intensity of the digital presence in the market country, without introducing a group size threshold, which also covers **smaller businesses** with a large digital footprint in a market Member State.³⁵⁰

Another issue is whether a **virtual PE could coexist with a physical PE** and whether the calculation of attributable profits is appropriate.³⁵¹ The OECD's BIAC Tax and Fiscal Affairs Committee has criticised the idea of expanding the concept of PEs in the absence of consensus, which would 'bypass the complexities built into the physical PE rules'. The proposed **formula for apportionment** is also unclear according to BIAC as it is unknown whether raw data is valuable, whether its value is independent and how its value should be calculated and why it should be treated differently to industrial data. In addition, more guidance would be needed on the proposed profit split method.

Unless attribution rules are further developed, there would be a strong case for **discrimination** under EU fundamental freedoms. For different treatment of domestic and cross-border activities could be an issue, as CJEU's *Brisal* case demonstrates.³⁵²

The 'worst outcome' would be a long-term scenario where **EU thresholds and attribution rules differ** to the rest of the world. At the same time, the alternative to introduce EU rules soon to be replaced with global rules would also lead to uncertainty, complexity and compliance cost.³⁵³

³⁴⁴ ADB Institute (2017) Fair Taxation in the Digital Economy.

³⁴⁵ Schippers and Verhaeren (2018).

³⁴⁶ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³⁴⁷ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

³⁴⁸ Hidalgo (2017), p.728.

³⁴⁹ ADB Institute (2017) Fair Taxation in the Digital Economy

³⁵⁰ Dourado (2018), p. 565.

³⁵¹ Requena and Gonzalez (2017), p.735.

³⁵² Baez and Brauner (2018).

³⁵³ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

The long-term proposal is said to be the Commission's **preferred option due to the flexibility to apply** in the single market yet finding a consensus might prove to be difficult. This is probably why the Commission abandoned previous plans to use the digital tax to fund the EU budget, which will be stranded by the Brexit.³⁵⁴

Such a fundamental change within the EU could result in greater difficulty in achieving **global consensus**. Especially, now that BEPS seeks consensus on profit attribution following the changes to the threshold from BEPS Action 7. It may be preferable to deal with changes to nexus threshold and determination of attributable profits as an entire package.³⁵⁵

Finally, **Member States will be affected differently** by the proposed long-term measure. Some export-oriented countries, such as Germany and Sweden, collecting tax revenue despite sales being outside their territory, could be negatively impacted by the introduction of virtual PEs and small countries with a strong export sector would be potentially hurt more.³⁵⁶

d. Divergences among Member States

On April 19, the European Taxation Commissioner Pierre Moscovici said that **20 out of 28-member states are 'supportive or accepting'** of the digital tax proposal, among which five biggest economies (France, Germany, Italy, Spain and the UK) appear. Ireland (home to the headquarters of Google, Facebook and other MNEs) and Luxembourg are against it. Interestingly, some interpret the U.K. and Germany's recent silence as backsliding.³⁵⁷ In fact, Germany may be 'fearing a backlash from the United States',³⁵⁸ as potential US retaliatory tariffs on European exports could damage Germany's car exports.

Given the recent steel and aluminium disputes, it is probable that the EU's trading partners could introduce a similar consumer tax on European digital services, which are worth USD 569,6 billion (56% of all EU services exports).³⁵⁹ To illustrate, a **retaliation** could be enacted by the largest consumer of EU exports of services, whose President has the power to increase tax rates for foreign citizens discriminating against US companies.³⁶⁰ Although the cross-ownership of US and European stakes may reduce the probability of such warlike conflict,³⁶¹ concerns were raised that the US could obstruct progress at an international level in order to protect US tech companies. The US Treasury Secretary Munchkin warned the EU against jeopardising the major contribution tech firms market to US jobs and economic growth, emphasising that the US firmly opposes proposals by any country to single out digital companies.

France, Austria, Bulgaria, Spain, Italy, Germany, Slovenia, Greece, Portugal and Romania are among the **initiators** of the digital tax, claiming that enterprises in the digital sphere reap unfair benefits from Internet-based operations.

The **UK** supports a reallocation of the profits recorded by companies to 'user jurisdictions' where user participation creates value (through user-generated content, data on user's behaviour, interest and

³⁵⁴ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.26.

³⁵⁵ Tax Executives Institute Inc. (2018) TEI Comments on European Commission Digital Economy Survey.

³⁵⁶ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

³⁵⁷ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p. 36.

³⁵⁸ Deutsche Welle (2018) Taxes coming to big data in Germany? 29 May.

³⁵⁹ International Tax Review (2016) Ireland-An attractive location in a post-BEPS world.

³⁶⁰ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax.

³⁶¹ Kiel Institut für Weltwirtschaft (2017) Zur Protektionismusgefahr im transatlantischen Wirtschaftsraum, IfW-Box 2017.1.

consumption habits, network effects and contribution to the brand)³⁶² all by sticking to the arm's length principle. In its updated position paper of March 2018, it highlighted some challenges that a digital tax would pose for start-ups suggesting safe harbour mechanisms to ensure that companies pay the tax when they are globally profitable.³⁶³ By contrast, the UK is less favourable to the proposed long-term solutions, as the country supports a tax that targets such groups' global IP residual income.³⁶⁴ Furthermore, in the UK's view, Articles 5, 7 and 9 of the OECD Model Tax Convention would need to be amended for such reforms, which would prove difficult considering the US opposition.

The Commission also started to exert pressure on **dissenting countries**, such as Ireland, Luxembourg, Malta, Belgium, Cyprus, Hungary and the Netherlands, publicly accusing them of aggressive planning structures on 7 March 2018.

In May, Ireland, Denmark, Malta and the Netherlands issued **reasoned opinions**, expressing that the Commission's draft legislative proposal was undermining the Union's subsidiarity principle. The opinions did not reach the threshold of votes required to trigger the 'yellow card' procedure, which would result in the review of the Commission's proposal, however they demonstrated the lack of consensus among the Member States.³⁶⁵

According to Genschel and Seelkopf, politicians are constrained to serve the distributive interest of median voters. 'In **small democracies**, the median voter gains from competitive tax cuts because the income gains from tax-induced foreign capital inflows (more employment, higher wages, more growth) more than compensate the income loss from reduced domestic redistribution. In large democracies, it is the reverse'.³⁶⁶

The smaller EU states host businesses that will have a Digital Services Tax liability deductible against local corporate income tax but they don't have many local users.³⁶⁷ Some believe that **low tax rates** helped States, such as Ireland or even the UK, to attract jobs and investment, but as in the case of Apple in Ireland, even these countries do not always generate revenues from their already low rates. Targeting the tech companies would narrow the current gap in tax rates between these companies and traditional ones.³⁶⁸

Ireland's argumentation focused on the allocation method (similar to the apportionment formula proposed in the CCCTB), which would favour large Member States with big consumer markets. It also warned against the creation of two divergent and incompatible models (a two-tier system), which would lead to uncertainty and fragmentation. The lack of discretion to change the tax rate would undermine the tax sovereignty of States, whereas loss-making businesses would be negatively affected. Even though Ireland has the power to block the EU initiative on digital taxation, the bloc's heavyweights could find ways to put pressure. In exchange of its continuing support on keeping the border between Ireland and Northern Ireland (in support of Ireland's position), the EU could ask Ireland to drop its opposition to tax changes. Yet, other Member States might also need to be convinced.

The Finance Ministers of the European Union's three **Nordic countries** have urged their partners to shelve the Commission's digital taxation plans. Nordic countries say that it would damage the

³⁶² HM Treasury (2018), Corporate Tax and the digital economy: position paper update. (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf).

³⁶³ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p. 53.

³⁶⁴ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

³⁶⁵ International Tax Review (2018), Ireland: Ireland's position on the EU's digital tax proposal, pp.1-2.

³⁶⁶ Genschel and Seelkopf (2016).

³⁶⁷ MNE Tax (2018) EU proposes digital services tax on large tech companies.

³⁶⁸ Brookings Institution (2017), Taxing the digital economy-it's complicated, p. 5.

European economy and criticise the application of the levy on gross income. Loss-making businesses, possible retaliation and a stall in international cooperation are major concerns, as the Nordic countries are home to several digital companies, such as the Stockholm-based Spotify.³⁶⁹

Although the decisions taxation matters need to be taken **unanimously**, the Commission expressed its intention to change the voting mechanism for this issue by introducing quality majority voting but such a change would also require unanimity and it is not clear how it could be achieved without changing the Treaties. If these efforts fail, enhanced cooperation might be sought by Member States, which requires only 9 States to join. Analysts warn against introducing the tax only in some Member States, which might lead to distortions in the internal market.³⁷⁰ Also, using enhanced corporation for cross-border provision of services is doubtful,³⁷¹ as it was not deemed successful for other tax measures,³⁷² such as the Financial Transaction Tax.³⁷³

e. Next Steps

The OECD is concerned that EU's unilateral actions would lead to an **incoherent international tax** system, risking retaliation from other countries, which is permitted under WTO rules. Numerous stakeholders consider that the proposed options **violate various tax principles**, such as neutrality, efficiency, certainty, simplicity, effectiveness and fairness, flexibility and sustainability, and proportionality stipulated in the Ottawa Taxation Framework.³⁷⁴ Amidst opposition to both short-term and long-term proposals, concerns were expressed that the EU's action may encourage other countries to indulge in unilateral tax measures, making international tax cooperation more difficult.³⁷⁵

Businesses are concerned that interim measures would have a **negative effect on investment and growth**, particularly if rules are not aligned among different EU jurisdictions. Many raised doubts about the implementation of unilateral measures at a regional level, as it would create differences between the EU and non-EU international tax rules, increasing the risk of double-taxation. Moreover, the current digital tax proposal coupled with EU anti-money laundering laws could pose a barrier to the EU's technological aspirations, such as pan-European Blockchain implementations.³⁷⁶ Last but not least, a tax on turnover can be much higher than a tax on profit, hence the contribution paid (as a % of profit) could be higher than ordinary corporation tax. To mitigate these negative effects, sunset clauses may be included to have a rolling review period of one or two years after which the Commission could analyse the impact and Member States would have to vote positively to keep the measures in force.³⁷⁷

Furthermore, the **target date** regarding the short-term solution set for the end of 2018³⁷⁸ is rather optimistic since many Member States may want to wait for the OECD outcome before acting.³⁷⁹ The timing of the digital tax proposal may not be ripe, considering that the US tax reform has only been enacted and could have 'a significant impact on tax profiles of all US MNEs', generating 'a change in a direction of the global debate about source and destination-based revenue taxation, and the application of the arm's length principle'. Similarly, BEPS recommendations are just being

³⁶⁹ Reuters (2018) Nordic countries oppose EU plans for digital tax on firms' turnover, 1 June.

³⁷⁰ Bloomberg Tax (2018), Special Report 'Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation', p.37.

³⁷¹ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax.

³⁷² PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

³⁷³ Ismer and Jescheck (2017).

³⁷⁴ Tax Executives Institute Inc. (2018) TEI Comments on European Commission Digital Economy Survey.

³⁷⁵ MNE Tax (2018) EU proposes digital services tax on large tech companies.

³⁷⁶ Ozelli (2018), p.2

³⁷⁷ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³⁷⁸ Ecommerce Europe (2018) The upcoming Austrian Presidency of the Council of the EU publishes its official programme, 19 June (<https://www.ecommerce-europe.eu/news-item/austrian-presidency-council-eu-publishes-official-programme/>).

³⁷⁹ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

implemented, with the ATAD to come into force in 2020 and some interest limitation rules becoming applicable in 2024.

The new rules proposed in the **long-term solution** intend to make online businesses contribute to public finances at the same level as traditional brick-and mortar companies. However, tangible goods (e.g. Amazon) would not be caught by the proposed PE rule. Moreover, these rules would entail **adjustments on permanent establishment**, transfer pricing and profit attribution applicable to digital technologies depending on the location of the user and the time of consumption.

It is argued that the likely lack of consensus on the long-term measure could **perpetuate the DST**, as was the case for the UK income tax, which was introduced as a temporary measure during Napoleonic wars.³⁸⁰ Hence, there is need for a substantial reform of 'the current system to reflect the new reality rather than introducing a new Google tax and essentially 'maintaining the status quo'³⁸¹, as the digital revolution would necessitate a robust design of measures, which will be valid in the long-term.³⁸²

4.4. The EU's CCCTB Plans

The traditional way in the EU to tax consumption is through sales taxes or VAT taxes, which is based on the destination principle. Corporate profit taxes were usually imposed on profits while the allocation of taxation rights has not been based on sales. Yet, through the CCCTB, the EU tried to incorporate a **destination factor in a regional apportionment formula**, as allocating taxing rights on the basis of the traditional production factors would not put an end to tax arbitrage.³⁸³

Following its first **CCCTB proposal** of 2011, the Commission released a two-step approach (the first being common tax base and the latter consolidation) in October 2016. The CCCTB's aim was to replace transfer pricing rules, which proved to be ineffective due to their separate accounting system, arbitrary nature and red tape. Accordingly, a single set of rules to calculate the taxable profits of all large companies operating in the EU and having consolidated revenues exceeding EUR 750 million would apply. In the second phase, full tax consolidation of the revenues of MNEs within the EU is foreseen. A separate proposal for a Directive for the second phase includes a formula for apportioning multinationals' taxable base, which weighs capital, labour and sales equally.

Although it was inspired to some degree by the **formulary apportionment method used in the US**, the EU's CCCTB proposed a single apportionment to group-wide income while the US defended to apply the formula to unitary business of the group. Contrary to the US states, which are free to choose the factors of formulae (some of them developing a single-factor formula based on sales), the CCCTB aimed at restricting Member States to change the weight of the formula in order to avoid double taxation.

On 21 February 2018, the European Parliament's Committee for Economic and Monetary Affairs voted 39-11 in favour of the idea that PE could be based on a company having a 'digital platform or any other digital business model based on the collection and exploitation of data for a commercial purpose'. The European Parliament supported this notion in its vote for the Commission's proposal on the CCCTB on 15 March 2018 with an amendment on the **establishment of a virtual PE**. Accordingly, a digital PE would be established when a platform generates revenue in excess of EUR 5 million from remote transactions in a jurisdiction, meeting either of the following conditions: At least 1,000 users, at least

³⁸⁰ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax.

³⁸¹ Schippers and Verhaeren (2018), pp.62-63

³⁸² PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

³⁸³ De Graaf and Visser (2018), p.42.

