Multilateral provisions against tax avoidance in digital business Thiago Barisson de Mello Oliveira

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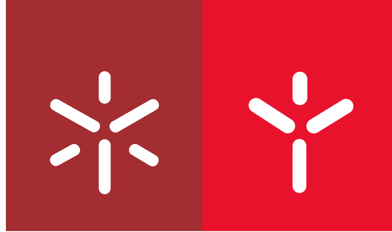

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Multilateral provisions against tax avoidance in digital business

Dissertação de Mestrado
Mestrado em Direito dos Negócios Europeu e Transnacional

Trabalho efetuado sob a orientação do
Professor Doutor João Sérgio Ribeiro

junho de 2020

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ACKNOWLEDGEMENTS

I would like to express my gratitude to my supervisor, Professor Dr. João Sérgio Ribeiro, who guided me throughout this project, with patience and care. Any mistake is my only fault.

Thank you also for the Professors of School of Law University Minho, by sharing their knowledge with me.

I wish to acknowledge the help provided by the technical and support staff in the School of Law University Minho. They kindly helped me in many occasions.

I would like to thank Robyn Freiheit, for the final grammatical revision made from the perspective of a native speaker.

Thank you to my classmates, whose friendship and enthusiastic debates offered me deep insight into the study.

Finally, I could not engage in this endeavour without the unconditional support of my family, Patrícia and Saulo. Their love allowed me to do my best in this research.

STATEMENT OF INTEGRITY

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Multilateral provisions against tax avoidance in digital business

ABSTRACT

Digitalisation of the economy is an extremely important issue. It generates reflexes in several fields of law, with tax law being one of the most affected. With the prevalence of intangible assets, the physical presence of a business is often no longer essential. This makes the traditional criteria of stable establishment no longer effective. In light of this, the OECD and other international organisations have been discussing ways to reform the general international taxation rules to cover new businesses. The present work aims to analyse the main points of failure in tax legislation, tax avoidance practices via the digital economy and the central aspects of the OECD and European Union proposals to reverse the erosion of the tax base.

Keywords: Digital Economy; Digital Service Tax; Digital Taxation; International Tax Law.

Provisões Multilaterais contra Elisão Fiscal em Negócios Digitais

RESUMO

A digitalização da economia é um tema de suma importância. Ela gera reflexos em vários campos do direito, sendo o direito tributário um dos mais afetados. Com a prevalência de ativos intangíveis, a presença física de um negócio muitas vezes deixa de ser essencial. Isso faz com que os critérios tradicionais de estabelecimento estável não sejam mais efetivos. Diante disso, a OCDE e outros organismos internacionais vêm discutindo formas de reformar as regras gerais de tributação internacionais abarcando os novos negócios. O presente trabalho visa analisar os principais pontos de falha na legislação tributária, as práticas de elisão fiscal via economia digital e os aspectos centrais das propostas da OCDE e da União Europeia para reverter a erosão da base tributária.

Palavras-chave: Direito Tributário Internacional; Economia digital; Imposto de Serviço Digital; Tributação digital.

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LIST OF ABBREVIATIONS

AG – Advocate General

AI – Artificial Intelligence

ATAD – Anti-Tax Avoidance Directive

BEPS – Base Erosion and Profit Shifting

B2B – Business-to-Business

B2C – Business-to-Consumer

CBCR – Country-by-country reporting

CCCTB – Common Consolidated Corporate Tax Base

CFC – Controlled Foreign Company

CIT – Corporate Income Tax

CJEU – European Union Court of Justice

COVID-19 – Corona Virus Disease 2019

CNY – Chinese Yuan

DBCFT – Destination-Based Cash Flow Tax

DPT –Diverted Profit Tax

DST – Digital Service Tax

DTCs – Double tax conventions

EBITDA – Earnings before Interest, Taxes, Depreciation and Amortization

EC – European Commission

E-Commerce – Electronic Commerce

E-tailor – Electronic Tailor

ETR – effective tax rate

EU – European Union

GAFA – Google, Amazon, Facebook, Apple

GILTI – Global Intangible Low Tax Income

GloBE –Global anti-base erosion

GST – Goods and Services tax

G20 – Group of Twenty

HMRC – Her Majesty's Revenue and Customs

ICT – Information and Communication Technologies

IMF – International Monetary Fund

IoT – Internet of Things

IPR – Intellectual Property Rights

MLI – Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

MNE – Multinational Enterprise

M2M – Machine-to-machine

OECD – Organisation for Economic Co-operation and Development

PE – Permanent Establishment

PPT – principle purpose test

R&D – Research & Development

TFDE – Task Force on the Digital Economy

TFEU – Treaty on the Functioning of the European Union

UK – United Kingdom

USA – United States of America

VAT – Value Added Tax

WTO – World Trade Organization

INTRODUCTION

The object of this thesis is the current challenge in dealing with direct taxation caused by the digitalisation of the economy. New economic models allow for aggressive tax planning and tax avoidance practices, both due profit changing practices and low harmonisation in tax legislation.

The developments in international direct taxation are mainly within Organisation for Economic Co-operation and Development's (OECD) recent reports and propositions. Since 2015, OECD Base Erosion and Profit Shifting (BEPS) Project has been ongoing, presenting multilateral solutions for the matter. However, up until now, there has been no consensus and many countries are now facing a declared tax war in digital taxation.

Considering an analytical and critical perspective, the scope of the research will be focused in direct taxation from multinational entities (MNEs) with heavy reliance on intangibles. The discussion excludes deeper considerations regarding indirect taxation (GST[1], VAT[2] and other indirect taxes) and other domestic solutions for digital taxation. This limitation is justified by two reasons: direct taxation remains much less developed in legal terms, when compared with consumption taxes; and unilateral digital taxes are usually provisory solutions, as regarded by their taxing entities.

The relevance of this subject derives from acknowledging that digital economy has been changing our lives, due to the internet revolutionising social relations through the exponential use of telecommunications. The technological changes in the XXI century are countless, having a particular impact on how society is organised nowadays. New technologies have generated significant changes in the processes of wealth production, changing the way the market is understood. In this sense, business models are rapidly evolving and new practices are emerging due to Internet of Thing (IoT), Artificial Intelligence (AI), Blockchain, collaborative economy and other technological improvements.

As the digital economy allows for new ways of doing business, such transformation undermines the relevance of physical presence. Traditional brick and mortar businesses are no longer the main way for doing business by multinational corporations, whereas, in the global economy, there can be many kinds of scale market activities with low investment. Using technology, even for a small business, can now provide goods and services worldwide, without the high costs of expansion in overcoming

[1] Goods and Services Tax.
[2] Value Added Tax.

international borders. The world economy now deals with new technologies and high-skill jobs for value creation. These shifts generate a massive increase of volumes of data gathered from digital platforms, sensors and smart phones, accompanied by increasing storage capacity, stronger computing power and more sophisticated algorithms[3].