1000 digital contracts per month in a taxable year, and the volume of the digital content collected by the company exceeding 10 % of the group's overall stored digital content.³⁸⁴

Although the Commission had discussed the possibility of a digital CCCTB back in September 2017, its digital package of March 2018 did not propose the long-term measure under the umbrella of the CCCTB much to the European Parliament's disappointment. Yet, it did not exclude the possibility of its **eventual introduction as an amendment to the CCCTB**. In fact, given the shortcomings of BEPS measures, the CCCTB could capture digital activities by seeking to apportion profits of businesses operating in the EU across relevant EU jurisdictions based on sales and value added by users rather than physical presence. Yet, due to implementation difficulties and opposition by Member States, the adoption of the CCCTB proposal is far from guaranteed.³⁸⁵

The CCCTB could provide an appropriate solution to tax competition, as pressure is increasing from Germany, France, Italy and Spain to stop a further race to the bottom, which is likely to accelerate with the exit of the United Kingdom.³⁸⁶ Yet, some Member States fear that it would eventually result in tax harmonisation among Member States. **Tax policies differ in Member States** due to different national interests and varying levels of technological advancements. At present, tax rates are varying from below 15% in Hungary, Bulgaria, Cyprus and Ireland to above 30% in France and Belgium.

³⁸⁴ European Parliament Committee on Economic and Monetary Affairs, Draft Report on the proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), Rapporteur: Alain Lamassoure, 2016/0336 (CNS), 13 July 2017.

³⁸⁵ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

³⁸⁶ KPMG (2017) OECD BEPS Action Plan- Moving from talk to action (<https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2017/09/ema-beeps-report-2017.pdf>).

5. RECENT DEVELOPMENTS IN THE US TAXATION LANDSCAPE

KEY FINDINGS

- One of the main weaknesses of the old tax system in the US was that profits were not taxed when they remained outside of the country but were fully taxed at the rate of 35% when transferred to the US.
- With the new tax reform, the US income tax rate is reduced from 35% to 21%. The TCJA foresees a participation exemption to encourage repatriation of foreign-earned profits. A Base Erosion and Anti-Abuse Tax is introduced to tighten the US interest deductibility rules. A Global Intangible Low-Taxed Income (GILTI) is meant to stop US corporations from shifting assets to low-tax jurisdictions by capturing the excess return on certain tangible investments outside the US. Under the Foreign-Derived Intangible Income (FDII) regime, corporate tax deductions are available for income earned directly by a US corporate.
- The US Act does not explicitly target the digital economy however some measures, such as 100% dividends-received deduction, could influence the structuring of business operations with respect to digital goods and services.
- The US tax reform takes important BEPS recommendations on board. Yet, the fact that the US refused to sign the MLI and did not join the CbCR could be interpreted as an attempt to protect its headquartered companies by minimising their tax burdens abroad in the same way it rejects to overturn check-the-box regulations that are lamented for MNEs BEPS practices. These are attributed to practical reasons, such as the difficulty to obtain Senate ratification, the existing domestic GAAR rule and limited and carefully scrutinised resources of the US Treasury's office.
- The long-term implications of the US tax reform remain unclear and may not change the dynamic that permitted companies to pay limited tax in the US. There is uncertainty about temporary tax changes, set to expire on schedule, which might influence business decisions.
- The US tax reform is likely to alter the 'delicate balance of US-EU taxation', possibly leading to a tax war and rebutting the stateless income argument used by the CJEU regarding its state aid cases against US multinationals.
- However, in the case of the US, different approaches at federal and state level should be taken into account. While the US states enjoy substantial tax autonomy, the US allocates tax revenue between the states, using a unitary formula apportionment based on three factors (sales, assets, labour) of equal importance.
- While the US opposes the ring-fencing the digital economy at the international level, the issue of remote taxation became extremely important for individual US states, which have resorted to unilateral action targeting the digital economy, especially e-commerce sales.
- The recent trend in the US states is to give more weight to sales when defining the formula for profit allocation. In some states a single-sales factor formula is preferred, as reducing the role of assets and wages, which are prone to manipulation, could play a role for economic growth, employment, investment and social welfare. Yet, concerns arise regarding double taxation and proliferation of different standards.

5.1. US Tax Reform

5.1.1. Changes to the US Tax Legislation

One of the main **weaknesses of the old tax system in the US** was that profits were not taxed when they remained outside of the country but were fully taxed at the rate of 35% when transferred to the US.³⁸⁷ This permitted MNEs to indefinitely defer US tax on their foreign income by borrowing from the US, investing in foreign subsidiaries and booking IP profits in low-tax jurisdictions³⁸⁸ through establishing headquarters or creating mergers with foreign companies.³⁸⁹ The TCJA signed into law on 22 December 2017 addresses this weakness by a shift from a worldwide to a semi-territorial system³⁹⁰, with multiple provisions that significantly impact the way European corporations are being taxed in the US.

The US tax reform contains the following provisions:

- The US income tax rate is reduced **from 35 % to 21 %**.
- Formerly, the foreign sourced income could not be taxed until the cash dividends were received in the US. With the **participation exemption** introduced by the new law, a domestic corporation that is a US shareholder of a specified 10% foreign corporation could be entitled to a 100% dividends-received deduction for the foreign-source portion of dividends received from the foreign corporation. This is an important anti-BEPS measure to enhance CFC rules.
- **BEAT** is a 10 % tax on the modified taxable income of large corporations with a minimum annual consolidated receipt of USD 500 million over a three-year period. It is an alternative minimum tax having the objective of tightening the US interest deductibility rules (i.e. Earnings Before Interest, Taxes, Depreciation and Amortisation - EBITDA) and limiting the deductibility of certain related party payments, such as paying headquarters or services fees, royalties, franchise fees or payment for procurement services to overseas companies.³⁹¹
- **GILTI** is meant to stop US corporations from shifting assets to low-tax jurisdictions by capturing the excess return on certain tangible investments. This global minimum tax regime requires US shareholders that are 10 % owners of CFCs to include in income excess returns earned by those CFCs but allows for a 50 % deduction and a partial foreign tax credit that reduces the effective US rate on GILTI. It is effectively taxed at 10,5% and foreign income subject to 13,125% tax rate is exempt from the GILTI tax.
- **Under the FDII** regime, corporate tax deductions are available for income earned directly by a US corporate. It is designed to give incentives to base intangibles in the US, which is why it is referred to as the American version to the 'patent box' regime. These include 100% expensing of tangible assets and a new preferential 13,5% tax rate on export income FDII, such as export sales, services, leases or licenses of property to foreign entities.³⁹²

³⁸⁷ Congressional Research Service (2017) Reform of US International Taxation: Alternatives.

³⁸⁸ Congressional Research Service (2017) Reform of US International Taxation: Alternatives.

³⁸⁹ Handler (2017), p.3.

³⁹⁰ Avi-Yonah (2018).

³⁹¹ EY (2017) Don't miss the BEAT on US tax reform.

³⁹² EY (2017) Don't miss the BEAT on US tax reform.

5.1.2. Effects of the US Tax Reform

With the tax reform, the corporate tax policy of the US will be shaped as **'a purely territorial tax system'** through exemptions of US companies on tax payment on foreign profits and reduced tax rate of 10 % to attract accumulated corporate profits of US companies parked abroad.

The US Act **does not explicitly target the digital economy** yet some measures, such as 100% dividends-received deduction, could influence the structuring of business operations with respect to digital goods and services,³⁹³ as the companies could strive to take advantage of such benefits or to minimise their tax cost.³⁹⁴

However, concerns are voiced over the new corporate tax rate, which, coupled with the participation exemption, could trigger a **race to the bottom** being slightly lower than the OECD average of 25%. Such a race could threaten budgetary stability in all involved countries even if the competitive advantages stemming from tax differences would be eradicated in the long term.³⁹⁵ Moreover, there is always a possibility that US multinationals could shift more income to foreign jurisdictions with a rate below 21%. It is also probable that source countries will continue to exempt income while it is invested in them but will impose corporate tax upon repatriation. There will be no foreign tax credit in the US for such taxes.

The BEAT only applies if annual base erosion payments of the company are at least 3 % of all deductible payments. Therefore, it would not have a significant effect on foreign MNEs selling goods to related US distributors, as the cost of goods sold is not included in the modified tax base. Yet, it could have a significant effect on foreign MNEs selling services and licensing intangibles in the US market through a US distributor.

Business interest deductions are disallowed for interest in excess of 30 % of measures of business income (EBITDA until 2021 and EBIT thereafter). BEAT is not a withholding tax on royalties or interest and does not represent a denial of deduction but the fact that it applies to imports of depreciable goods from a related party, a rare provision - could trigger WTO violation. In this context, the EU stressed that the BEAT economically denies the deduction in part. Although the current savings clause gives the US the ability to override treaties, the EU may choose to apply similar retaliatory measures for US MNEs.

The fact that GILTI is 'a separate foreign tax credit limitation basket' and 'an anti-abuse backstop to a territorial system' simultaneously makes the **interaction of GILTI and expense allocation complex**, which could be clarified when a number of regulations regarding the international provisions of the measures will be released by the end of 2018. At the same time, the US does not intend to tax companies, which already paid at least 13,125 % tax in other jurisdictions.³⁹⁶

As GILTI operates as a minimum tax with cross crediting, it could **induce foreign tax rates to rise** because it is possible to average tax credits across countries and thus escape GILTI. Another issue of concern is the **unduly harsh measures** such as services' cost-method exception.³⁹⁷ Moreover, the temporary expensing provision could reduce the effective tax rate on normal returns to capital to zero, which could attract tangible investment into the US.

³⁹³ Jones, Seabrook, Sciliberto and Jones (2018).

³⁹⁴ Jones, Seabrook, Sciliberto and Jones (2018).

³⁹⁵ Handler (2017), p.8.

³⁹⁶ Bloomberg Tax (2018), Special Report 'Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation', p. 7.

³⁹⁷ Bloomberg Tax (2018), Special Report 'Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation', p. 8.

As regards to the FDII, the corporate tax rate cuts on income from exported intangibles to 13,125% can **encourage shifting of intangible profits into the parent company**. Hence, US business units would be run more globally and digital strategies could be better aligned. In addition, the FDII could trigger the expansion of adaptive manufacturing in the US and its export to non-US jurisdictions.³⁹⁸

According to the US Treasury, the US tax reform, consisting of transition tax, a global intangible low-taxed income (GILTI) as well as new rules to address interest stripping and hybrid mismatches, tackles BEPS concerns 'more thoroughly than any other jurisdiction's rules'. The OECD views the reform as '**the most far-reaching implementation of BEPS principles**', as it is eliminating 'stateless income'- the phenomenon of MNEs untaxed offshore revenue. The effects of the US tax reform could be multiplied if other governments adopted minimum tax regimes and strengthened CFC rules.³⁹⁹

In the opinion of Clifford Chance, the long-term **implications of the US tax reform remain unclear** and may not change the dynamic that permitted companies to pay limited tax in the US.⁴⁰⁰ There is uncertainty about temporary tax changes, set to expire on schedule, which might influence business decisions.⁴⁰¹

5.1.3. EU-US Taxation Balance in a Post-BEPS World

The US tax reform appears to take the **most important BEPS recommendations** on board. Some examples include the triangular permanent establishment rule, the possibility to subject dividends, interests and royalties paid by an expatriated entity to 30% WHT for a period of 10 years after the inversion that created it, and the special tax regime to prevent reduction of withholding taxes for deductible related-party payments when the beneficial owner pays little or no tax.⁴⁰²

However, the fact that the **US refused to sign the MLI and did not join the CbCR** could be interpreted by some as an attempt to protect its headquartered companies by minimising their tax burdens abroad in the same way it rejects to overturn check-the-box regulations that are lamented for MNEs BEPS practices. According to Herzfeld, this could be explained by some practical reasons, such as the difficulty to obtain Senate ratification, the existing domestic GAAR rule and limited and carefully scrutinised resources of the US Treasury's office. The US also finds arbitration provisions weak and is concerned about the lack of clarity regarding the legal status of the MLI.⁴⁰³

The 'delicate balance of **US-EU taxation**' was altered due to the participation exemption, BEAT, GILTI and FDII provisions in the US tax reform. Although some believe that the TCJA could lead to a tax war⁴⁰⁴, others call for an EU response to impose CFC rules on US subsidiaries of their own multinationals investing into the US. As the Anti-Avoidance Directive requires all EU Members to adopt CFC rules by 2019, there are no limits on applying such rules to non-EU subsidiaries (as if they are inside the EU).⁴⁰⁵ The CCCTB was also highlighted as 'a key response to US tax reform'.⁴⁰⁶

³⁹⁸ EY (2017), Don't miss the BEAT on US tax reform.

³⁹⁹ Bloomberg Tax (2018), Special Report 'Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation', p. 6.

⁴⁰⁰ Clifford Chance (2018) Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax.

⁴⁰¹ Tax Foundation (2017) Preliminary Details and Analysis of the Tax Cuts and Jobs Act.

⁴⁰² Avi-Yonah (2018).

⁴⁰³ Herzfeld (2018).

⁴⁰⁴ Avi-Yonah (2018).

⁴⁰⁵ Avi-Yonah (2018).

⁴⁰⁶ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.46.

Additionally, the changes to the US tax law **could 'rebut' the stateless income argument** used by the CJEU regarding its state aid cases against US multinationals.⁴⁰⁷

5.2. Digital Taxation in the US

While the US recognises the challenges posed by digitalisation, it is in favour of a system-wide reform rather than ring-fencing the digital economy. On multilateral platforms, the US does not support the opinion that tech giants permit base erosion and is of the view that no changes to the scope of the PE are needed on the basis that large multinationals are changing their structures to use local Low Risk Distributors.

However, in the case of the US, different approaches at federal and state level should be taken into account. While the US states enjoy substantial tax autonomy, the US allocates tax revenue between the states, using a **unitary formulary apportionment** based on three factors (sales, assets, labour) of equal importance.

The following criteria is used to establish a nexus threshold:

- A dollar amount of dollars 50,000 property;
- A dollar amount of dollars 50,000 payroll;
- A dollar amount of dollars 50,000 sales; and
- Twenty-five % of total property, payroll or sales.

The US federal government strongly opposes ring-fencing the digital economy while the issue of remote taxation became extremely important for individual states, which have resorted to **unilateral action targeting the digital economy**, especially e-commerce sales. There is also a concern regarding double taxation and proliferation of different standards.⁴⁰⁸

The recent trend in the **US federal states is to give more weight to sales** when defining the formula for profit allocation. In some states a single-sales factor formula is preferred, as reducing the role of assets and wages, which are prone to manipulation, could play a role for economic growth, employment, investment and social welfare.⁴⁰⁹

This is exemplified by different approaches adopted by various US states:

- **Click through nexus** (New York State, 2008) - If a seller enters into a commissionaire agreement with a resident for referring customers to the remote seller via link on the resident's website, the seller has created a taxable presence in New York and is required to collect and remit sales taxes.
- **Affiliate nexus** (Louisiana, 2016) - Taxable presence is attributed to any person who sells similar products as a Louisiana retailer under a similar name and similar intellectual property, solicits business through an agent with a Louisiana nexus or holds a substantial ownership (over 5 %) in a Louisiana retailer.
- **Economic nexus** (South Dakota, 2016) - An online retailer with a sales threshold of more than USD 100,000 per year or over 200 transactions essentially create an economic nexus even if there is no physical presence.