The digital transformation in the economy is putting into question the existing taxation framework. All of those new features cause difficulties for tax authorities, and favour for more elaborated tax planning, sometimes disrespecting legal limits. One typical example is an investor that changes his or her operational basis in order to cut costs, with the sole intent to circumvent taxation. As consequence, state revenue tends to decrease while traditional brick and mortar businesses lose market share day by day. Such economic scenarios raise concerns among the public, because it may cause the reduction of jobs in the work force or stores closures, and certain economic sectors could retract due the borderless competition that they have to deal with.

The main target of the new digital taxes are the so-called "tech giants". These technological MNEs use practices of aggressive tax planning such as hybrid mismatching, treaty abuse, artificial permanent establishment (PE) and treaty shopping, among others available strategies to low the tax paid. In this sense, this thesis will analyse the international concept of tax avoidance, and whether the MNE's practices are tax avoidance themselves.

Many of these sophisticated arrangements consist in moving the MNE's headquarters to low-tax jurisdictions. For instance, sometimes companies creates subsidiaries to where they send the taxable incomes, leaving to the incorporated ones in large economies a marginal profit rate, barely being taxed in the end. In addition, even small and middle-sized tech companies are more capable today to act in scale business, due to the technology available. In this sense, accountability automation allows majority of digitalised businesses to gain advantages in international tax avoidance schemes.

Although these technology companies did not invent aggressive tax arrangements themselves, they have been recognised as been part of MNEs policies since the first transactions between certain groups of companies. Nevertheless, the tech MNEs use those tax arrangements exponentially, causing tax losses wherever they act. In perspective, they are imitating traditional MNEs arrangements, but performing in a generalized form, having a much bigger impact in local economies.

[3] 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 and shopping habits); Submitted data entered by a user through a search engine; and inferred data compiled by pooling together data strands from a variety of sources (HADZHIEVA, Impact of Digitalisation on International Tax Matters, Study for the Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg, 2019, p. 22).

Notwithstanding, the advancements in the international taxation of digital economy remain in the early stages, leaving a large field for aggressive tax planning in the digital economy. In spite of this, governments have successively been reporting tax avoidance practices in digital businesses, pointing out that big tech companies paid marginal tax rates, if compared to traditional businesses. As the latter do not have the mobility of a digital business, they end up suffering with some kind of *unfair* competition.

As a reaction to the problems of revenue loss, the public opinion looks for solutions by their representatives, which may be compelled to create remedies in order to rebalance the social structures. Usually, these remedies are brought in the form of new taxes addressing specifically intangible assets, as a way to counterbalance the strength of the digital economy. The official solution proposed by authorities is to adopt anti avoidance measures, limiting the improper use of tax law conventions, constraining tax avoidance and tax evasion. These specific anti-avoidance measures are the core object of this research, encompassing policies directly driven to taxation of digital business, whether national or internationally. In any case, the progress made in international taxation still does not yet cover the frame of the digital economy. Taking in consideration that many established digital companies have multiple business lines divided internationally, the differentiation between multi-sided platforms and other digitalised businesses becomes challenging.

A second issue arises from the extensive use of data and user-generated content, which is particularly relevant for multi-sided businesses. It leads to question whether the users of big data contribute or not to value creation, by providing their personal information to platforms in exchange for free access. If so, such exchange should be taxed.

In sum, the identification of taxable events is a paramount aspect in taxing the intangible assets, and a more thorough legal conceptualisation is necessary in order to go along with technology developments.

Foremost it is necessary to diagnose the core questions involving digital taxation, as following. What is and what is not a digital business? What is considered digital for tax purposes? How to tax intangibles effectively? Which metric must be applied in taxing digital businesses? Is there real tax avoidance in digital businesses, considering international standards? Is there a real base erosion in state's revenue? What is the current stage in terms of consensus in the OECD BEPS Project? What advancements are lacking to an implementation of a multilateral solution?

If a digital transaction involves only two persons, for tax purposes one may rely on bilateral tax treaties. In this case, the treaty will limit the taxation using a binary question whether one or another state will be limited. A problem may arise when dealing with transactions involving more than two based states (i.e. commission services, guarantees payments, capital gains, profits in MNE, and others), by which a bilateral agreement cannot completely cover.

Furthermore, many products available in the digital market are usually provided through an interconnected production chain. In this sense, there are global value chains, whereby successive phases of production of goods and services are carried out in different countries, allocating resources to obtain the best yield at the lowest possible cost. For example, the Research & Development (R&D) may occur in one country, whereas the human resources comes from a second country, the infrastructure from a third country and the raw materials from a fourth country. This can be all be combined to provide a single product in a global value chain. This business arrangement, albeit legal, creates considerable problems in identifying where to tax in triangulations arranged by companies.

Another relevant concern for taxation is automatized communication and data transfer, where there are even more opportunities for improvements. It is reality that today many provided services do not have a person as part of the contract. Instead, they are settled between AI solely, being than called machine-to-machine (M2M) services. Sometimes this kind of service is to intermediate other digital services, providing needed data to feed automatic reports, or to provide sufficient bandwidth to a server. Most M2M services are barely visible to electronic device users, yet they have a significant impact on the market as they collect information on an automated and large-scale. Such information gathering increasingly affects and will continue to affect health services, transportation, consumer electronics, energy, and virtually every other sector of the economy. Accordingly, they have a substantive impact on the economy. It is undeniable the recognition of economic value in these services. Thousands of transactions per second in M2M should not have the same tax law treatment as regular human made transactions. In this field of taxation, there is almost no development in calibrating tax rates, or even in levying specific taxes for M2M transactions.

All these changes in the digital economy raise fundamental questions about how companies in the digital economy add value and earn their profits, moreover how the digital economy relates to concepts of source and residence or the characterisation of income, for tax purposes.

As a reaction to the matter of digital taxation, OCDE and Group of Twenty (G20) started a plan of entangling the causes of base erosion worldwide realising 15 action plans to be further developed,

the so-called BEPS Project. The project events can be listed as follows. In October 2015, the final report of Action Plan 1 was published under the heading *Addressing the Tax Challenges of the Digital Economy*. In April 2017, the *OECD Releases International VAT/GST Guidelines* was also published. In March 2018, the *Tax Challenges Arising from Digitalisation - Interim Report 2018* was released. In January 2019, the *International Community Makes Important Progress on Tax Challenges of Digitalisation* was released. In February 2019, the *OECD Invites Public Input on Possible Solutions to the Tax Challenges of Digitalisation* was released. In May and June 2019, the *Consolidation and Meeting of G20 Finance Ministers* was released. In November 2019, the *Public Consultation - Secretariat Proposal for a "Unified Approach" under Pillar One* was released. In December 2019, *Public Consultation - Global Anti-Base Erosion (GloBE) Proposal under Pillar Two* was released. And in January 2020, the *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy* was released. The work is still ongoing, and there is no definitive resolution so far. Yet, in short, the explicit object of the OECD is to achieve multilateral consensus for a long-term solution by 2020, despite the slow advancement in terms of international deals.

Nevertheless, the OECD BEPS Reports recognises that the digital economy is a challenge for international taxation. New concepts such as the significant economic presence, withholding taxes on digital assets and the digital equalisation tax are on the implementation agenda. The aim is to protect international tax treaties against unilateral digital economy measures by countries, while increasing the taxation of consumer markets.