⁴⁰⁷ Bloomberg Tax (2018), Special Report 'Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation', p.7.

⁴⁰⁸ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

⁴⁰⁹ Llopis (2017).

Taxation rules in the US are governed by the 1992 Supreme Court decision in **Quill Corp. vs. North Dakota**, which prohibits states from imposing sales tax obligations on vendors lacking physical presence. However, South Dakota challenged the Quill decision after establishing an economic presence nexus in 2016 according to which companies performing 200 separate sales or sales with a total of USD 100,000 will be subject to a sales tax. The US Supreme Court decision of 21 June 2018 has a 'significant influence on taxation and the economy',⁴¹⁰ as it overturned Quill, ruling that the physical presence rule decided from Quill was 'unsound and incorrect' in the current age of Internet services.

Currently, treaty standards do not apply to state taxes or for the collection of state sales taxes. The Supreme Court is expected to reconsider state law in order to define nexus to capture more tax related to digital economic activity. It may be that **US will have separate standards for the collection of indirect taxes (sales tax on sales in the digital economy) and direct taxation** of income earned by sellers in the digital economy. An economic nexus may be sufficient to require collection by sellers of digital goods and services but the current view is that it should not be extended to direct taxation.⁴¹¹

5.3. Money Laundering in the US

Although the US seems to have developed a robust legal framework to address money laundering activities and combatting terrorist financing, the 2016 Financial Action Task Force (FATF) mutual evaluation report⁴¹² highlights some deficiencies: There is **no uniform approach** to state-level anti-money laundering (AML) efforts and it is not clear that all states give money laundering due priority. **Exemptions** implied to in the regulatory framework of the Bank Secrecy as well as **minimal coverage** of certain institutions and businesses other than trust companies point to limitations in the US regulatory framework. Most designated non-financial businesses and professional (lawyers, accountants, real estate agents, trust and company service providers) except trust companies are not subject to AML measures, including requirements on reporting transactions involving more than USD 10,000 in cash and targeted financial sanctions. The criticism by FATF on the US AML regime's lack of controls related to beneficial ownership resulted in a new rule with regards to identifying beneficial owners. Despite various federal legislative proposals aimed at requiring identification and disclosure of beneficial owners, not all of them have been adopted and implemented yet.

⁴¹⁰ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation.

⁴¹¹ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

⁴¹² FATF (2016) United States' measures to combat money laundering and terrorist financing (<http://www.fatf-gafi.org/countries/uz/unitedstates/documents/mer-united-states-2016.html>).

6. ALTERNATIVE APPROACHES TO DIGITAL TAXATION

KEY FINDINGS

- A century-long debate on source vs. residence still maintains its relevance although many believe that it is obsolete in the digital age. The debate on source and residence stems from the nexus principle, which ‘forms part of general international law of income tax jurisdiction’, deeming both a personal and territorial link necessary for income taxation.
- Instead of reforming international taxation rules based on physical presence, the BEPS project ‘renewed support to this basic principle’, failing to catch up with the changes brought about by the rapid spread of digitalisation. The frustration by the lack of substantial reform at the international level led to the proliferation of unilateral measures, which create legal uncertainty and double taxation.
- With digitalisation allowing business activities to spread across the globe, it is difficult to identify the location of value creation and to decide on how to allocate profits. Moreover, scandals, such as Paradise Papers, demonstrate that shareholders continue to book ever-increasing volumes of personal savings in tax havens putting the whole idea of corporate taxation into question.
- Several options are put forward to change the profit allocation rules. These include supply-side oriented global profit splitting systems, supply-side or demand-side global formulary systems, destination-based cash flow taxes (DBCFT) and taxation of MNEs solely in the ultimate parent jurisdiction. Different formulae suggested for profit allocation reflect different political choices as to whether or not to remunerate producing or marketing states, thus creating winners and losers.
- Supply-side approaches attribute value creation to factors, such as assets, labour, risks, intangibles and human capital while demand-side approaches focus on sales and users in market jurisdictions.
- The problems and distortions in the unitary formulary apportionment model in the US as well as difficulties to adopt a CCCTB in the EU led policymakers to focus on destination-based models, such as sales-based apportionment, allocation of residual profits or DBCFT.
- Whereas some highlight positive aspects of the DBCFT, such as the elimination of BEPS, less transfer pricing manipulation, increased tax revenues, focus on investments through equity rather than debt, elimination of tax competition and simplification of the tax system, questions arise regarding its legitimacy, fairness and compatibility with international obligations as well as double taxation risks.

6.1. A Century-long Debate: Source vs. Residence

International taxation rules give the **primary taxation right to the state of residence** (as opposed to the state of source), which could be primary (local enterprise) or modified (foreign enterprise with a PE status). Instead of moving away from these rules, which are based on a physical link and thus fail to match the realities of the highly mobile and borderless digital economy, BEPS project ‘renewed support to this basic principle’.⁴¹³

⁴¹³ De Graaf and Visser (2018), p. 36.

The century-long **duality between source and residence** maintains its relevance for allocating taxing rights while many believe that they have become obsolete. In this context, the concept of source is seen as problematic. When it is used in the sense of ‘source of income’, which ‘lacks geographical attributes’, the source rules could become ‘artificial and arbitrary’. Hence, the distinction between ‘source as origin’ and ‘source as destination’ could be more appropriate, the former accounting for supply-side factors (where production is based) and the latter for demand-side factors (where consumption is based).⁴¹⁴

The debate on source and residence stems from the **nexus principle**, which ‘forms part of general international law of income tax jurisdiction’, deeming both a personal and territorial link necessary for income taxation. The nexus requirement is deeply rooted in the state sovereignty and the state’s power to assert jurisdiction and to tax income from domestic sources.⁴¹⁵ From a constitutional perspective, the justification of a tax claim is made with reference to a person’s economic and or political allegiance. A state wanting to assert unlimited tax jurisdiction⁴¹⁶ may lack ‘valid support from the perspective of public international law’.⁴¹⁷ Hence, different policy options shall be evaluated in this light.

6.2. Is there a Need to Reform the Current Taxation System?

Currently, there are three **diverging views among the 117 Members** of the OECD’s Inclusive Framework on digital taxation: The first group, including the EU, believes that ‘reliance on data and user participation may lead to misalignments between the location in which profits are taxed and the location in which value is created’, opting for targeted measures rather than wide-ranging change.

A second group, including the US, recognise the challenges posed by the digital transformation and globalisation to the effectiveness of the international tax system for business profits but do not think that these challenges are ‘exclusive or specific to highly digitalised businesses’.

A third group believes that BEPS largely addresses double taxation issues and no further reform of international taxation rules is needed. The lack of consensus and limited action to address the problems seems to have led to frustration by many States, which went ahead to develop their own measures.⁴¹⁸

Given the pace of the **spread of the digitalisation**, coupled with changes that might occur by future technologies, such as collaborative economy, Blockchain, AI and robotics, the current system is not fit to catch up with today’s economic realities. Moreover, scandals, such as Paradise Papers, demonstrate that shareholders continue to book ever-increasing volumes of personal savings in tax havens **putting the whole idea of corporate taxation into question**. Some even go further with the argumentation that personal taxation could be more appropriate than corporate taxation to capture such untaxed wealth in an increasingly digitalising economy.⁴¹⁹

While limiting worst cases of tax avoidance, **BEPS measures introduce more complexity** into the taxation system without necessarily addressing the problems at the heart of base erosion and profit shifting activities: nexus, profit allocation and transfer pricing. With the US tax reform having dubious effects, it is likely that the MNEs will continue their aggressive tax planning schemes by artificially manipulating their organisational structures.

⁴¹⁴ Turina (2018).

⁴¹⁵ Gadzo (2018).

⁴¹⁶ Monsenego (2016), p.46.

⁴¹⁷ Gadzo (2018)

⁴¹⁸ OECD Brief on the Tax Challenges Arising from Digitalisation: Interim Report 2018 (2018) (<https://www.oecd.org/tax/beps/brief-on-the-tax-challenges-arising-from-digitalisation-interim-report-2018.pdf>).

⁴¹⁹ Schippers and Verhaeren (2018), p.64.

Apart from profit shifting, numerous problems of the existing system, such as economic inefficiency, complexity and competition among States were outlined by academics, such as Devereux and Vella. In their view, a fundamental reform is needed,⁴²⁰ as BEPS measures could further distort the real economy and lead to a race-to-the-bottom type of tax competition with states attempting to attract real economic activity.⁴²¹

Supporters of this view underline the need to **shift value towards demand-side factors** in market jurisdictions⁴²², which would mean an overhaul of the international tax system through the re-evaluation of fundamental cornerstones of taxation (i.e. nexus principle)⁴²³, to readjust taxing rights among jurisdictions and the redefinition of PE status. Such a radical change could be achieved 'by adopting a destination-based tax and integrating the digital sector in a formula-based transfer pricing regime, or a formulary apportionment regime, such as profit-splitting method'.⁴²⁴ Critics of destination-based taxes highlight potential problems, such as compatibility with WTO rules and fairness.

6.3. Different Profit Allocation Approaches

The continuing technological developments and changing business models, the IoT, robotics and the collaborative economy '**may prove influential and disruptive in the near future**' and raise questions as to whether the existing tax system used to determine where economic activities are carried out and where value is generated for income tax purposes will still be relevant.⁴²⁵

Two fundamental pillars of the international taxation system are being challenged: **Nexus and profit allocation**. With increasing pressure from the EU and other countries, the OECD is currently trying to find appropriate solutions to address these issues.⁴²⁶

Changing the PE, as exemplified by unilateral measures and the EU proposals, is likely to face **technical, procedural and political obstacles**. These include the difficulty of valuing consumers' use of digital platforms while such valuations are key for profit allocation, the lack of consensus within the OECD and EU, the unanimity obligation among EU Member States and decisive vote of the US Congress in the case of OECD.⁴²⁷

Once a new nexus is established, it is essential to decide on profit allocation rules. These rules are extremely complex and the new digital PE proposed by several countries, as well as the European Commission, would require them to become even more complex and hard to apply. One of the most difficult areas for taxpayers to comply is the existing PE attribution rules, where **different countries apply the 2008 AOA, 2010 AOA, or non-AOA**.⁴²⁸ On the other hand, the Commission argues that the AOA is outdated as it relies too heavily on PE principles to tax the company based on the location of its European headquarters rather than a significant digital presence.

Many options are put forward to **change the profit allocation rules**. These include supply-side oriented global (residual) profit splitting systems (echoing transfer pricing approaches but without

⁴²⁰ Devereux and Vella (2014)

⁴²¹ Devereux and Vella (2018).

⁴²² Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.15.

⁴²³ Gadzo (2018).

⁴²⁴ Dourado (2018).

⁴²⁵ OECD Observer (2017), Tax challenges, disruption and the digital economy, p.3.

⁴²⁶ Andersson (2017).

⁴²⁷ Schippers and Verhaeren (2018), p.64.

⁴²⁸ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

separate accounting and comparability issues), supply-side or demand-side global formulary systems, destination-based cash flow taxes and taxation of MNEs solely in the ultimate parent jurisdiction.⁴²⁹

Some support the view that such solutions should involve the **demand-side** of the equation, accounting for the consumer market as a factor contributing to the added value of the company in light of the debate surrounding the digital economy.⁴³⁰ Others underline the fact that ‘**human capital** in its specific form of knowledge-based capital is becoming a predominant value driver of businesses’ in the digital age and that such capital should have substantial weight in the functional analysis to determine profit allocation⁴³¹, even suggesting taking into account the number of days that an individual works in a country.⁴³²

6.3.1. Formulary Apportionment

Unitary taxation is a uniform system of worldwide reporting of corporate income with profits apportioned to different jurisdictions in which corporations are active in accordance with a formula. Being currently in practice at the domestic level in Canada, Switzerland and Canada⁴³³, it has been seen as an alternative to the current arbitrary arm’s length principle relying on separate entity accounting and estimated transfer prices for intra-group transactions for long time.⁴³⁴

Some believe that the adverse effects of BEPS could be eliminated if consolidated worldwide profits of MNEs were to be determined uniformly (unitary and consolidated basis) and then appropriately apportioned to various countries (**global formulary apportionment**)⁴³⁵ Yet, this approach, which has been mainly championed by Picciotto, is seen as utopian for the reason that it has to be globally implemented in order to be effective.⁴³⁶

The debate on **formulary apportionment** was fuelled by Action 8-10 of BEPS, whereby the further scope of work on the use of the profit split method has been the trigger point for some stakeholders to departure from the arm’s length principle by the OECD in favour of some sort of formulary apportionment methodology.⁴³⁷ Countries, such as, the United States are opposed to the application of the formula apportionment internationally but are shifting to a single-factor formula at the domestic level.⁴³⁸

Although the current international system is sometimes criticised for its arbitrary nature, its high costs and its vulnerability to manipulation, the OECD rejects the formulary apportionment for the following reasons:

- **Difficulty for countries to agree on the same formula**, on the same definition of the appropriate factors (location of sales, value of assets etc.), which is likely to be weighed according to national interests of countries each seeking to maximise their revenue and concerns that different formulae may lead to double taxation or under-taxation;⁴³⁹

⁴²⁹ De Wilde (2018).

⁴³⁰ Turina (2018).

⁴³¹ Olbert and Spengel (2017).

⁴³² Kemmeren (2018), p.73.

⁴³³ Edesten and Almling (2016).

⁴³⁴ Ismer and Jescheck (2017).

⁴³⁵ De Graaf and Visser (2018).

⁴³⁶ Ismer and Jescheck (2017).

⁴³⁷ Edesten and Almling (2016).

⁴³⁸ Edesten and Almling (2016).

⁴³⁹ Edesten and Almling (2016).

- **The arbitrary nature of the formula**, disregarding market conditions, leaving out factors, such as intangibles and risk allocation, which are at the core of the BEPS transfer pricing and the risk of assigning profits to an entity that would incur losses if it were an independent enterprise;
- **High compliance costs and data requirements**, as the formula applies to the entire MNE group operating in different jurisdictions with possibly different accounting rules; and
- **Possibility to manipulate the components** of the relevant formula for tax avoidance purposes (i.e. moving mobile assets when the asset is used as one of the apportionment factors in the formula).

It is argued that a **three-factor formula** based on capital/assets, workers/payroll and sales would be fair for profit allocation but it would necessitate tax cooperation between administrations at a world-wide level as well as a supranational tax administration, which is regarded as impossible despite the Country-by-Country reporting obligations.⁴⁴⁰ By contrast, adequate enforcement mechanisms could be put in place in case of the CCCTB inspired by the EU's success to develop a fiscal system to finance itself through customs duties, VAT levy and Gross National Income (GNI) levy, where national tax authorities are responsible for tax collection.⁴⁴¹

Many criticise the fact that formulary apportionment aims at allocating the profit to the place where certain economic nexus is located, while such **nexus between profit and certain countries is not defined and is totally up to the discretion of different States**.⁴⁴² Unitary taxation is also believed to drive an artificial distinction between domestic and foreign-based MNEs.⁴⁴³

It is hard to determine **which factors are value-driving** and should be included in a global formulary apportionment. Although some believe that sales at destination should be included as an income producing factor⁴⁴⁴, others do not consider sales as part of the production factors (wages, assets, land, technology, knowledge etc.)⁴⁴⁵ The main criticism regarding the inclusion of the sales factor is that it doubles the effect of the VAT on destination.

A third group supports a **hybrid form of taxation**, similar to the two-factor formula applied in Canada, which gives equal weight to sales and labour. Some argue that this approach could be disadvantageous for developing countries.⁴⁴⁶ According to Avi-Yonah, neither the arm's length principle, implying that integrated firms across borders pretend to be separate entities to determine intra-company transaction prices, nor the global apportionment on a country-by-country basis make sense.⁴⁴⁷ He believes that profit allocation should not be based solely on sales but also on other production factors and suggests a 50-50 split between sales on one hand, and assets and labour, on the other. Yet, combining production factors and consumption factors, such as sales, could be also problematic.⁴⁴⁸

⁴⁴⁰ Dourado (2018), p.570.

⁴⁴¹ Ismer and Jescheck (2017).

⁴⁴² Edesten and Almling (2016).

⁴⁴³ Avi-Yonah (2016).

⁴⁴⁴ Llopis (2017).

⁴⁴⁵ Andersson (2017).

⁴⁴⁶ Schippers and Verhaeren (2018).

⁴⁴⁷ Llopis (2017).

⁴⁴⁸ Llopis (2017).

Different formulae reflect **different political choices** as to whether or not to remunerate producing or marketing states⁴⁴⁹ and thus create winners and losers.⁴⁵⁰ It is impossible to find a perfect formula because of design issues as to the set of business income to which an apportionment formula should be applied (single apportionment to group-wide income as proposed by the CCCTB or unitary business of the group as it is the case in the US), the measurement of the income subject to the formula and the factors to be included in the formula.⁴⁵¹ Furthermore, the location of assets, labour and sales is sometimes difficult to identify.⁴⁵²

Cottani is of the view that **formula apportionment** would not capture value created by modern businesses better than the arm's length, as some states omit risks and intangibles in their formula apportionment systems. While the author further underlines that formulary apportionment could have risks of harmful tax competition or profit shifting depending on the factors, he sees a possibility that the arm's length and formula apportionment may converge eventually in the highly integrated businesses.⁴⁵³ At the same time, several unilateral measures in France, Hungary, India, Italy, the UK, Australia, US and Israel alongside with the EU initiatives, such as the CCCTB and the new digital package,⁴⁵⁴ show a certain shift towards the recognition of the contribution of market jurisdictions towards value creation.⁴⁵⁵ Especially, developing countries with large export shares in services do already base their systems on the destination principle.

6.3.2. Destination-based Taxation

The problems and distortions in the unitary formulary apportionment model in the US and the CCCTB in the EU led commentators to focus on **sales-based apportionment** or allocation of **residual profits**,⁴⁵⁶ which are seen as structural rather than avoidance measures, regardless of their being 'more or less legitimate than origin-based taxation or the CCCTB'.⁴⁵⁷

The main arguments for destination-based taxation are:

- **Real economic distortions** that can be caused by States wanting to attract R&D activities;
- **The increasing importance of market jurisdictions** with customer-based intangibles as a source of profit; and
- **Difficulty to stop tax competition** with the existing tax system.⁴⁵⁸

The virtues of levying the tax at the destination instead of the origin are 'simplicity, minimal distortions on location choices, providing incentives for investments, unbiased treatment of debt and equity, and robustness against tax-avoidance'.⁴⁵⁹

The destination-based taxation is seen as the only viable solution in the long-term although it is generally acknowledged that it would create both losers and winners.⁴⁶⁰ While a move to a destination-

⁴⁴⁹ Llopis (2017).

⁴⁵⁰ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

⁴⁵¹ Andrus and Oosterhuis (2017).

⁴⁵² Llopis (2017).

⁴⁵³ Monsenego (2016).

⁴⁵⁴ Dourado (2018).

⁴⁵⁵ Dourado (2018).

⁴⁵⁶ Andrus and Oosterhuis (2017).

⁴⁵⁷ Schippers and Verhaeren (2018).

⁴⁵⁸ Devereux and Vella (2018).

⁴⁵⁹ Handler (2017).

⁴⁶⁰ Devereux and Vella (2018).

basis would not necessarily mean the exclusive application of the destination principle, as in the case of the sales-based formulary apportionment and Destination-Based Cash Flow Tax, **coherence is key** to allow for the smooth evolution of the current system in order to give some taxing rights to consumer jurisdictions. Advantages of the destination-based taxation would vary depending on the selected destination base.⁴⁶¹

Different options for **destination-based models** are:

- Sales-based Formulary Apportionment;
- Residual Profit Allocation; and
- DBCFT.

a. Sales-based Formulary Apportionment

A switch to a purely destination-based principle would mean the elimination of factors of production, such as wages and labour, from the formulary apportionment. The sales-based taxation **leaves the principles of source and residence taxation**, which are no longer suited to deal with taxation in a digital economy by focusing on the location of the consumer. Income from sale of goods or services are accordingly taxed in the market jurisdiction in a similar way to VAT.⁴⁶²

While a **purely production-based formula** could lead to a more accurate formula to allocate companies' income, it does not remunerate market states and does not solve the BEPS problems due to inefficiency of companies' decisions about location and investment as well as possibility to manipulate production factors for the MNEs. A purely demand-based formula ignores the role of assets and labour as income-generating factors but could prove more efficient in comparison to BEPS. At the same time, such a destination-based principle may distort economic behaviour because of the uptake of online transactions.⁴⁶³

Many states in the US, Canada and Switzerland opted for an apportionment formula based entirely on sales. The destination principle is seen as **corporate-tax neutral** with the promise to eliminate the problem of manipulation of formulae components by MNEs.

b. Residual Profit Sales Apportionment

Under the current entrepreneur model, most of the risks are borne in one **entrepreneur affiliate** and other affiliates in the supply chain are treated as if they were doing routine activities and functions. The residual profit is attributed to the entrepreneur residing in a low-tax jurisdiction. To reverse the situation, the residual profit sales model deems the customer jurisdiction as entrepreneurial affiliate.

The profit allocation is determined according to traditional transfer pricing cost-plus or return on asset methodologies or some other type of apportionment method.⁴⁶⁴ Routine profits could be allocated on a cost plus basis and taxed where the costs are incurred. The remaining profit would be considered residual and attributed to the various jurisdictions on the basis of a **sales factor**.⁴⁶⁵

One of the advantages of this formulary apportionment method is that the level of mark-up on costs could give **disincentives** to businesses to move to low-cost jurisdictions.

⁴⁶¹ Vella (2018).

⁴⁶² Baumann (2017).

⁴⁶³ Olbert and Spengel (2017).

⁴⁶⁴ Andrus and Oosterhuis (2017).

⁴⁶⁵ Andrus and Oosterhuis (2017).

c. Destination Based Cash Flow Tax

According to the Commission's Impact Assessment accompanying its proposals on digital taxation, 'fundamental reforms, such as destination-based cash flow tax, unitary taxation and residence tax base with destination tax rates, would not only fundamentally challenge the international tax system, but they also have the potential to address the problems at their roots. They however do not yet seem to be a priority of Member States at this stage, who prefer to adapt the current system.'⁴⁶⁶

The proponents of a destination-based corporate tax advocate for the **overhaul of the 'flawed' international tax system** as it distorts real economic activity, causes efficiency losses, facilitates profit shifting, distorts real economic activity and promotes tax competition and imposes high compliance costs on business.⁴⁶⁷

It is argued that by **aligning with consumers**, which are relatively immobile factors, the destination-based cash flow tax could eliminate the disruptive effects of the current international tax system. Such a destination-based tax would not require global implementation to be effective, as in the case of the global formulary apportionment while bringing an end to tax competition and avoiding a race to the bottom, which can be observed by the continuously decreasing corporate tax rates since 1990.⁴⁶⁸ Unlike the formulary apportionment, a destination-based tax relying on one factor (either sales or shareholders) could be administered in each single jurisdiction without giving rise to double taxation.⁴⁶⁹

A destination-based tax with border adjustment was advanced by Congress Republicans in the US to replace the CIT back in 2016. It is akin to a subtraction-method VAT intended to provide for a deduction of the costs of domestic production factors, mostly the compensation of employees.⁴⁷⁰ The basic difference between origin-based CIT and the destination-based tax is that the former applies to domestically produced goods and the latter to domestically consumed goods. The proposed tax did not get adopted due to national and international lobbying⁴⁷¹ but it is speculated that that financing requirements could bring it back to the US agenda soon.⁴⁷²

It is generally acknowledged that focusing on the location of consumers would be complicated in the digital sector, as **identifying the place of destination** in two-sided markets and free usage models could be obstructed by the use of the VPN, for instance.⁴⁷³ Moreover, sovereign states may not be ready to give up taxing rights according to residence and other places where value is created.

Whereas the Tax Foundation highlights positive aspects of the DBCFT, such as the elimination of BEPS, less transfer pricing manipulation, increased tax revenues, increased focus on investments through equity rather than debt and simplification of the tax system,⁴⁷⁴ Dourado believes that allocation between the supply-side and the demand-side, a formula-based transfer pricing regime or another type of formulary apportionment would be **fairer systems**.⁴⁷⁵

⁴⁶⁶ European Commission Impact Assessment (2018) SWD(2018) 81 final/2, p. 34 (https://ec.europa.eu/taxation_customs/sites/taxation/files/fair_taxation_digital_economy_ia_21032018.pdf).

⁴⁶⁷ Vella (2018) Presentation on 'Taxing the digitalised economy' in the TAX3 Committee of the European Parliament, 7 June 2018. Also see Devereux (2017) (http://www.etpf.org/files/Devereux_ETPF_policy_paper_2017.pdf).

⁴⁶⁸ Avi-Yonah (2016).

⁴⁶⁹ Dourado (2018), p.570.

⁴⁷⁰ Avi-Yonah (2016).

⁴⁷¹ De Graaf and Visser (2018), p. 41.

⁴⁷² Handler (2017), p. 4.

⁴⁷³ Moreno (2018).

⁴⁷⁴ Handler (2017), p.7.

⁴⁷⁵ Dourado (2018).

Notwithstanding the fact that the border adjustment would offset long-run effects on the trade balance,⁴⁷⁶ **temporary advantages would be given to domestic companies** at the expense of foreign companies considering that the adjustment of exchange rates and prices would require some time for taxes to be trade-neutral.⁴⁷⁷ These asymmetries would lead to a situation where exporters enjoy tax reductions while importers face an increase in their tax liabilities, which could be reflected in the resale prices.⁴⁷⁸ A decrease in the trade deficit would cause the currency to appreciate, which could have negative effects on domestic consumers. Also, transition costs may be significant.

Baumann argues that such a tax could also **disfavour developing countries** that export more than they import.⁴⁷⁹ Others note that Brazil, Russia, India and China (BRICs) are immense markets and would greatly benefit from the application of the destination principle⁴⁸⁰ as well as from a possible introduction of a virtual PE by the EU.⁴⁸¹ Auerbach et al. consider short-term difficulties, such as the treatment of natural resources, the impact on the tax base, non-compliance and weakness of administrations, destination-based taxation could pose for developing countries but conclude that the gains from escaping the origin-based system, which often means revenue losses due to BEPS-type avoidance measures and aggressive tax competition for developing countries, could outweigh these short-term difficulties (except in relation to natural resources).⁴⁸²

The compatibility of the DBCFT with the WTO rules is also questioned. Border adjustment is permitted in case of indirect taxes but could violate WTO rules as it could substitute an illicit export subsidy. In the short run, before price adjustment occurs, the measure would favour the US domestic products.⁴⁸³ Yet, it is unlikely that the issue would be taken to the WTO because of the lengthy dispute settlement procedures.⁴⁸⁴

⁴⁷⁶ New York Times (2017) 'The Case for a Border-Adjusted Tax', 6 March.

⁴⁷⁷ Tax Foundation (2017) Understanding the House GOP's Border Adjustment, 15 February.

⁴⁷⁸ Handler (2017), p.6.

⁴⁷⁹ Baumann (2017).

⁴⁸⁰ Avi-Yonah (2016).

⁴⁸¹ Andersson (2017).

⁴⁸² Auerbach, Devereux, Keen and Vella (2017) (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2908158).

⁴⁸³ Peterson Institute of International Economics (2017) Border tax adjustments: Assessing risks and rewards.

⁴⁸⁴ Kiel Institut für Weltwirtschaft (2017) Zur Protektionismusgefahr im transatlantischen Wirtschaftsraum, IfW-Box 2017.1.

7. TAX CHALLENGES AND OPPORTUNITIES FOR ADMINISTRATIONS CREATED BY THE COLLABORATIVE ECONOMY AND BLOCKCHAIN

KEY FINDINGS

- Due to its novelty, 'taxing sharing earnings have been proven difficult for tax authorities as much as for users reporting them in their tax returns', where reporting control and taxation is rather rare. This is partly due to the largely varying types of transactions, which can be categorised as 'cash transactions, barter arrangements, cost-sharing arrangements, and gifts and donations'. It is argued that compliance is stronger in economies where electronic payments are widely used, as the use of cash transactions tends to boost informal economy.
- Individuals with little experience in tax matters becoming service providers, activities spread around multiple markets enabling individuals earn small incomes and new production facilities potentially causing degradation of resources, the lack of visibility, the extent of differentiation, the inability to design uniform rules for diverse activities, and competitive advantages over traditional businesses are major taxation concerns. Moreover, VAT-related issues become increasingly problematic because of the difficulty to define the taxable person in relation to economic activity and income in the collaborative economy.
- Many EU countries, including Ireland, the Netherlands, Spain, Belgium, France, the UK, Finland, Italy, Denmark, Slovakia and Hungary, adopted specific measures to foster tax compliance. These measures focus on awareness raising of tax obligations, cooperating with platforms on compliance issues, collecting tax from the platform and BEPS measures in general concerning MNEs.
- Cryptocurrencies and Blockchain technology, on which they rely, are becoming a major source for economic diversification and growth in the EU. At the same time, cryptocurrencies are suspected to facilitate money laundering, illicit financing, fraud and tax evasion due to their unique characteristics, such as the possibility of peer-to-peer cross-border transfer, anonymity, mining on private phones and storing in unregulated wallets.
- Cryptocurrencies also pose challenges for the EU competition policy, as many players are operating outside the EU, which makes their surveillance on anti-competitive behaviours difficult. The existing rules are not adequate to address such new realities, as the question of whether or not cloud mining or smartphone mining cryptocurrencies would trigger a PE and give rise to taxation remains unanswered.
- One major challenge is the different classification of cryptocurrencies as capital assets or property, which leads to different taxation rules. The taxation of cryptocurrency also depends on whether it is held for business or personal purposes.
- Currently, cryptocurrencies are regulated differently in various Member States due to their legal framework, economies and institutional practices. Moreover, tax reporting requirements differ from one country to another regarding cryptoasset disclosure. The EU is working at the G-20 level to regulate cryptocurrencies and achieve an-EU wide harmonisation on their classification and taxation.
- Thanks to new technologies, tax departments are becoming data managers instead of data consumers, actively handling, managing and evaluating tax-sensitive data while moving ahead with digital transformation through centralisation, data, and automation.