Although there is no significant implementation addressed to digital economy, some states are reacting by themselves by implementing national legislation in order to tax transactions operated inland. Unilateral measures represent a response to the OECD's delay in establishing effective policies in this respect, but lead to a pernicious tax race between countries. This stance creates an environment of uncertainty, which for the economy is a negative symptom of how the market is behaving. Nevertheless, any measure taken must not constrain R&D, otherwise economic development may be harmed.

As a result, the fact this new ways of doing business generates the reallocation of essential business functions along with a different distribution of the tax burden on wealth generators. It is crucial to closely examine how businesses in the digital economy add value and make a profit, so that it is possible to determine whether and to what extent current tax rules need to be adapted to meet these specific characteristics, avoiding erosion of the tax base.

The intent of this work is to consider the impacts of tax avoidance practices, addressed to direct taxation concerns in digital economy, considering mainly multilateral policies. The indirect taxation is mostly harmonised and eventual concerns in such area are here postponed for further investigation. Nevertheless, it has been chosen to focus the issues of direct taxation because – in the context of EU law and international tax law – this area is the most peculiar and continuously evolving branch of law. Direct taxation also has a more significant impact in tax avoidance practices, being so the main target in multilateral discussions. As the objective of this thesis is to analyse tax avoidance in digital economy, the first necessary step is to beacon well-accepted concepts of tax evasion, tax avoidance and tax planning. Other basic concepts of tax law that are relevant for the matter will be examined, especially those territoriality legal concepts, derived from international tax law, namely *residence*, *source* and *PE*. Some consideration will appear in terms of moving to a different tax allocation system, and overcoming the territorial approach in one of the BEPS proposals.

Considering the innovation in the proposal, it is paramount to point out law principles that are relevant to the matter, clearly highlighting principles orbiting the nexus rules and profit allocation. In this sense, the first chapter presents a list of fundamental tax law principles in the environment of digital taxation. Indeed, not all tax law principles are relevant here; therefore the comparison will encompass the following principles: principle of equality, neutrality, principle of proportionality, ability to pay, home state taxation, simplicity, efficiency, cost minimisation arm's length, value creation and good faith. These principles are all relevant to international taxation, within the scope of digital economy.

Following, in Chapter II there will be an analysis of the ongoing problem of base erosion – in a broad sense –, exposing practical cases of manoeuvres that lead to tax avoidance which are the failing tax law concepts and how tax administrators traditionally deal with them.

In the Chapter III, there will be a summarised description of the main solutions proposed by OECD, taking into account the current stage of the reports, as they still have no final conclusions.

In the final part of this thesis, a critical analysis is made by the researcher, considering the commitment with tax law principles, while also providing predictions for digital taxation for the upcoming years. The last chapter presents some critiques to the proposals, taking in account that there are still no consensus in how to tax digital assets. Some considerations are made regarding the possible scenarios in which a multilateral measure is adopted or not to mitigate the effects of the ongoing fiscal war.

CHAPTER I – DELIMITATION OF OPERATIVE NOTIONS IN INTERNATIONAL TAX LAW

A more coherent solution for tax avoidance in digital economy demands a clear notion of the concepts involved. With this in mind, it is important to define a uniform vocabulary for the discussion, considering that the myriad of national tax law concepts are obstacles for a focused analysis. Therefore, the first part of this chapter gives an outlook of the core legal concepts necessary to grasp the implications of digital economy in taxation, whereas the second part focuses on with law principles, relevant to digital taxation.

The chosen language of the paradigm is from the OECD legal tradition. This option is justified because such entity is the most developed one in pre-existing research for international taxation, considering the focus in digital taxation hereabouts. Accordingly, the OECD has been in the upfront of the digital economy since the last decade, having hundreds of studies already published on the challenges of the theme. Countries and other international entities have been explicitly holding positions in order to encompass their tax policies with OECDs understandings. Notwithstanding, some references from European Union (EU) law are also in place, mainly taking account of the recent proposals to tax digital assets made by EU Commission[4], but also in relying on directives and related case law decisions.

Marginally, some national domestic law vocabulary will appear in this work, while the domestic law-making processes can result from the advancements in multilateral negotiations taken in OECD, EU or within another international institution and *vice versa*. In other words, the development of international law comes usually from complex negotiations between states. Thus, an implementation of a treaty or a directive (in the case of EU law) may cause causing changes in domestic legislation.

One last reservation is necessary: not all international tax law concepts are defined here, but just those whose reasoning are direct consequences of actual blemish in digital taxation.

[4] Directive proposal 2018/0072 and Directive proposal 2018/0073.

1 TAX AVOIDANCE DEFINITION

One of the crucial concepts in this research is *tax avoidance*, being it a negative conduct that leads to the economic problem of base erosion. In terms of tax avoidance, it does not matter whether the economic activity is either intangible or tangible. In both cases, the taxpayer may operate with the intention to avoid artificially the incidence of a tax. Then, before tackling the transformations of digital economics, it is necessary to differentiate *tax evasion*, *tax avoidance* and *tax planning*.

Tax evasion is a general term for efforts made by taxpayers to mitigate taxes by illegal means, considering that what is illegal may vary according to domestic legislation. In tax evasion, the taxpayer avoids the payment of tax without avoiding tax liability. Although he or she escapes from the payment of tax, this levy is unquestionably due according to the law of the taxing jurisdiction[5]. Tax evasion is usually easier to identify, as the law objectively defines it.

Regarding tax avoidance, there is not a properly illegal conduct in sight. Instead, in this case, a taxpayer should not be allowed to use legal constructions of transactions to avoid similar situations, and he or she must be subjected to the same tax burden. Thus, this means taxpayers should not abuse their right to minimize tax burden. Otherwise, tax authorities may consider the existence of an unacceptable conduct, by categorising the taxpayers' actions by their intentions. Notwithstanding, tax planning is perfectly acceptable, when reasoning derives from basis of consideration of economic efficiency and fiscal justice[6]. Going further, more details are necessary to differ tax avoidance from legitimate tax planning.

In fact, the notion of tax avoidance may vary from country to country, because each state will have different notions regarding: what is a circumvention of tax liability; what is abuse of law; and what are domestic principles of economic efficiency and fiscal justice. Indeed, the multiplicity of definitions reveals the need for harmonisation in international taxation, in order to constrain efficiently tax avoidance, causing different consequences to the taxpayer. As an example, a taxpayer conduct may be considered as tax planning in country A, but tax avoidance (or tax evasion) in country B.

Adding, the expression "abuse of law/right"[7] is only known in civil law jurisdictions, being alien to common law jurisdictions such as the USA, UK and Ireland[8]. Thus, there is not a definitive

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[5] RUSSO, Fundamentals of International Tax Planning, 2007, p.50.
[6] *Idem*, p.52.
[7] "Abuse of legal provision can be said to consist in using or claiming a right in a manner that conflicts with the aims of the provisions granting it" (*Ibidem*).

international legal conceptualisation to separate tax avoidance from tax planning, requiring a case-to-case analysis of comparative law in order to solve questions regarding the nature of the conduct.