- Blockchain represents an opportunity for tax administrations because of its ability to deliver real-time information from many layers to a large audience via decentralised, democratic, transparent, accountable, and inclusive mechanisms.
- The role of tax professionals will also undergo a transformation thanks to robotics and AI, leading to automisation of some of their work, such as preparation of tax returns and advisory roles.

Due to their novelty, collaborative economy and Blockchain **may exacerbate current and future challenges** posed by the digital sector while providing new opportunities for tax administrations.⁴⁸⁵

7.1. Tax Challenges posed by the Collaborative Economy

The fast-growing collaborative economy is expected to reach USD 335 billion by 2025.⁴⁸⁶ The collaborative economy is defined by **blurred lines** between users-providers-platforms and consumers-businesses-intermediaries, two-sided markets and tri-partite transactions, differences between pure sharing, and commercial platforms.

Multi-sided platforms facilitate transactions, which occur outside traditional business structures, such as **online marketplaces**. There are a variety of platforms ranging from durable goods, intangibles and investment goods, to online labour market and crowdfunding.⁴⁸⁷ Uber, Airbnb, BlaBlaCar and Handy have become prominent platforms where individuals are put in touch with their peers who can match their need for certain goods and services.

The OECD's report on **shadow economy** of 2017 highlights that the growth of the digital economy and the emergence of new technologies could lead to new informal economy activities.⁴⁸⁸ According to the IMF, 'Sharing economy suppliers of short-term property rental services or labour services may be informal, i.e., unregistered and untaxed'.⁴⁸⁹ Due to its novelty, 'taxing sharing earnings have been proven difficult for tax authorities as much as for users reporting them in their tax returns', where reporting control and taxation is rather rare.⁴⁹⁰ This is partly due to the largely varying types of transactions, which can be categorised as 'cash transactions, barter arrangements, cost-sharing arrangements, and gifts and donations'.⁴⁹¹ It is argued that compliance is stronger in economies where electronic payments are widely used, as the use of cash transactions tends to boost informal economy.⁴⁹²

According to the Norwegian Sharing Economy Committee, **tax challenges related to the collaborative economy** are as follows: Individuals with little experience in tax matters becoming service providers, activities spread around multiple markets enabling individuals earn small incomes and new production facilities potentially causing degradation of resources. The lack of visibility, the extent of differentiation, the inability to design uniform rules for diverse activities, and competitive advantages over traditional businesses also cause taxation concerns,⁴⁹³ threatening to weaken tax base

⁴⁸⁵ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

⁴⁸⁶ OECD, Re-thinking policies for the tourism sharing economy, (<http://www.oecd.org/cfe/tourism/re-thinkingpoliciesforthetourismsharingeconomy.htm>).

⁴⁸⁷ European Parliament, The collaborative economy and taxation, p. 5

⁴⁸⁸ OECD Report (2017) Shining Light on the Shadow Economy: Opportunities and threats (<https://www.oecd.org/tax/administration/shining-light-on-the-shadow-economy-opportunities-and-threats.htm>).

⁴⁸⁹ IMF (2018) Measuring Digital Economy.

⁴⁹⁰ Beretta (2017), p.3.

⁴⁹¹ Beretta (2017), pp.4-5.

⁴⁹² Bozdoganoglu (2017).

⁴⁹³ Pantazatou (2018).

if the collaborative economy is not regulated and where activities shift from traditional to collaborative economy.⁴⁹⁴

Moreover, issues related to **distortion and state aid may** arise when the collaborative economy pays lower taxes through tax relief measures, special tax regimes, non-payment of social contributions or benefits from competitive advantages over traditional sectors (i.e. transportation and hotel industry).⁴⁹⁵

The interaction of the collaborative economy with the **labour law** is equally important for taxation purposes. Whether workers of an online taxi, car transportation or food delivery mobile app, in which drivers use their own vehicles, are considered employees or self-employed independent contractors is unclear, as is their treatment for tax purposes.⁴⁹⁶ VAT-related issues become increasingly problematic because of the difficulty to define the taxable person in relation to economic activity and income in the collaborative economy.⁴⁹⁷

Possible ways to address tax challenges in the collaborative economy could be awareness raising of tax obligations, cooperating with platforms on compliance issues, collecting tax from the platform and BEPS measures in general concerning MNEs. Moreover, compliance could be enhanced by information exchange and modernisation of the legal framework.⁴⁹⁸

While some are convinced that taxing the collaborative economy could be realised within the existing income tax and capital gains tax laws, others start introducing **tailored regimes**,⁴⁹⁹ sometimes taking advantage of new technologies provided by the collaborative economy to increase tax compliance.⁵⁰⁰ Many EU countries adopted specific measures to foster tax compliance. These include Ireland, the Netherlands, Spain, Belgium, France, the UK, Finland, Italy, Denmark, Slovakia and Hungary.

For example, **Ireland** set up a sharing economy tax centre.⁵⁰¹ In the **Netherlands**, Amsterdam Municipality signed a contract with Airbnb that resulted in Airbnb's collecting the city's tourism tax on behalf of service providers. In a similar way to the Amsterdam Municipality, some US states collaborate with platforms on data reporting on transactions and tax collection, which increases tax compliance.

In **Italy**, a general legal framework targeting the collaborative economy was established that obliges platforms to register. Income earned up to EUR 10,000 within the scope of the collaborative economy must be declared as it will be subject to a 10% withholding tax to be collected by platforms.⁵⁰²

In **France**, a system of voluntary and automatic tax collection is in place since 2015 for Airbnb and other rental platforms, which are required to calculate, collect and remit hotel and occupancy taxes from every booking. In **Spain**, the Catalan government makes hotels and tourist apartments subject to a license fee.

Other countries take radical measures developing new tax reporting tools by making online platforms responsible for information reporting to tax authorities.⁵⁰³ For instance, **Estonia and Lithuania** started a partnership with Uber with the intention to develop new platforms for submitting individual

⁴⁹⁴ Bozdoganoglu (2017).

⁴⁹⁵ Pantazatou (2018).

⁴⁹⁶ ADB Institute (2017) Fair Taxation in the Digital Economy (<https://www.adb.org/sites/default/files/publication/390261/adbi-pb2017-5.pdf>).

⁴⁹⁷ Pantazatou (2018).

⁴⁹⁸ Pantazatou (2018).

⁴⁹⁹ Beretta (2017), p.7.

⁵⁰⁰ Bozdoganoglu (2017).

⁵⁰¹ European Parliamentary Research Service (2018) The collaborative economy and taxation, p. 19.

⁵⁰² Bozdoganoglu (2017).

⁵⁰³ Beretta (2017), p.8.

providers' tax returns electronically. In **Belgium**, digital platforms are also required to send necessary information to tax authorities in the same way employers do for their employees. This allows to reverse the fiscal information stream, as platforms are better suited to do the task.

Australia, on the other hand, is set to tax sharing earnings on an equal footing of other businesses and requires individuals to keep records of income earned by such activities plus any allowable deductions by accurately separating business from personal expenses.

The UK and Canada embarked on developing interactive tools (online calculators and mobile apps) to guide sharing economy users to better report their tax obligations in order to enhance their compliance.

If sharing earnings are sufficiently low, they could be subject to exemptions, as in the case of the UK and Belgium. In the UK, **annual allowances** of 1000 Great Britain Pound (GBP) were introduced for trading and property income of individuals. The former applies to certain income derived from assets or services.⁵⁰⁴ In 2016, **Belgium** set a minimum threshold above which the sharing earnings will be subject to a one-time withholding tax of 20% after the deduction of a 50% lump sum expense, leading to an effective rate of 10%.⁵⁰⁵

The introduction of a withholding tax is encouraged by the OECD for the facilitation of tax collection in the collaborative economy. Yet, they are imposed on gross amounts and could overtax payers if their expenses are significant. Therefore, such taxes are typically imposed on passive income, covering dividends and interests. In the sharing economy the deductions are likely to be low. Hence, it could eliminate the mixed use of assets stemming from the need to apportion personal and business expenses. Another argument in favour of withholding taxes are that they are at a proportional rate and allow for appropriate peer-to-peer lending. Yet, some foreign companies could still be asked to have a PE in a country to act as withholding agents.⁵⁰⁶

7.2. Tax Challenges posed by Blockchain

Cryptocurrencies and Blockchain technology, on which they rely, are reshaping global cross-border financial connectedness and its increasing ability to automate cognitive tasks given their borderless and intangible nature. They are becoming a major source for **economic diversification and growth in the EU** with many EU countries easing their Foreign Direct Investment policies to attract technology companies, including from the US to develop their infrastructure and to drive innovation.⁵⁰⁷ For instance, the EU Blockchain Observatory Forum is advised by a US Blockchain production studio and many EU financial institutions are testing Blockchain technology for financial operations, as it is widely believed that virtual currencies are the future.

At the same time, cryptocurrencies are suspected to **facilitate money laundering, illicit financing, fraud and tax evasion** due to their unique characteristics such as the possibility of peer-to-peer cross-border transfer, anonymity, mining on private phones, and storing in unregulated wallets.⁵⁰⁸

⁵⁰⁴ HM Revenue and Customs (2018) Income Tax: new tax allowance for property and trading income (<https://www.gov.uk/government/publications/income-tax-new-tax-allowance-for-property-and-trading-income/income-tax-new-tax-allowance-for-property-and-trading-income>).

⁵⁰⁵ Loyens&Loeff (2017) Sharing economy – An encouraging framework to get out the fog? (<https://www.loyensloeff.com/nl-nl/news-events/news/sharing-economy-an-encouraging-framework-to-get-out-of-the-fog>).

⁵⁰⁶ Baretta (2017), p.10.

⁵⁰⁷ Ozelli (2018).

⁵⁰⁸ Ozelli (2018), p.3.

The existing rules are not adequate to address new technologies as such, as the question of **whether or not cloud mining or smartphone mining cryptocurrencies would trigger a PE** and give rise to taxation remains unanswered. The same question is valid for cross-border withholding taxes, which may or may not apply to cryptocurrencies.⁵⁰⁹

Cryptocurrencies also pose challenges for the **EU competition policy**, as many players are operating outside the EU, which makes their surveillance on anti-competitive behaviours difficult. In this regard, it is important to note that the EU Anti-Trust Mechanism, which is monitoring crypto-businesses, has no ongoing investigation.⁵¹⁰

One major challenge is the **different classification of cryptocurrencies** as capital assets or property, which could lead to different taxation rules. The UK, for instance, treats virtual currencies, such as Bitcoin, as property. This causes accounting challenges for every day cryptocurrency transactions as each time a purchase is made with the virtual currency, gain or loss has to be recognised. The taxation of cryptocurrency also depends on whether it is held for business or personal purposes.⁵¹¹

Most Member States evaluate Bitcoin exchange under the supply of services stipulated in the VAT Directive and exempt cryptocurrencies from VAT due to lack of a legal definition but **a future G-20 agreement could harmonise their characterisation** for taxation purposes. The EU is working at the G-20 level to regulate cryptocurrencies and to achieve an-EU wide harmonisation on their classification and taxation. The EU's Capital Markets Union and EU's financial single market plans may help fulfilling this goal.

Currently, **cryptocurrencies are regulated differently** in various Member States due to their legal framework, economies and institutional practices. Moreover, tax reporting requirements differ from one country to another regarding cryptoasset disclosure. For example, cryptocurrencies in offline wallets are not expected to be declared in Spain as they are deemed to be located outside of Spain, which differs from legislation in other Member States. In general, a cryptocurrency exchange platform could be considered as a financial institution for CRS purposes to harmonise reporting.⁵¹²

Extending current financial and tax laws to Bitcoin may combat its anonymity, reducing criminal activity and price volatility in the market. It is essential to bring it under the anti-money laundering laws and to provide a uniform classification of Bitcoin as currency.⁵¹³ In this context, the work of the G-20 Financial Action Task Force on AML, concerning cryptoassets to mitigate concerns over security, consumer protection and financial crime, is important and could influence the BEPS framework.⁵¹⁴

The challenge posed to AML rules concerning **fraudulent situations** related to cryptocurrencies⁵¹⁵ could be tackled by establishing a new body to counter money laundering in the EU or giving more competencies to the European Banking Authority to tackle the issue. A diverse approach to cryptoasset categorisation, taxation and reporting at an income tax, VAT and international level among Member

⁵⁰⁹ Ozelli (2018), p.7.

⁵¹⁰ Ozelli (2018), p.4.

⁵¹¹ Forbes (2018) What should you know about taxation of cryptocurrencies? 3 January (<https://www.forbes.com/sites/greatspeculations/2018/01/03/what-you-should-know-about-taxation-of-cryptocurrencies/#3f687d491346>).

⁵¹² Ozelli (2018), p.7.

⁵¹³ Mirjanich (2014).

⁵¹⁴ Ozelli (2018), p.3.

⁵¹⁵ Ozelli (2018), p.4.

States, may add to excessive tax burdens to cross-border cryptoasset transactions that may complicate implementing cross border pan-European Blockchain platforms.⁵¹⁶

Lack of implementation and cooperation in the area of AML is another challenge regarding cryptocurrencies. In response to this, some States are calling for a regulator at the EU level while others prefer to empower already existing EU financial regulators.⁵¹⁷

7.3. Tax Administrations Going Digital

There is a **major shift in the tax enforcement landscape** by new digital tax administration requirements. Tax departments are becoming data managers instead of data consumers, actively handling, managing and evaluating tax-sensitive data as exemplified by Germany's taxonomy project for electronic standardisation of all German book/tax differences, which obliges tax payers to submit a fully standardised tax basis balance sheet and tax income statement (E-Bilanz) in machine-readable format to authorities.⁵¹⁸

Tax departments that are moving ahead with **digital transformation** focus on several key opportunities: Centralisation, data and automation. Centralisation in physical locations (shared service, global business services) or virtual centres of excellence is likely to facilitate tax compliance and help address tax risks, through increased quality, enhanced value, greater transparency and lower costs. Improving data governance, data management and quality is also key to assess gaps and duality issues in current data sources. Automation and AI could reveal many insights and improve tax operations, planning and reporting.

Although it is costly, the **Robotic Process Automation** is an emerging software capability that captures and interprets data from other software applications for the purpose of transaction processing, data manipulation and communication across multiple IT systems.⁵¹⁹ **Open government data** (the publication of machine-readable data by public entities) is becoming the default approach for governments as an effort to ensure that it is available for business, civil society and the public at large.⁵²⁰

New technologies do not only represent challenges but also opportunities for tax administrations, which could **digitalise their operations to ensure tax compliance and enforcement**. This could be achieved in five steps: E-filing (standardised electronic forms for filling tax returns) e-accounting (e-invoices and similar data in an electronic format), e-matching (cross-referencing with accounting, bank and source data), e-auditing (electronic audit assessments) and e-assessment (assessments without tax forms by use of Blockchain technologies etc.)⁵²¹ Yet, the fifth step is only exploited by a small number of countries. Blockchain allows a direct peer-to-peer exchange of value and reduces transaction costs. It keeps records on transparent and immutable ledges accessible to everyone, thus eliminating the risk of fraud.⁵²² Blockchains can reduce tax fraud by 'increasing transparency and integrity, real-time tax administration and tracing'.⁵²³

The potential of digitising tax administration is being exploited by new solutions, such as **SAF-T** in Europe or **real-time invoicing** in Brazil. For compliance and efficiency matters, tax administrations seek

⁵¹⁶ Ozelli (2018), p.8.

⁵¹⁷ Ozelli (2018), p.4.

⁵¹⁸ International Tax Review (2016) Digital Management in International Tax Compliance, pp. 1-2.

⁵¹⁹ Deloitte (2017) Tax compliance in a digital world.

⁵²⁰ PwC (2018) OECD and EC release disparate recommendations on tax and the digitalisation of the economy.

⁵²¹ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

⁵²² Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

⁵²³ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

to gather and analyse information digitally. Digitalisation could also make tax payments easier and less time-consuming.

Blockchain is a promising technology because of its ability to deliver real-time information from many layers to a large audience. Hence, it could be also seen as an opportunity for tax administrations, as its decentralised and democratic order is embedded in 'transparency, accountability and inclusiveness mechanisms'.⁵²⁴ According to WEF, the average expectation is that in 2023-2025 governments could start collecting taxes using Blockchain.⁵²⁵ Payrolls are digitalised in most countries but each government institution involved holds its own register, duplicating data. Blockchain could eliminate this flaw by smart contracts that fully automate the process.⁵²⁶ Blockchain could be also used for transfer pricing, by tracking accounting systems to the transaction level, improving the substance over form approach and providing information to auditors anywhere in a network with trustworthy records. Smart contracts would assist the accounting systems of MNEs to be autonomous and automated.⁵²⁷

The role of **tax professionals** will also undergo a transformation. A new breed of professionals highly skilled in science, technology, engineering and mathematics will emerge to enhance tax operating model strategy and transformation plan.⁵²⁸ Moreover, tax professionals would be also affected by technology, as some of their work, such as preparing tax returns and advisory roles, could be taken over by robotics and AI in the future.⁵²⁹

⁵²⁴ Centre for International Governance Innovation (2017) Blockchains and the G20: Building an Inclusive, Transparent and Accountable Digital Economy.

⁵²⁵ Deloitte (2017) Blockchain technology and its potential in taxes.

⁵²⁶ Deloitte (2017) Blockchain technology and its potential in taxes.

⁵²⁷ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

⁵²⁸ International Tax Review (2017) Combining Technology and Talent for the digital tax future.

⁵²⁹ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.65.

8. IMPACT OF DIGITALISATION ON INDIRECT TAXATION

KEY FINDINGS

- The ever-growing e-commerce based on remote selling poses a threat to indirect tax revenues, as non-residents fall outside the consumption tax system. To address these challenges, the OECD's Action 1 Report recommends that countries apply the principles of the OECD's VAT/GST Guidelines, which allocate the VAT taxing rights to the destination country regarding the digital taxation of e-commerce activities.
- Contrary to the expectations that the implementation of the reverse charge system allowing the market jurisdiction to collect VAT would result in more efficiency in the area of indirect taxation, businesses complain that inconsistent global VAT/GST rules and non-existent double tax agreements in VAT matters contribute to uncertainty, add administrative burdens and increase potential issues of double taxation.
- While many focus on the cost of lost revenues, VAT fraud has significant costs such as 'distorted competition, taxpayer inequity and the funding of organised crime', posing enforcement issues for indirect taxation.
- Traditional value chains are disappearing with the emergence of new technologies, such as 3D printers, collaborative economy and cryptoassets, creating uncertainty on whom the VAT burden would fall, whether a person could be taxed as if he/she was an enterprise, whether or not VAT would be chargeable in peer-to-peer structures involving no identifiable remuneration, which value the VAT would be based on and how it should be charged.
- Several jurisdictions, including the UK, US, China, Saudi Arabia, Kuwait, Israel, Taiwan, Turkey, Australia and Japan started levying VAT taxes to capture services provided over the Internet.
- The current EU VAT system puts EU businesses at a disadvantage, as non-EU suppliers are not obliged to pay VAT while constituting a burden for SMEs. Moreover, tax returns and settlements are calculated over a fixed period and calculations are based on actual transactions but rather arbitrary dates. Therefore, governments have difficulties to track VAT payments, resulting in various forms of fraud. The current system is also criticised for focusing on goods and not keeping up with the increasing services sector in the digital era.
- To address these pitfalls, the EU recently adopted new rules on B2C electronic commerce based on the destination principle, which will enter into force in 2019. On 25 May 2018, the EU published a proposal to amend the VAT Directive by a Definitive VAT System for B2B, applicable in 2022. Accordingly, the cross-border trade of goods will be treated as a 'single taxable supply'; VAT registration will be effectuated through a uniform online portal in any EU Member States; and the seller will charge VAT at the destination state.
- The new VAT rules are expected to cut down fraud, simplify procedures and ensure equal treatment of inter-community and national purchases of goods. While providing a level playing field for e-commerce suppliers, offering simplification and increasing compliance for suppliers and platforms outside the EU, the new rules could adversely affect carriers and postal operators. Yet, the vendor collection model has its weaknesses as reliance on intermediaries could lead to complexity, double-or non-taxation and legal uncertainty.
- Blockchain technology could eliminate administrative burden, conducting transactions real-time by use of smart contracts, reduced risk of fraud due to real time checks and verifications and high speed of money transfer. It could be also used to enhance VAT collection.

Digitalisation is also transforming trade with fast-expanding e-commerce. The value of **digital trade** is estimated to rise to about USD 1 trillion by 2020, reaching one third of all B2C transactions worldwide.⁵³⁰ Historically, VAT was based on the location of supplier as it was assumed that the supplier and customer would be based in the same country. Today, customers can shop online from remotely located suppliers, which **threatens indirect tax revenues and complicates tax collection**, as non-residents fall outside the consumption tax system.⁵³¹ The ever-growing e-commerce based on remote selling and characterised by consumer preferences, the low barrier to enter a market, operational efficiency, and a growing services economy are posing serious tax challenges.⁵³²

8.1. OECD's Response to Indirect Tax Challenges

In the area of indirect taxation, **tax challenges generated by e-commerce** under OECD's Action 1 were summarised as follows:

- **Remote digital supplies** to business in a jurisdiction giving full deduction rights with internal (branch to branch) recharge to an exempt business;
- **Under-declared VAT** on B2C supplies;
- **Understatement of value of low-value imports**; and
- **Inappropriate use of thresholds.**⁵³³

To address these challenges, the OECD's Action 1 Report recommended that countries apply the principles of the **OECD's VAT/GST Guidelines**,⁵³⁴ which allocate the VAT taxing rights to the destination country regarding the digital taxation of e-commerce activities. The guidelines suggest that the supplier registers, collects, and remits VAT according to the rules of the customer jurisdiction.⁵³⁵

As indirect taxes represent a **major source of revenue** for states, authorities agree on the need of a reform to protect tax revenues corresponding to some internal pressure. At the same time, society, NGOs, and lobbies exert external pressure for reform. Unlike corporation tax measures, which were conservative with the objective of preserving the status quo by adopting mainly national and international anti-avoidance measures, addressing the symptoms and not the cause of tax avoidance, such pressures resulted in a bold and innovative approach with regards to VAT. This probably explains the wide acceptance of the OECD's soft law in International VAT/GST Guidelines, which were endorsed by 100 countries.⁵³⁶

In addition, Merkx argues that **BEPS Actions would have a side effect on VAT**, as the changes to the PE status would incline businesses to change their business models, with important implications in the

⁵³⁰ International Centre for Trade and Sustainable Development (2017) Fuelling Trade in the Digital Era: Policy Roadmap for Developing Countries' (https://www.ictsd.org/sites/default/files/research/suominen_fuelling_trade_in_the_digital_era_0.pdf).

⁵³¹ EY (2016) Managing indirect taxes in the digital age 'E-commerce: today's indirect tax challenges' ([https://www.ey.com/Publication/vwLUAssets/ey-indirect-tax-chapter-report-2/\\$FILE/ey-indirect-tax-chapter-report-2.pdf](https://www.ey.com/Publication/vwLUAssets/ey-indirect-tax-chapter-report-2/$FILE/ey-indirect-tax-chapter-report-2.pdf)).

⁵³² KPMG (2016) Comments with respect to the request for input with respect to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

⁵³³ PwC (2014) Options for addressing the tax challenges of the digital economy summarised by OECD.

⁵³⁴ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

⁵³⁵ BBVA Digital Economy Outlook (2016) Tax challenges of the digital economy.

⁵³⁶ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

VAT area regarding the tax amount, reporting and invoicing obligations, place of supply changes, import duties, and import VAT.⁵³⁷

Contrary to the expectations that the implementation of the **reverse charge system**, allowing the market jurisdiction to collect VAT, would result in more efficiency in the area of indirect taxation,⁵³⁸ businesses complain that inconsistent global VAT/GST rules and non-existent double tax agreements in VAT matters (except for the EU Directive) contribute to uncertainty, add administrative burdens, and increase potential issues of double taxation.⁵³⁹

Critics highlight the **discrepancies of the destination principle**, suggesting alternative solutions, such as 'follow the money approach', to align taxes with payments. However, this approach would need a means to determine the location of the consumer.⁵⁴⁰

8.2. Indirect Tax Challenges posed by New Technologies

Traditional transaction chains are disappearing with the emergence of new technologies, such as 3D printers. The final product could be produced at the buyer's premises, even though the design can be made in other places, which makes the **determination of the location of value creation** hard. Questions arise as to where the value is derived from, who owns IP and how to capture the full value of a 3D sale because of the intangible nature of the product.⁵⁴¹

This creates **uncertainty** on whom the VAT burden would fall, whether a person could be taxed as if he/she was an enterprise, whether or not VAT would be chargeable in peer-to-peer structures involving no identifiable remuneration, which value the VAT would be based on, and how it should be charged.

The digital economy also has a huge impact on the methods developed for **VAT fraud**.⁵⁴² While many focus on the cost of lost revenues, VAT fraud has significant costs such as 'distorted competition, taxpayer inequity, and the funding of organised crime', posing enforcement issues for indirect taxation.⁵⁴³

The artificially increased input costs, fake invoices and the possibility to obtain refunds of input VAT in the absence of a compensation with output VAT present **major risks for tax collection**. Sale suppression is another type of fraud affecting VAT on output, which is technology-assisted. For instance, add-on programs automate sales suppression, produce financial report updates by deleting and modifying data, and ensure compliance between purchase records and sale records.

A new French regulation has as an objective to capture this type by use of an **accounting software**, which is unchangeable. Similarly, cash management systems prevent the installation of add-on programs. Yet, even these high-tech regulatory systems can be cracked.

Another issue is the **VAT returns**. A small e-commerce seller could be burdened by a customer returning a good, as the seller would have to pay the full amount including the VAT and could face long delays before receiving a return.

⁵³⁷ Merckx (2017), p.39.

⁵³⁸ Bloomberg Tax (2018), Special Report 'Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation', p. 12.

⁵³⁹ KPMG (2016) Comments with respect to the request for input with respect to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

⁵⁴⁰ Schippers and Verhaeren (2018).

⁵⁴¹ BBVA Digital Economy Outlook (2016) Tax challenges of the digital economy.

⁵⁴² Herbain (2018).

⁵⁴³ BBVA Digital Economy Outlook (2016) Tax challenges of the digital economy.

In addition to cryptocurrencies, the collaborative economy poses VAT challenges for the main reason that it is hard to determine the value of a performance in the absence of a monetary consideration.⁵⁴⁴

Platforms are made more and more responsible for remitting VAT taxes on any fees or commission charged for their intermediation services. When the platform is considered to employ the providers, it faces tax obligations as an employer.⁵⁴⁵ Yet, platforms are not technically ready to collect VAT. Alibaba, Etsy and eBay, for example, do not own or sell goods but merely connect buyers and sellers, which raises doubts about on whom the liability will fall to collect taxes for goods sold on third party marketplaces. Another issue is the difficulty to differentiate between indirect and direct e-commerce cases.⁵⁴⁶

8.3. Indirect Tax Measures targeting the Digital Sector

More and more jurisdictions are levying VAT taxes to capture services provided by an electronic agent, electronic communication or over the Internet, which account for an ever-increasing share of tax revenues. This may be attributed to the **low perception costs** due to the invisible nature of VAT and their relatively easy imposition.⁵⁴⁷ The fact that corporate tax rates are steadily declining, may also lead governments to raise their VAT rates to project their tax revenues. One of the drivers of BEPS was the politician's need to justify why consumers were paying higher VAT rates, while businesses were paying less and less tax while exploiting more and more loopholes.⁵⁴⁸

8.3.1. The UK

In the UK, online marketplaces led to **growth in overseas sellers**, which do not register for VAT, and 'disappear' as soon as they are identified by tax authorities only to return in 'another guise'. In the UK, online retailers are said to be profiting from VAT fraud by ignoring the presence of overseas sellers who sell products into the UK without paying VAT. Failing to prevent the facilitation of both domestic and foreign tax evasion was made a criminal offence in the UK.

The VAT evasion caused by overseas sellers having no PE status in the UK was addressed by new rules introduced by the UK's HMRC. Consequently, **online marketplaces** were made liable for VAT unpaid by UK sellers. All overseas sellers were requested to appoint a UK VAT representative. Requiring online marketplaces to monitor and police their sellers led to a ten-fold increase in VAT registration applications from overseas sellers in 2016.

In 2017, new VAT rules were introduced to oblige sellers to show their **VAT registration numbers** on the online marketplaces they use. Online marketplaces were charged with the responsibility to implement checks on their sellers (checks on the VAT number and the location of the seller as well as previous record of removal from the marketplace) and report if sellers fail to comply with the UK VAT law. Ensuring that marketplaces cannot avoid the tax by changing their legal form temporarily to become the owner of the third-party product and classification as an e-retailer is key.