Whereas the concept of tax avoidance is still open, it is difficult to reach an international consensus on a concept. In an international tax law perspective, it is necessary to converge a definition of tax avoidance in standardised concepts, at least for tax treaty interpretation. That is an ongoing challenge for OECD, EU and the international community as a whole, although some attempts have been made through reforms in bilateral treaties and by multilateral agreements. In this sense, it is worth highlighting the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI), as the effort taken by the G20. However, multilateral provisions have only been adopted by some of the economies, staying out of MLI relevant countries, such as USA, Brazil, China and Russia. Moreover, G20 is still far from a practical consensus in terms of tax avoidance. Indeed, many Contracting States (including China and Russia) are pending ratification, but, in any case, there are dozens of nations that have adopted implicit policies such as low tax jurisdictions, weakening the effectiveness of the instrument.

As stated, there is a significant difference between tax evasion and tax avoidance: the first is illegal and the second legal. However, as tax planning is also legal, there is a subjective aspect in tax avoidance that separates it from tax avoidance, and such aspect has to be clearly defined, at least for the purpos of this thesis. As a first step of clarifying the used language, tax avoidance must be delimited. According to the OECD, tax avoidance is

> a term that is difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow[9].

Unfortunately, there is no further definition of what it means to act in contradiction with the intent of the law while been lawful, while distinguishing from legitimate actions. The openness of this concept is a powerful tool for arbitrary decisions in a case-by-case grounding.

As the OECD definition of tax avoidance is too broad in scope, it is therefore necessary to borrow the reasoning from another international organisation. In the EU law, the lawmakers are reticent regarding tax avoidance definition, leaving the conceptualisation task for each Member-State legislation. Nevertheless, in domestic law, the approximation made is usually to the concept of abuse of law in EU

[8] *Ibidem.*
[9] OCDE, Glossary of Tax Terms, 2019, Retrieved from https://www.oecd.org/ctp/glossaryoftaxterms.htm

Law[10]. Accordingly, abuse occurs when the application of a rule cannot be extended to protect abusive practices made by economic operators, when transactions carried out are not in the context of regular commercial transactions, but solely for wrongfully obtaining advantages provided for by EU law.

In this sense, the main aspects of anti-abusive EU's policy are in the Directive 2003/49/EC of 3 June 2003, regarding common system of taxation applicable to interest and royalty payments, there is the recognition of avoidance practices. In this sense, article 5 of Directive 2003/49 states the following:

> Fraud and abuse
>
> 1. This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse.
>
> 2. Member States may, in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, withdraw the benefits of this Directive or refuse to apply this Directive.

The article 5 establishes the non-application of taxpayer protection against double taxation in case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, or withdrawing the benefits held in the directive (recital 6)[11]. Although Directive 2003/49 itself does not define abuse, other EU directives provide necessary pointers. For example, the Mergers Directive refers in the second sentence of Article 11(1)(a) to an absence of valid commercial reasons for the operation as a typical example of such motivation.

Furthermore, the recent Directive 2016/1164 (ATAD – Anti Tax Avoidance Directive) held main rules against tax avoidance practices that directly affect the functioning of the internal market), diplaying in article 6 a more precise definition of tax abuse:

> an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part[12].

The touchstone in identifying tax abuse is whether a non-genuine arrangement has been put into place for the *main purpose*, or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law. According to Article 6(2), an arrangement is regarded as

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[10] C-115-16- N Luxembourg 1 v Skatteministeriet, Opinion, §59.

[11] See also, judgments of 22 November 2017, Cussens and Others, C-251/16, EU:C:2017:881, paragraph 27; of 5 July 2007, Kofoed, C-321/05, EU:C:2007:408, paragraph 38; of 6 April 2006, Agip Petroli, C-456/04, EU:C:2006:241, paragraph 20; of 12 September 2006, Cadbury Schweppes and Cadbury Schweppes Overseas, C-196/04, EU:C:2006:544, paragraph 35; of 21 February 2006, Halifax and Others, C-255/02, EU:C:2006:121, paragraphs 68 and 69; and of 9 March 1999, Centros, C-212/97, EU:C:1999:126, paragraph 24 and the case-law cited; see also my Opinion in Kofoed, C-321/05, EU:C:2007:86, point 57.

[12] EU Directive 2016/1164.

non-genuine to the extent that it was not put into place for valid commercial reasons, while not reflecting economic reality.

In the context of ATAD, Raffaele Russo admitted difficulties in defining tax avoidance, notwithstanding he considers, in sum, that:

> Tax avoidance can be defined as a way of removing, reducing or postponing a tax liability, otherwise than by means of tax evasion or tax planning. It may be seen as the exploiting of areas that the legislator intended to cover but, for one reason or another, did not. More generally, tax avoidance can be viewed as the achieving of tax consequences that the government of the country concerned considers unacceptable, or at least undesirable[13].

Case law can lead to a better understanding of tax avoidance delimitation. In *Imperial Chemical Industries plc (ICI) v Her Majesty's Inspector of Taxes*, the European Union Court of Justice (CJEU) held that:

> tax jurisdiction shopping is a legitimate activity in the internal market, even if the choice of jurisdiction is solely based on the wish to circumvent less attractive domestic rules. However, there are certain limits to this principle. From the *ICI* case it may be concluded that the ECJ will accept restrictive anti-abuse measures if, disregarding the tax effects, the corporate or trade arrangement at issue is "wholly artificial[14].

Considering the subjective definition of abuse according to CJEU, there were Court discussions about what limits the interpreter has to respect. In case law *N Luxembourg 1 v Skatteministeriet*, the CJEU recognised some general boundaries about tax avoidance. Juliane Kokott, Advocate General (AG), in an opinion narrowed the definition of tax abuse, as following:

> (...) for a restriction of freedom of establishment to be justified on grounds of the prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory[15].

Therefore, according to EU case law, it suffices if the business arrangement is set not with the sole aim, but with the *essential* aim, of obtaining a tax advantage which otherwise would be regularly charged. In *N Luxembourg 1 v Skatteministeriet*, Kokott understands that two requirements must be fulfilled for an arrangement to qualify as abusive circumvention of the objective of the law. First, in the case of direct disbursement, tax must be chargeable in source country. Second, there must be a risk

[13] RUSSO, Fundamentals of International Tax Planning, 2007, pp.58-59.
[14] Case C-264/96 ICI.
[15] C-115-16- N Luxembourg 1 v Skatteministeriet, Opinion, §63.

that the income will not be caught in the actual State of receipt and thus will not be taxed[16]. For encompassing a tax avoidance, it suffices to recognise an abusive circumvention of the objectives of the law, whose list of possible conducts may vary according to the objectives themselves. For instance, if a new tax law had been enacted explicitly to restrain a specific operation, any conduct that clearly aims such undesired operation is deem to be a tax avoidance practice.

In sum, according to EU case law perspective, tax abuse or tax fraud relies on the intention of the taxpayer. It is an illegitimate arrangement (tax avoidance) when the decisions carried out in the context of normal commercial transactions or solely for the purpose of wrongfully obtaining advantages provided for by EU law. Such behaviour involves the creation of wholly artificial arrangements not reflecting economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory. Although, the concepts of tax avoidance and tax abuse are not objective, there are still relevant grounds for a general application of sanctions, respecting the rule of law.

For the purposes of the discussion regarding digital taxation, this research opted to use the EU case law tax avoidance concept, as described above. It is important to mention, that such options were made without underestimating any other domestic law concept. The EU case law has been chosen by two reasons: it is broad enough to be applied in at least 27 EU Member-States; and it does not represent a national imposing definition, which otherwise would possibly be challenged in a foreign court.

The adoption of the European notion of abuse derives in two possible scenarios: either an absence of a law aiming explicitly towards digital taxation, or the existence of such rule. In the first case, taking advantage of the reliance in intangibles to circumvent tax collection is a legitimate tax arrangement; whereas only in the second scenario there will be a tax avoidance practice. Accordingly, if the tax authority already has a firm understanding about the legality of the operation, such understanding would be enforced in a *back door* stance[17].

This conclusion justifies – at least in theory – the need of elaboration on specific digital taxation rules, revealing the urgency in tackling the matter of BEPS in digital businesses. Without a legislation

[16] *Idem*, §87. Also, the case discussion in N Luxembourg 1 v Skatteministeriet essentially exposed an open antinomy between OECD principles and EU principles. In the decision, the CJEU found that the exemption from withholding tax on payments of interest to a company resident in another member state (Directive 2003/49 on interest and royalty payments) did not apply in circumstances where the recipient companies were mere conduits. Notwithstanding, the CJEU found that outside situations of fraud or abuse, national legislation which taxes payments of interest between resident companies differently from payments by resident companies to companies resident in other member states is precluded by TFEU, article 63.

[17] Indeed, a back door law making process may is valid. Notwithstanding, the legitimacy of the decision is a relevant concern in terms of a democratic society and rule of law in a deeper sense.

focused in intangibles assets (digital economy), it is difficult to frame a conduct in the area as tax avoidance practice.

2 RESIDENCE AND PERMANENT ESTABLISHMENT

The second concept to take account to deal with digital taxation is *residence* in tax law. The *situs* of a company is a crucial legal element concerning digital economy while it is possible that the business is located far away from the customer, due the intangible nature of the product or the ability to deliver it in a reasonable time. Due to changes in the economy, the definition of the prevalent nexus in terms of residence is a major concern, as the physical location no longer necessarily corresponds to the economic value produced. Usually, the basic concepts of international taxation are differentiated between residence income and source income, which may cause double taxation if there is no treaty limiting the taxing rights. For further considerations, it is paramount to expose this qualification process, relying on typical double tax conventions (DTCs). The article 4 of 2017 OECD Model convention defines resident as:

> any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein[18].

The subsequent paragraphs of the same article are rules to determine which of the Contracting States will prevail as residence state for tax purposes. It may be, in the following order: due permanent home available, centre of vital interest, habitual abode, nationality and mutual agreement of the Contracting States.

Paragraph 3, by its turn, held rules for a *person other than individual*, which means legal entities have more than one residence. The Model Convention will regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors.

The Model Convention applies the concept of PE to identify whether the company is or is not subdue by domestic taxation as resident. PE is a concept of international tax law that limits the taxing power of different countries. In international affairs, it is common for two countries to claim to have the

[18] OECD 2017 Model Tax Convention on Income and on Capital, 2017.

ability to tax the same income, because of this, they often enter into international tax treaties to establish criteria that identifies which State Party can tax in a given situation. If there is the possibility of identifying more than one PE between the signatory countries of the bilateral treaty, the bilateral ruling must provide a solution, pointing out the prevalent criteria.

Bilateral treaties usually follow the OECD Convention Model, which in article 5 states that there is the legal concept of PE, being "*a fixed place of business through which the business of an enterprise is wholly or partly carried*".

According to paragraph 2 of the referred article, the term "permanent establishment" includes specifically: a) a place of management; b) a branch; c) an office; d) a factory; e) a workshop, and f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

In practice, a foreign company may operate, for example, in a country without being registered locally (being a tax resident only), and consequently not being treated as a domestic company in turn. This does not mean - from the perspective of international tax law - that tax authority cannot calculate and collect taxes derived from the operations of this foreign company. Such power, however, can neither extrapolate local law nor act in the contrary of the content of the treaty concluded by the taxing country. Finally, with the existence of an international tax treaty, it is possible to verify if any of the countries exceed the limits determined with respect to the taxes collected.

Following, in paragraph 4, the term "permanent establishment" shall be deemed not to include: a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity; f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

The referred paragraph will not be applicable if the overall activity results from the combination of the activities carried out by the two enterprises at the same place, or by the same enterprise or if

closely related enterprises at the two places are not of a preparatory or auxiliary character (subparagraph 4.1)[19].

In the case of legal entities, the residence is determined whether by the place of incorporation or the place of management. When the first is adopted, one has the *place of incorporation test*, when it is the second, *place of management test*. The first is simpler and more certain, limiting the ability to shift residence for tax avoidance. The second favours the free movement of capital and the reestablishment of the company's head office or the place where the board of directors meet. The ease in moving the company's seat is a feature typical of the free market, yet it facilitates tax avoidance schemes.

The caveat of non-characterising PEs is relevant for understanding the problem of taxing digital businesses. While in many cases the business activities are spread through different countries, this arrangement may cause problems because of dissemination of triangulation in interpreting bilateral tax treaties[20].

3 SOURCE INCOME

It is typical for country states to levy taxes on income and capital, which have an economic attachment to the state, even if the company is not based nationally. This means that states not only levy tax on the worldwide income and capital of their residents, but they also levy tax on the income and capital of non-residents that have a domestic origin (whether considering a foreign PE or a foreign incorporation). The concepts of source and *situs* are therefore relevant in respect of the taxation of non-residents, especially in the case of the digital economy.

One of the main tax law concerns of states in this respect is to determine which income and capital of non-residents is subject to tax. Thus, the legislation often implies that income or capital has its source or situs in the state. The rules on the taxation of the foreign income of residents may also refer implicitly to source and *situs* taxation. Nevertheless, such rules vary from state to state, being difficult to

[19] For natural persons, there is no perfect method to determine a personal residence for tax purposes, even so the following presumptions might be used to establish a prima facie case for residence: 1) being present in a country for 183 days or more; 2) having a dwelling in the country; 3) not having a dwelling abroad for more than 183 day; 4) not establishing residence abroad; 5) status granted by visa immigration purposes; or 6) being engaged in other activities established by law. Important to note that all these six forms of personal residence derive from an arbitrary test, instead of facts and circumstances test.
[20] See chapter III for examples of tax arrangements abusing the concept of PE.

harmonise tax law legislation. As income can arise in many forms, it is not possible for one definition of source to deal with all cases.

In summary, as a general concept for source, if a close personal connection exists between the taxable person and the state, taxation will be over a person's worldwide income. This is the so-called full tax liability. On the other hand, according to territoriality principle, if the connection is weak, or consists solely of objective factors, only the income earned in that state is taxed. This last situation is called limited tax liability[21]. A person may be considered with close connections by more than one state at the same time. It is not rare – therefore – for a person to be subject to full tax liability in two or more states. Perhaps this person lives in Country "A", whereas the centre of economic interests is in Country "B". In the case of existing no tax treaty between these countries, both would be considered for the person's entire worldwide income.