In addition, **fulfilment houses and warehouses** used by overseas sellers to distribute goods are also expected to play an active role by registering for a new due diligence scheme to ensure VAT was

⁵⁴⁴ Schippers and Verhaeren (2018).

⁵⁴⁵ European Parliamentary Research Service (2018) The collaborative economy and taxation.

⁵⁴⁶ Baumann (2017), pp.10-11.

⁵⁴⁷ Schippers and Verhaeren (2018), p.64.

⁵⁴⁸ BBVA (2016), Digital Economy Outlook, Tax challenges of the digital economy.

properly paid by overseas sellers. Non-compliance by businesses could result in monetary penalties, criminal conviction, and loss of right to trade.⁵⁴⁹

The **collaborative relationship** between the HMRC and online marketplaces could be further enhanced by an agreement showing commitment to tackling VAT evasion to which marketplaces are expected to sign up. The HMRC plans to publish the names of the cooperative marketplaces in a public list.⁵⁵⁰

8.3.2. The US

At present time, Internet sellers in the US have to comply with **a variety of tax collection regimes**⁵⁵¹:

- **Economic nexus models** that impose sales tax collection duties on retailers that rise above a specified sales threshold;
- **Colorado-style notice/reporting regimes** that require retailers to alert customers to their tax liabilities;
- **Marketplace provider provisions** that require Amazon-type sellers to collect sales tax on third-party transactions conducted on their platforms; and
- **Cookie nexus regulations**, which require online vendors to collect state sales tax if they have property interests in or use in-state apps and cookies.

The **Online Marketplace Seller Voluntary Disclosure Initiative** was established in the US to allow third-party marketplace sellers using platforms to collect and remit sales and use taxes in participating states.⁵⁵² To give an example, **Amazon** collects and remits sales taxes in all states that impose one when selling its own inventory but it does not require third-party sellers on its marketplace platform to collect state sales taxes as of 2017. For those sales that make up to about half of the company's volume, Amazon says the third-party vendors bears the collecting responsibility. However, it started collecting sales and use taxes on behalf of third-party sellers in Washington and Pennsylvania⁵⁵³ and will be soon collecting taxes on sales in Minnesota and Rhode Island.⁵⁵⁴

8.3.3. China

In April 2016, China introduced **new regulations to make e-commerce platforms** responsible for collecting indirect taxes from online trades. There are some enforcement issues which China intends to address through changes to both the corporate income tax and VAT. There is a possibility that China adopts a point-of-sale tax collecting system to ensure that when customers buy goods online, the requisite VAT is diverted directly to the tax authority. The country also declared its intention to adopt a revised PE. The import of retail goods through e-commerce will be subject to customs duty, VAT and consumption tax.⁵⁵⁵ To fight the VAT fraud, China adopted the **Golden Tax System**, a central VAT monitoring database of invoice data using encryption technology, which notifies administrations in real-time of transactions between sellers and buyers. Automated authentication of invoices and a centralised invoice matching clearing system allows for the detection of fake invoices and rejection of

⁵⁴⁹ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.22.

⁵⁵⁰ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.23.

⁵⁵¹ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.40.

⁵⁵² Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.43.

⁵⁵³ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.38.

⁵⁵⁴ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.38.

⁵⁵⁵ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

VAT refunds and deduction claims. Within the OECD, China is playing a major role to find consensus in taxation of digital economy in line with the principle of neutrality (traditional and digital economies) and the rest of the Ottawa principles.⁵⁵⁶

8.3.4. Saudi Arabia and Kuwait

Saudi Arabia ratified the **Gulf Cooperation Council VAT framework** and introduced VAT on 1 January 2018 on the basis of the destination principle.⁵⁵⁷

8.3.5. Israel

Non-resident suppliers of digital services that carry out substantial business in Israel must register and account for VAT in Israel.⁵⁵⁸

8.3.6. Taiwan

Taiwan amended its VAT legislation so that **foreign business that supply digital services** (video gaming streaming, image downloads etc.) to Taiwan residents have to register for VAT in Taiwan, file VAT returns and, pay VAT. It is the responsibility of the digital service supplier to collect and remit the VAT.⁵⁵⁹

8.3.7. Turkey

In an attempt to increase its tax revenues, Turkey also introduced an **18 % VAT for digital services** offered to individuals by foreign companies residing abroad as of January 2018.⁵⁶⁰ The extension of the registration requirement for VAT to non-resident digital service suppliers⁵⁶¹ could have potentially disruptive tax treaty implications.⁵⁶²

8.3.8. Australia

Australia has a **goods and services tax of 10%** on the cross-border supply of digital products to Australian consumers, which a non-resident company must register for.

8.3.9. Japan

Japan introduced a **consumption tax on digital services** provided to Japanese services, which operate through a reverse charge mechanism for B2B services. The businesses receiving the digital service have the obligation to pay. Other countries in Asia, such as Korea and New Zealand, also took steps to collect VAT on cross-border digital trade.

⁵⁵⁶ KPMG (2018), OECD Task Force on the Digital Economy release Interim Report.

⁵⁵⁷ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

⁵⁵⁸ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

⁵⁵⁹ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

⁵⁶⁰ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p. 30.

⁵⁶¹ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

⁵⁶² Turina (2018).

8.4. EU Measures in the Area of Indirect Taxation

Unlike the corporate tax, VAT bases are harmonised in the EU. 0.3% is levied on each Member States' VAT base (apart from Germany, Sweden and Netherlands which provide some funding for the EU), which goes to the EU's own resources. The new EU budget called for a more streamlined system with higher transparency and accountability.⁵⁶³

The EU introduced a **simplified compliance regime** in 2015, following the OECD recommendations, which resulted in an excess of EUR 3 billion.⁵⁶⁴ Certain telecommunications, broadcasting and electronically supplied services are taxed according to the destination principle, where the customer is located. The MOSS (Mini One-Stop-Shop) allows such suppliers to register in one jurisdiction thereby obviating the need to register for VAT in each Member State in which it has customers.

In December 2016, a proposal on a **reverse charge mechanism** was put forward by the Commission to fight against non-remitted VAT by operators, making the purchaser remit to the authorities. Yet, an agreement has not yet been reached in the Council.⁵⁶⁵

The European Commission is in the process of reforming the VAT system following the VAT Action Plan of 7 April 2016.⁵⁶⁶ The **new definitive single EU VAT area** will be based on four cornerstones: Tackling fraud, One-Stop-Shop, greater consistency and less red tape.⁵⁶⁷

The Commission aims at modernising VAT for cross-border B2C e-commerce, including the extension of the MOSS regime. The Commission created a VAT portal, a simplified tool for VAT compliance that enables the collection of VAT in the state of the final consumer, which will be implemented in 2018-2021.⁵⁶⁸ As of 2021, the **MOSS regime will be extended** to cover intra-Community sales of goods to non-taxable persons. The deadline for submitting VAT returns will be extended and corrections will be possible in subsequent returns.

On 5 December 2017, **the EU adopted new rules on B2C electronic commerce**, which will enter into force in 2019. Accordingly, taxpayers are expected to collect and remit in the country of destination. As of 2019, simplifications for sales of digital services to consumers will be made as businesses having a turnover below EUR 10,000 would be able to pay their VAT at the country of origin. A second measure will apply to EU suppliers with a turnover below EUR 100,000, which will be able to provide only one piece of evidence instead of two to determine the location of the consumer. Non-EU suppliers with EU VAT will be able to use a non-Union scheme, where home country rules could be used for invoicing.⁵⁶⁹

EU **distance sales thresholds** of EUR 35,000 or EUR 100,000 are going to be replaced by a Community annual threshold of EUR 10,000. Over this threshold, taxation will be made at the destination rate.

⁵⁶³ Bloomberg Tax Special Report (2018) Taxing Digital Companies: Challenges for Multinationals Amid Emerging Regulation, p.26.

⁵⁶⁴ OECD Interim Report (2018) Tax Challenges Arising from Digitalisation.

⁵⁶⁵ European Council (2018) VAT reverse charge mechanism: preventing VAT fraud, 17 July. (<http://www.consilium.europa.eu/en/policies/vat-reverse-charge/>).

⁵⁶⁶ European Commission (2016) Action Plan on VAT (https://ec.europa.eu/taxation_customs/business/vat/action-plan-vat_en).

⁵⁶⁷ European Commission Press Release (2017) European Commission proposes far-reaching reform of the EU VAT system. 4 October. (http://europa.eu/rapid/press-release_IP-17-3443_en.htm).

⁵⁶⁸ Asia Internet Coalition (2017) Indirect Taxation Challenges in the Digital Economy, June.

⁵⁶⁹ European Commission COM (2018) 329 final. Proposal for a Council Directive amending Directive 2006/112/EC as regards the introduction of the detailed technical measures for the operation of the definitive VAT system for the taxation of trade between Member States. 25.5.2018 (https://ec.europa.eu/taxation_customs/sites/taxation/files/25_05_2018_proposal_on_detailed_technical_measures_for_the_operation_of_the_definitive_vat_system_en.pdf).

In the case of imported goods with a value exceeding EUR 150 a full customs declaration will be required. Marketplaces, facilitating the sale of distant goods will be liable for VAT, while being recognised as commissionaires, who bought and now are selling products on their platform.⁵⁷⁰

On 25 May 2018, the EU published a proposal to amend the VAT Directive by a **Definitive VAT system for B2B**, applicable in 2022. The cross-border trade of goods will be treated as a 'single taxable supply' and VAT registration will be effectuated through a uniform online portal in any EU Member State. The seller will charge VAT at the destination state.⁵⁷¹

8.4.1. Evaluation of the New VAT Measures in the EU

Under the present system, goods are split into two transactions, which are both reported by the purchaser: A VAT-exempt sale in the country of origin and taxed purchase in the country of destination. This puts EU businesses at a disadvantage, as non-EU suppliers are not obliged to pay VAT. Moreover, it puts an additional burden on SMEs. On the other hand, tax returns and settlements are calculated over a fixed period and calculations are based on actual transactions but rather arbitrary dates. Therefore, governments have difficulties to track VAT payments, resulting in Missing Trader Intra-Community Fraud (MTIC), Missing Trader Extra-Community Fraud (MTEC) and carousel fraud.⁵⁷² The current system is also criticised for focusing on goods and not keeping up with the increasing services sector in the digital era. In addition, some see the EU's VAT system as an impediment to national solutions, as common rules on VAT have to be followed.⁵⁷³

The amendments to the EU VAT Directive proposed on 25 May 2018, based on the destination principle, reverse charge mechanism and deeming provision, where the supplier acts on behalf of the initial supplier of services for taxation purposes,⁵⁷⁴ are expected to cut down fraud, simplify procedures and ensure equal treatment of inter-community and national purchases of goods⁵⁷⁵ by eliminating VAT exemptions in intra-Union cross-border trade.⁵⁷⁶ On the downside, the new rules could adversely affect carriers and postal operators. Some double taxation concerns have been voiced, especially regarding the cases, where non-EU suppliers comply with the new rules for remote sales from outside the EU without applying OSS, in which case, they could pay both for import VAT and VAT on distance sales.⁵⁷⁷

Possible difficulties regarding the proposed B2B provisions include customers not having a VAT number, who could be treated as private customers not being subject to taxation. Besides, there is no real-time verification of EU VAT numbers, except for the VAT Information Exchange System (VIES), which is seen as insufficient and thus could give way to legal uncertainty. Moreover, customers self-declaring their location could end up having multiple locations. On the other hand, the deeming provision, established by the concept of the 'Certified Taxable Person' can be rebutted when the initial

⁵⁷⁰ KPMG Tax and Legal News (2017) New EU VAT System for the Digital Economy as of 2019 and 2021 (<https://blog.kpmg.ch/tax-legal-news/new-eu-vat-system-digital-economy-2019-2021/>).

⁵⁷¹ KPMG (2018) VAT: EU update including definitive VAT system and e-publications (<https://home.kpmg.com/uk/en/home/insights/2018/06/tmd-vat-eu-update-including-definitive-vat-system-and-e-publications.html>).

⁵⁷² Deloitte (2017) Blockchain technology and its potential in taxes.

⁵⁷³ BBVA Digital Economy Outlook (2016) Tax challenges of the digital economy.

⁵⁷⁴ Lamensch (2018) ([https://www.wfr.uni.lu/content/download/108620/1284581/file/Tax%20and%20the%20Digital%20Economy_Slides_20180420%20\(downsampled\).pdf](https://www.wfr.uni.lu/content/download/108620/1284581/file/Tax%20and%20the%20Digital%20Economy_Slides_20180420%20(downsampled).pdf), p.101).

⁵⁷⁵ Lexology (2018) New EU-VAT system for the trade of goods by 2022? (<https://www.lexology.com/library/detail.aspx?g=2de24431-1595-4ade-ad0f-51494ffe57c3>).

⁵⁷⁶ Deloitte (2018) European Commission issues detailed technical proposal for the definitive VAT system (<https://www2.deloitte.com/nl/nl/pages/tax/articles/european-commission-issues-detailed-technical-proposal-for-the-definitive-vat-system.html>).

⁵⁷⁷ EY (2018) New EU VAT rules simplify VAT for e-commerce (<https://www.ey.com/gl/en/services/tax/international-tax/alert--new-eu-vat-rules-simplify-vat-for-e-commerce>).

service provider is explicitly declared as the supplier by the taxable person taking part in the supply by contracts.⁵⁷⁸

When it comes to the **responsibility to collect taxes** with the seller, it shall be considered that the vendor collection model has its weaknesses as reliance on intermediaries could lead to complexity, double-or non-taxation and legal uncertainty. It remains to be seen whether the EU VAT system is ready for such a drastic change in the short-and long term.⁵⁷⁹ Alternative ways, such as turning to the customer, who is within jurisdictional reach, could also be considered but like vendor collection models, customer collection models have their shortcomings.⁵⁸⁰

Another option could be **real-time securing of VAT**, known as split payment mechanism, where the VAT is invoiced by the supplier but paid by the recipient of the invoice in B2C type businesses. It uses technology to identify and collect any VAT due and could be even coordinated with an automated system using Blockchain. Such an automated system of auditing in real-time would permit to cross-check VAT audits at each level of the goods lifecycles and a rapid detection of VAT leakages. Yet, it is costly for businesses and authorities.

Negotiations are ongoing in the Council on a **reverse charge mechanism**, under which VAT is remitted to the tax authorities by the purchaser. Reservations are manifold regarding such a measure, as it implies moving away from the traditional VAT system and departing from a fractional payment. In any event, as the consumers could be hardly relied on for self-assessing and remitting, the changes would likely be restricted to B2B situations.