Situations that are more typical occur when people are subject to full tax liability based on their residence, citizenship, or any other criteria, in only one state, whilst receiving income from another state. In this aforementioned situation, people are subject to limited tax liability. This limited tax liability applies only to the income earned in that other state, while not considered resident there. Notwithstanding, when the state of residence levies tax on worldwide income, the *income from the other state is taxed twice*, because of a withholding tax in the source country. In conclusion, full tax liability in a state and limited tax liability in another can still lead to double taxation[22].

In the case of income taxation, the income has first to be characterised into various categories in order to find the appropriate source rule. Thus, it is possible for income to have its source in more than one state under their national law. A similar phenomenon is also possible, however less probable, in the case of capital taxation.

Nevertheless, in the case of limited tax liability in two states, the reasoning is different. Double taxation will not usually arise in this situation, since limited tax liability is based on the principle of territoriality. Thus, the two states will only levy tax on income arising in their respective territories. Even so, in the scenario of no harmonised rules, double taxation may even arise on the basis of limited tax liability.

In resume, regarding source, it concerns the connection between the income itself and a country. When the income has more than one connected country, one may use the *place of taxpayer*

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[21] LANG, M. (2010). Introduction to the Law of Double Taxation Convention. Vienna: Linde. pp. 23-24.
[22] *Ibidem*.

activity test to set where there is a significant activity or not (active or passive income). Such reasoning can be made in the case of a digital enterprise, acting in more than one tax jurisdiction. If there is no tax treaty between the countries, both are able to tax in a full rate; however if there is a bilateral agreement, its articles shall rule the issue, deeming which tax authority are able to tax.

4 PRINCIPLES APPLICABLE TO DIGITAL TAXATION

To deal with digital taxation is, indeed, to deal with tax law. Therefore, one cannot neglect the grounds of this legal area in order to think about solutions for the new ways of doing business. Then, an analysis of taxation effects that digital economy must refer to tax law principles, making necessary to point out the main principles involved in digital taxation.

There is an infinite number of principles that tangent the subject, however not all of them have direct application in the interpretation of tax rules regarding the digital economy. Also, the principles below may overlap each other, what is in fact not an indistinct incidence, yet a reassurance of the complexity in calibrating them with the new economy standards.

For the sake of simplicity, the principles are in three groups, considering digital taxation objectively: profit allocation principles, nexus principles and procedural principles. The division is not arbitrary, rather it is based on the recent reports from OECD[23], referring to concepts found in the frontlines in setting new international rules of digital taxation.

Whereas this chapter describes and relates the principles within digital taxation, the commitment of the measures are in the next chapter.

4.1 PROFIT ALLOCATION PRINCIPLES

In Tax Law terms, profit allocation rules require an amount of profit to be allocated to jurisdictions in which those businesses' active and participatory user bases are located, irrespective of whether those businesses have or have not a local physical presence. In a practical sense, these rules

[23] OECD/G20. (2019). OECD/G20 Base Erosion and Profit Shifting Project Addressing the Tax Challenges of the Digitalisation of the Economy Public Consultation Document, p.8.

limit the profit shifting operations, in order to grant minimal taxation in a respective jurisdiction. They measure and balance the effective power to tax.

Any taxing rule of direct taxation in international law can be subdued to profit allocation principles, being deemed as committed or not with them. Hence, the most relevant principles to digital taxation are equality, proportionality, ability to pay and neutrality.

Regarding the principle of equality, there are two possible understandings. The first is a procedural meaning, by which law must be applied to all those in the same circumstances, regardless of the status of the person involved; and the second is a substantive meaning, considering to grant equal opportunities for disadvantaged and marginalised people and groups in society, in the form of an *economic theory of sacrifice*.

According to the principles of proportionality and ability to pay, there must be a proportional relationship between the goals to be attained and the means used by the legislator when dealing with setting taxing rights in bilateral treaties. This means that tax allocation cannot be excessive, nor avoiding confiscatory rates. As consequence and the more ability to pay exists, higher is the burden of the taxpayer.

In the case of an equality, proportionality and ability to pay, it matters whether there is or there is not an intervention in an economic sector, in order to calibrate and balance such area. Considering the digital economy, the question is if it is necessary to implement a policy to foster or to raise the burden of an undertaking. For instance, a R&D sector may suffer if it is overtaxed, but on the other hand, an E-Tailor (electronic retailer) may cause massive unemployment and loss of revenue if his or her activity does not have an excise tax to balance with brick-and-mortar businesses.

On the opposite side of taxing principles, there is the neutrality principle. In this case, the tax system has to be neutral so that decisions are made on their economic merits and not for tax reasons. The main idea is that a tax must not create an economical misbalance, and an ideal tax system does not distort relative price, while relative price is the actual cost of each good or service. In some cases, neutrality is impossible and policymakers have to accept a certain level of distortion in the behaviour as inevitable. These distortions usually come from political pressure from specific economic sectors of a country. The neutrality has prior relevance in indirect taxation (GST, VAT and excise taxes), because it aims at an economic situation where, in theory, there is no clear advantage to each side of the

transaction. In terms of direct taxation, the argument favouring neutrality can rely on protecting the business feasibility from possible damages caused by public managers that use taxes as a political tool.

It is important to note that the idea of pure neutrality is inapplicable in terms of economic development. Considering a democratic regime that decides by itself the country goals, the tendency is to enact laws that favours economically hers citizens and compatriot companies, prior to foreign people or MNEs with headquarters abroad. For instance, rules (including tax regimes) would in theory favour jobs creation in national companies, in detriment of foreign citizens and companies.

Even when politics raise the flag of liberalism, the argument is that an open market is a better solution for national citizens and local entrepreneurs. What remains when arguing in favour of neutrality is that any measure towards economic state interference (by tax law, in this case) has to be well justified. Thus, the lawmaker has to show social or economic reasons that are relevant, when applying an active tax policy towards digital economy.

In sum, the discussion about profit allocation principles derives from different political views, and any obtuse perspective (disregarding the need of balance of principles) is negative in solving the challenges of the digital economy.

4.2 NEXUS PRINCIPLES

In international taxation, nexus is the relation between a relevant economic fact and the aptitude to tax. It represents a link between a particular event and an act of taxing. In domestic legislation, technically, there are no limits in establishing taxing obligations; even so, states usually choose to tax what is feasible to them. However, in tax in international tax law, there may occur an event where more than one jurisdiction taxes at the same time, leading to a double taxation.

A common solution to this problem are the DTCs, in which the contracting states withdrawal their taxing power when the opposite party has – broadly speaking – a stronger connecting factor (nexus). In order to clarify which is the prevalent nexus, the interpreter has to rely on the nexus principles. Three of them are the most important in digital taxation: home state taxation, arm's length, and value creation.

The principle of home state taxation is applicable to the taxation of income from the source of the State of origin, recognising that the amount has already been paid in that place and exempting it (in whole or in part) from further collection. This principle applies from the location of the physical presence of the company or from a PE in the foreign country. Although such principle has worked relatively well previously in the digital economy, it can now be said that all of these dynamics are now obsolete[24].