Past attempts to improve the VAT system through intra-Community transaction reporting, cooperation between Member States and destination regime to ensure fair and comprehensive taxation are seen as a failure by some, who highlight the emergence of a digital strategy seeking for **technology-based solutions**.⁵⁸¹ With the new technologies, one is likely to see the proliferation of SMEs 'born global' rather than requiring the traditional path from local to global reach. The tax landscape shall adapt accordingly.⁵⁸²

In the EU, average VAT **compliance cost** was on average EUR 8000 per market, which causes a big burden for SMEs. Hence, policy regarding VAT should focus on low compliance costs in addition to minimum sales exemption threshold, fast, cost-effective and data-driven VAT systems, involvement of industry to avoid burdens and market distortions all by promoting free flow of data across borders to enable digital trade to flourish and local SMEs to benefit from global marketplace.⁵⁸³

Blockchain technology could eliminate administrative burden, conducting transactions real-time by use of smart contracts, reduced risk of fraud due to real time checks and verifications, and high speed of money transfer.⁵⁸⁴ It could be also used to enhance VAT collection. In Brazil, for instance, electronic invoices are mandatory and are received by tax authorities in real-time. European countries, such as

⁵⁷⁸ Lamensch (2018)

([https://www.fr.uni.lu/content/download/108620/1284581/file/Tax%20and%20the%20Digital%20Economy_Slides_20180420%20\(dow nsampled\).pdf](https://www.fr.uni.lu/content/download/108620/1284581/file/Tax%20and%20the%20Digital%20Economy_Slides_20180420%20(dow nsampled).pdf), p.101).

⁵⁷⁹ Deloitte (2018) European Commission issues detailed technical proposal for definitive VAT system

(<https://www2.deloitte.com/content/dam/Deloitte/be/Documents/tax/TaxAlerts/VATAlerts/VAT%20Alert%20-%20European%20Commission%20issues%20detailed%20technical%20proposal%20for%20t...pdf>).

⁵⁸⁰ Herbain (2018).

⁵⁸¹ Herbain (2018).

⁵⁸² KPMG (2016) Comments with respect to the request for input with respect to the series of questions related to the BEPS Action 1 report on Addressing the Tax Challenges of Digital Economy (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

⁵⁸³ Asia Internet Coalition (2017) Indirect Taxation Challenges in the Digital Economy, June.

⁵⁸⁴ Deloitte (2017) Blockchain technology and its potential in taxes.

Hungary, also decided to use real-time reporting solutions starting this year. Poland is also planning to produce electronic reporting based on the OECD's Standard Audit File for Tax (SAF-T).

The Digital Invoice Customs Exchange was designed to facilitate the EU to reform its VAT Information Exchange System by allowing for an automated and immediate exchange of invoice data. Digital signatures are placed on e-invoices and encrypted data is submitted to databases that match transactions. Customs exchange is the second element of the system. Some believe that **Blockchain could be a better option**, as taxes are reliant on centrally based ledgers on both domestic and EU level.

As VAT is prone to **fraud**, Blockchain could be the solution to VAT problems with its real-time and consensus-based mechanism prior to issuing an invoice. There would be a ledger for every traded good and service and verified transactions would be added to the Blockchain irrevocably.⁵⁸⁵ However, with the CbCR becoming available by tax administrations,⁵⁸⁶ such a decentralisation would create a disadvantage, as data possessed by governments are sensitive and obstacles could be presented due to data privacy, protection and security.⁵⁸⁷ The lack of intermediary or key master is also a source of concern because of the threat that a user could be permanently locked out of the network if he/she loses his/her private key. Finally, the right to be forgotten is not possible as deletion is not an option in Blockchain technology.⁵⁸⁸

A good example to the fight against tax fraud is **China's Golden Tax System**. This central VAT monitoring database of invoice data uses encryption technology, notifying administrations in real-time of transactions between sellers and buyers. Such technology-focused policy options could be considered in the EU notwithstanding the fact that the system does not produce a solution for VAT missing on output or invoices containing misleading information. An anti-VAT fraud European Public Prosecutor's Office, which will be in operation this year, could further investigate and prosecute criminal cases affecting the EU budget, such as cross-border VAT fraud.⁵⁸⁹

⁵⁸⁵ Deloitte (2017) Blockchain technology and its potential in taxes.

⁵⁸⁶ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

⁵⁸⁷ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

⁵⁸⁸ Committee of Experts on International Cooperation in Tax Matters (2017) Tax Challenges in the Digitalised Economy.

⁵⁸⁹ Herbain (2018).

9. CONCLUSIONS AND POLICY RECOMMENDATIONS

Rapid digitalisation of the economy, new business models and the challenges they pose to the international tax system

The digital economy is **expanding at a tremendous pace** while the **entire economy is being digitalised**. The scale of and pace of digitalisation coupled with aggressive tax planning schemes to shift profits to low-tax jurisdictions by Multinational Enterprises (MNEs), which was put under the spotlight by Luxembourg Leaks (LuxLeaks), Panama Leaks and Paradise Papers, is putting pressure on tax administrations to ensure fair taxation.

Only after some 20 years of their inception, the **ever-increasing prominence of tech companies** is unstoppable. **Business models are rapidly evolving** and new business models are emerging due to Internet of Things (IoT), Artificial Intelligence (AI), collaborative economy and other technological advancements. With many established digital companies having multiple business lines, the differentiation between multi-sided platforms and other digitalised businesses becomes challenging. Moreover, some traditional industries, such as automotive manufacturing, have begun to digitise their processes and services.

With the **digital goods being highly mobile or intangible**, the physical presence of a company in the market country is often not needed, which is at odds with the outdated international tax system based on the condition of a connecting link to assert jurisdiction for taxation purposes.

With digitalisation allowing businesses activities to spread across the globe, it is more and more **complex to identify the location of value creation** and to decide on how to allocate profits. With the concept of headquarters becoming 'meaningless', digitalisation exacerbates many problems in the existing system – real economic distortions, profit shifting, complexity and competition.⁵⁹⁰ Moreover, the new business models are constantly changing, making it difficult to separate the digital economy from the rest of the economy.

In addition to globalisation, '**environmental unsustainability, demographic change, inequality and political uncertainty**' may all be relevant to thoroughly address digital transformation.⁵⁹¹

Tax competition and the ensuing race to the bottom also contributes to inequality. According to Oxfam, 62 people own the same wealth as the bottom 3,6 billion people in the world. Over the last thirty years, net profits by the MNEs tripled from USD 2 trillion in 1980 to USD 7.2 trillion by 2013. This increase shall be properly reflected in the amount of taxes they pay instead of being accumulated in tax havens.⁵⁹²

While the **effects of some BEPS measures** (as well as US tax reform having unclear implications on MNE behaviour and the implementation of ATAD measures) remain to be seen, appropriate policy solutions need to be considered to address acute tax challenges given the exponentially expanding digital world. Soon, a fully digital world disrupting some fundamental assumptions of the international tax system could emerge.⁵⁹³ The Blockchain technology, collaborative economy, AI, robotics and 3D printing started already changing the taxation landscape.

The current PE threshold is not sufficient for fair allocation of profits. The **unilateral measures** in countries such as France, Italy, Israel, India, as well as at the EU level show a search for a **new nexus** to

⁵⁹⁰ Devereux and Vella (2018).

⁵⁹¹ PwC (2018) European Commission Proposals for Directives regarding fair taxation of the digital economy ("Digital Tax Package").

⁵⁹² Oxfam Policy Paper Summary (2016) Tax Battles: The dangerous global race to the bottom on corporate tax.

⁵⁹³ OECD Observer (2017), Tax Challenges, disruption and digital economy, p. 3.

capture companies with a solely digital presence. **Developing countries**, such as India, argue that paying capacity of the consumer is made possible due to the state's contribution via public goods, law, order, market facilitation, infrastructure and redistribution.⁵⁹⁴ Following such pleas, the UN already developed new nexus rules on service fees (justifying withholding taxes),⁵⁹⁵ which substantially diverge from the OECD rules. New taxes, such as equalisation levies and VAT measures targeting the digital sector were introduced in many countries, not to mention taxes in the form of Diverted Profit Tax, specifically targeting large MNEs. At the EU level, state aid measures were widely used against aggressive tax planning schemes of the MNEs.

The reluctant states might eventually agree **to limitations to their fiscal sovereignty** in favour of globally accepted standards,⁵⁹⁶ as digitalisation limits their legitimacy and ability to tax.⁵⁹⁷ Global taxes, such as passenger levy on airline tickets and emission taxes are feasible.⁵⁹⁸ 'A complex decision-making structure which embodies widely divergent interests and realities' may be a better way to cope with constantly changing conditions and to develop a more global tax policy through transparency, linkage and inclusivity than the centralised approach.⁵⁹⁹

Multilateralism as a 'new tax principle' could be the response to the global solutions needed given the fact that unilateral measures proved insufficient to stop double non-taxation. Answers to the long-debated source vs. residence dilemma could emerge in time from the 'messy process through which countries have always resolved fiscal conflicts', either through conflict or cooperation.⁶⁰⁰

OECD's BEPS Measures and the Ambition to Reach International Consensus on Key Taxation Matters

The **OECD supports the principle of aligning the application of tax rules with the legal form** unless the legal reality is totally disconnected from the economic reality. BEPS reduced but did not eliminate profit shifting. Moreover, post-BEPS MNEs' tax planning activities will likely continue if they don't have a local presence or they use intra-group transactions to exploit differences in tax rates. Companies will still be able to move their real activities in response to tax rates, thus distorting real economic activity. The broader tax challenges, including nexus, characterisation and data, also largely remain unaddressed.

The **minimum standards** of the OECD, such as Action 5, are considered to have some success despite their soft law nature but the most relevant OECD measures to the digital economy, such as Action 7, Action 8-10 and Action 3 seem to have failed to address the 'troika of threshold requirement, separate legal entity principle and attribution of profit' to reach a coherent and globally acceptable solution. While probably limiting worst excesses of the profit shifting and increasing transparency requirements, greater complexity was introduced by BEPS measures. It might even worsen economic distortion and tax competition, if MNEs decide to relocate their real activities to low-tax jurisdictions, for example in response to the new Transfer Pricing Guidelines.⁶⁰¹

⁵⁹⁴ Singh (2017).

⁵⁹⁵ Jones, Seabrook, Sciliberto and Jones (2018) (<https://www.eversheds-sutherland.com/documents/services/taxation/tax-digital-economy-020318.pdf>).

⁵⁹⁶ Hidalgo (2017), p. 720

⁵⁹⁷ Ismer and Jescheck (2017).

⁵⁹⁸ Bird (2018).

⁵⁹⁹ Ismer and Jescheck (2017).

⁶⁰⁰ Ismer and Jescheck (2017).

⁶⁰¹ Avi-Yonah (2016).

It remains unclear whether there is **consensus** at the OECD level whether the digital economy should and can be ring-fenced or not. Another issue at the heart of the debate is whether reform should address specific problems raised by certain digital business models (as favoured by the EU) or whether it should seek to address the fundamental problems faced by the system as a whole and which have been exacerbated by digitalisation.

The lack of consensus on **value creation** leads to a multitude of profit allocation methods, which somewhat diverge from the arm's length principle. The destination-based formulary apportionment and other destination taxes, such as sales-based formulary apportionment, residual profit sales and Destination Based Cash Flow Tax are being put forward to reform the existing tax system in a more fundamental manner.

Global solutions at the OECD level would be preferable but it is doubtful whether consensus will be reached on nexus and profit allocation rules by 2020. If OECD fails to address the issue in time, it might lose its role as a standard setting body.⁶⁰² A multitude of uncoordinated and complex unilateral rules are harbingers of the fragmentation of international tax rules. While both the EU and the US are recognising the need to change the international tax system, the former supports a targeted change while the latter is in favour of a system-wide change. Yet, commentators say that there is still room for optimism to find a common ground as 'the US is not as capital-export biased as half a century ago and self-interest would dictate an active participation in development of new standards'.⁶⁰³

Possible scenarios for taxing the digital economy and the fate of the EU's Digital Services Tax proposal

Possible scenarios for taxing the digital economy include specific taxes for the digital sector, to continue work on BEPS measures, especially regarding transfer pricing and value creation by amending the PE concept, granting more power to source countries via withholding taxes, radically changing the tax system by adopting a destination-based tax and integrating the digital sector in a formula-based transfer pricing regime, a formulary apportionment regime such as profit-splitting method⁶⁰⁴ or robust VAT measures to ensure compliance and collection.

The destination based-tax has its appeal with a promise to eliminate BEPS and to address the broader issues faced by the existing system by focusing on immobile factors. However, such alternative approaches as well as new taxes with no available tax credits on digital services create the risk of double taxation in the absence of full global coordination.⁶⁰⁵ According to Dourado, the OECD's insistence on taking 'user value creation' as a condition for expanding taxation to source jurisdictions sends a message that a generalised destination-based tax is hardly acceptable in the Inclusive Framework for the time being.⁶⁰⁶

Business circles, practitioners and academics fiercely criticised the **EU's digital tax proposal** as 'populist and flawed', highlighting the problems that this would cause for loss-making businesses, the possible deterrent effect it would have on start-ups, the risk of double taxation, potential retaliation of third countries, as well as technical difficulties, such as identification of the user location.

EU Member States are divided over digital taxation, as their tax policies differ due to diverse national interests and varying levels of technological advancements. The lack of unanimity leads the

⁶⁰² Eisenboss (2016).

⁶⁰³ Eisenbeiss (2016).

⁶⁰⁴ Dourado (2018), pp. 565-566.

⁶⁰⁵ Ismer and Jescheck (2017).

⁶⁰⁶ Dourado (2018), p. 568

Commission to seek for alternative ways, such as informal pressure, Quality Majority Voting (QMV) and enhanced cooperation.

The consequences of the EU's proposal to introduce a Digital Services Tax are unclear: It may put some pressure to reach agreement in the international arena or could lead to retaliatory unilateral measures, for example, by the US. At the same time, policymakers shall be aware of the fact that unilateral measures, even at a regional level, could hamper international efforts, risking to trigger a tax trade war. Such temporary measures are generally known to stay in place. One such example is the UK's Corporate Income Tax (CIT), which was introduced as an interim measure during the Napoleonic Wars and became permanent until present day. **The proposed long-term solution** has also several weaknesses, including its vagueness and complexity, and its adoption is far from guaranteed, as it would necessitate some 2000 tax treaty changes.

A balanced approach is needed not to harm growth and technological advancement in the EU by alienating digital firms and to provide legal clarity.⁶⁰⁷ Better coordination, creativity, and an inclusive framework would help the EU and its Member States tackling taxation challenges in a digitalised world.

Also, the inclusion of the virtual PE in the CCCTB proposal could be seriously considered despite some reservations regarding such formulary apportionment methods.

⁶⁰⁷ International Tax Review (2017) Combining Technology and Talent for the digital tax future.

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This paper was prepared by Policy Department A at the request of the Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3) to discuss tax challenges posed by digitalisation, especially regarding new business models and value creation process, the impact of Base Erosion and Profit Shifting (BEPS) actions, unilateral measures and recent tax developments in the European Union (EU) and the United States (US) while evaluating alternative approaches to reform the international tax system and highlighting difficulties and opportunities presented by Blockchain and collaborative economy for international taxation.

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