Regarding the arm's length principle, it identifies tax liability in the case of group of companies. As a MNE will probably have to incorporate abroad at some point, many of these created subsidiaries come as a result of complex tax arrangements. In other situations, the central idea is to acquire shares of another company in order to grant presence in a certain market. For tax purposes, it is relevant whether the shareholder has effective control of the company's activities. In case of a positive answer, tax authorities may consider that the company is in the "arm's length," being therefore liable in tax law.

Arm's length is particularly relevant in attributing tax liability in transactions between companies of the same group, where such transactions have the name of transfer price, technically being general practice of calculating the prices of goods, merchandise or services imported or exported between companies belonging to the same economic group. In this case, the arm's length principle has been updated to ensure concrete economic results. Thus, many MNEs use transfer pricing to lower their profits in high taxed countries, having only marginal profits there, or even losses. Nowadays, the level of aggressive tax planning is so high that legal mechanisms made to provide transparency are in fact favouring BEPS. What is in fact an anti-avoidance instrument cannot be used precisely to achieve the opposite result of what it seeks to obtain[25]. However, the complete abandonment of arm's length principle seems to be too radical of a measure. Instead, the tendency is to adopt objective and restrictive application of the principle, leaving way for others methods to identify where the profit is from.

In terms of the value creation principle, the intent is to recognise that taxation must reflect over the amount of wealth produced in an economic process, in the place that it happens. Hence, country states that identify the creation of a value inland are – in principle – legitimate to tax it. *Contrario sensu*, other jurisdictions should not tax a value created outside their borders. The typical case of value

[24] BIASCO, S. (2016). The Damages of Fiscal Competition in Europe and Alternatives to Anarchy. Em F. BOCCIA, & R. LEONARDI, The Challenge of the Digital Economy (pp. 17-38). Roma: Palgrave Macmillan, pp. 31-32.

[25] RUSSO, R. (2016). Base Erosion and Profit Shifting. Em F. &. BOCCIA, The Challenge of the Digital Economy (pp. 39-54). Roma: Palgrave Macmillan., p. 48.

creation reasoning is the taxation of royalties. Companies that host R&D sectors, or hold an Intellectual Property Rights (IPR), are usually bound to the tax jurisdiction where they are established.

Value creation is the group of actions responsible for increasing the worth of goods, services or business. The adoption of the principle of value creation is a complicated matter, because it grants to administration a too large power to tax. From a more democratic perspective, it is up to the lawmaker as to decide the definition what should be taxed.

The principle of value creation is more an economic principle than a tax law principle. Some entities (EU Commission, UK Treasury and OECD) argue that the existing system is based on the principle of value creation, notwithstanding others support the view that the existing system does not actually follow this principle. 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[26]. For example, in terms of economic development, it is not wise to tax R&D, and it is still too early to say that technologies, as algorithms and big data are well established. Then, maybe an attempt to tax will hold the use of new technologies and stunt economic growth.

4.3 PROCEDURAL PRINCIPLES

Procedural principles relate to public administration's concepts that evaluate *how well* a tax authority acts, whether in economic terms or in moral terms. The most typical principles are simplicity, efficiency, cost minimisation and good faith. The notion of procedural principles are rather arbitrary, in opposition of the former groups. Yet, these principles do not fit in those categories, being better set in a *tertium genus* of principles, more related to economic efficiency parameters.

Broadly speaking, in establishing a new tax on the digital economy, this new levy would have to be fair, simple, applied to an effective economic event - showing the creation of wealth or the provision of a service - and instituted without causing special difficulties or a high cost of conformity. Therefore, it would be compatible with principles like simplicity, efficiency and cost minimisation. Moreover, it is the Uricchio's opinion that the introduction of these new taxes would help to reduce the existing tax bias in

[26] HADZHIEVA, E. (2019). Impact of Digitalisation on International Tax Matters, Study for the Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies. Luxembourg: European Parliament, p. 19.

favour of the Internet and make it possible to reduce the tax pressure on other productive factors, including work[27].

Adding, simplicity, efficiency and cost minimisation consist in a group of principles that summarise what is desired in the bureaucracy. When projecting or reforming a taxation system, the news rules cannot transform the subject in an insurmountable law area. Entrepreneurs, accountants and lawyers have to have a way to predict - in the majority of cases – when and how a taxable event will occur.

Therefore, when dealing with digital taxation, lawmakers have to grant sufficient clarity to their theoretical proposals and bills presented in parliaments, otherwise digital taxation reforms would become much more of a problem than a solution overall.

The final principle to take into account is good faith. Its understanding requires acknowledging that most of the international regulation in tax law comes from bilateral treaties, so international law then affects the creation and the interpretation of these agreements. In planning an international system of digital taxation, the lawmakers will definitely have to deal with these general rules. When celebrating a DTC, states must follow general principles of international law. The main principles are codified in the Vienna Convention on the Law of Treaties (article 31 *et. seq.*).

According to article 31 of Vienna Convention, a *treaty must be interpreted in good faith* with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. For the purpose of interpretation of the treaty, paragraph 2 of the same article states that context covers the text, the preamble and annexes. Therefore, any agreement made between the parties in connection in the treaty must be interpreted accordingly. In the same sense, the good faith must prevail in any instrument made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

According to paragraph 3 of article 31, there shall be taken into account any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions, any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation, and any relevant rules of international law applicable in the relations between the parties.

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[27] URICCHIO, A. (2016). A Few Ideas for Reforming Internet Taxation. In F. &. BOCCIA, The Challenges of the Digital Economy (pp. 83-96). Roma: Palgrave Maximilian, pp. 91-92.

In a broader perspective, international law rules of interpretation do not significantly differ from domestic law. Thus, one also uses the grammatical, the systematic, the teleological and the historical interpretation methods[28]. A DTC's interpretation usually relies in a combination of these methods with the principles of Vienna Convention. However, the convention cannot be interpreted as unlimited authorisation for the development of the law by tax authorities, as contracting parties celebrate a tax treaty to *limit* the power to tax. Any enlargement of this limitation must derive from an amendment to the convention, when the parties agree[29].

Considering aggressive tax planning in the digital economy, treaties' benefits can be denied in cases of abuse, because the principle of good faith is binding on states and can be relied upon by the citizens. Lang understood that international law contains a prohibition against abuse of law, mainly because of the principle of good faith. Considering relationships between contracting states, there is a general prevention from interpreting law unfairly in their own favour, by consequence against taxpayer. Moreover, most states recognise the possibility of considering the *substance* over the *form*, if the result contradicts principles of justice[30].

Many states also prohibit the abuse of law in a sense, as they usually rely on specific anti-abuse rules, however Lang adverts that one cannot derivate from those a general prohibition against abuse of law. Moreover, he says "*the policy considerations underlying those specific anti-abuse rules are unequivocally subordinate to international law and in particular treaties"*, but these so-called anti-abuse rules "*would have to be at least on the same level as international law treaties*". Adding, human beings can only exceptionally be subjects of international law, which does not happen in the area of DTC. In conclusion, a general principle of (international) law cannot be binding on taxable persons, but only to contracting parties[31].

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[28] LANG, M. (2010). Introduction to the Law of Double Taxation Convention". Vienna: Linde, p. 37.

[29] *Idem*, p.38: a change in the DTC may require authorisation by parliament; and administrative bodies cannot change DTCs by way of a new interpretation. As consequence, the purpose of a DTC is to restrict existing tax claims; they cannot be interpreted in an opposite sense. Furthermore, any interpretative rule derived from national law must be taken cautiously, while they must not add or change the original meaning of the DTC. Moreover, when celebrating a treaty, there is an implicit conformity with constitutional principles of each member state. Even in the case of mutual agreement between the competent tax authorities, they cannot alter the provisions of domestic law after the incorporation of the treaty in domestic law

[30] *Idem*, pp.60-61.

[31] In other words, technically only a party may infringe the treaty, in terms of international law. As consequence, abusive practices regarding DTC are hard to be contained. Then, a practical solution is to implement anti-abuse rules in a multilateral level. In this case, these rules would have a status in international law, but in a multilateral level, anticipating abusive practices by binding general rules. The first large implementation of such policy is the Multilateral Instrument (MLI). The MLI already covers 93 jurisdictions and entered into force on 1 July 2018. Signatories include jurisdictions from all continents and all levels of development.

CHAPTER II – BASE PROBLEMS

1 DIGITAL BUSINESSES CHARACTERISTICS

Prior to highlighting the stressing aspects of digital taxation, it is necessary do define what are digital businesses, at least for tax purposes. This research does not cover all MNE tax arrangements, yet only those engaged in digital activities as a main business. Nevertheless, not all MNE in the digital sector are low-taxed nor have exclusively non-physical assets; sometimes the tax authority already has an interpretation that classifies the business as a traditional model, despite of its disruptive features. A digital company can then have many intersections with traditional businesses, making the need of delimitation of digital business a more complex challenge.

As a preliminary consideration, there is still no official definition for the digital economy. Most often, the term *digital* refers only to the economic value derived from the Internet, for instance in Electronic Commerce (E-Commerce), but may also refers to economic and social activities resulting from other information and technology source.

Accordingly, International Monetary Fund (IMF) defines digital economy as "*the incorporation of data and the Internet into production processes and products, new forms of household and government consumption, fixed-capital formation, cross-border flows, and finance*"[32]. The OECD, by its turn, defines digital economy as "*comprised of markets based on digital technologies that facilitate the trade of goods and services through e-commerce*"[33]. Adding, according to European Parliament, 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*"[34]. In resuming conceptualisation, the digital economy is a global network of economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks.

[32] IMF, Measuring the digital economy, Washington-DC, 2018, p. 6.

[33] OCDE, Hearings - The Digital Economy, 2012, p. 5. The OECD BEPS Action Plan on Base erosion and Profit Shifting also did not define the digital economy *per se*, but nevertheless described its characteristics as: "*reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs*" (OCDE, Request for Input Regarding Work on Tax Challenges of the Digital Economy, 2013, p. 2).

[34] European Parliament, "Effective Corporate Tax Rate" and "Digital Business Establishment" in the Corporate Tax Base Proposals, 2017, p. 2. However, 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.

The quoted definitions are not narrow enough for taxing purposes. Otherwise, one must considers any economic activity that benefits from Internet as digital. This includes mobile and sensor networks, mechanised agriculture, bureaucracy, education, and so on. Also, digitalisation increasingly intertwines with the traditional economy, making the differences between them less clear.

Going further into the argument, as the global economy has greater reliance on nonphysical assets, in many cases exchanges made have moved from face-to-face dealings to remote negotiation. In doing so, from a legal perspective, when the Internet is used as an intermediary, the services are still physically provided, and therefore are not technically considered a digital. In this situation, the network acts merely as a media tool for the ease of business. A typical example is a teacher that uses a videoconference app to teach remotely, or a psychologist that meets her patients using the same app.

In addition, eventually, these dealings may be replied to off of the Internet, such as a typical purchase contract solely being facilitated by the Internet. The communication changes regarding the Internet occur due the interaction of spontaneous forces such as supply and demand for a more open, interconnected and borderless environment. The use of a digital channel is merely a communication tool to keep negotiations fluid, whereas in the end the contract will be fulfilled in person. For instance, in a purchase contracting, negotiations and a contract may be concluded remotely, but the delivery of the object and the payment end up being closed in a traditional way, because of practical reasons[35].

In a different scenario, in case of a service that operates exclusively on the internet, otherwise being impossible to exist, one can consider the existence of a pure digital economy. Practical examples are brokerage services offered by a web site of a travel agency or a market place for distance learning. In both cases, the online service provider is usually due a commission for the contracts signed, in addition to subcontracting some insurance and other ancillary fees. Largely, the financial returns of digital companies come from the typical digital service, although it is commission based[36]. This type of intermediation of services is already known by private law and it is not exactly considered a new legal institute altogether (possibly being characterised as agency services), therefore demanding no greater

[35] This many times results in the so-called "Research Online, Purchase Offline" effect, whereby the network favours market activity, but does not replace it, being legally recognized only as a facilitating means for negotiation and contracting (URICCHIO, Antonio, A Few Ideas for Reforming Internet Taxation, in BOCCIA, Francesco & LEONARDI, Robert, The Challenges of the Digital Economy. Palgrave Maximilian, Rome, 2016, p.86).

[36] Examples of new digital businesses include: 1) multidimensional businesses where two or more user groups benefit from using the digital platform (for example, search engines are used by both individuals to access information on the internet and by advertisers to access their spectators); 2) outside-in business, where an organisation makes its own resources available to customers (*e.g.* Amazon Elastic Compurter Cloud Service, a third-party cloud solution, based on insight developed by Amazon Web Servives around the cost of maintaining a reliable infrastructure and scalable on a traditional multi-data center model); and 3) collaborative consumption, by which an economic model based on sharing, exchanging, negotiating or renting access to products as opposed to ownership. In the latter, there is the example of Airbnb's innovative business model, which brings together people looking for vacation rentals and other short-term accommodations with hosts who have unused space for rent.

concern in terms of legal definition. Notwithstanding, controversy mainly arises in tax law, while the PE may be not easily identified, creating conflicts of laws in international taxation.

The digital economy is characterised by an unmatched reliance on intangible assets, the massive use of data (notably personal data), widespread adoption of multilateral business models capturing value from externalities generated by free products and the difficulty of determining jurisdiction in which value creation occurs. At the same time, new ways of doing business lead to the reallocation of resources in the production chain.

The most central part of the debate is questioning how companies in the digital economy add value and make a profit, and how the digital economy relates to the concepts of source and residence or the digital economy overall while taking into account the results operated for tax purposes. In this sense, OECD has identified some recurrent characteristics of digital companies that are indeed able to benefit from the actual tax systems, distinguishing from traditional ones. According to some recent reports conducted by the OECD, three characteristics are frequently observed in certain highly digitalised business models: 1) scale without mass; 2) heavy reliance in intangible assets and data; and 3) data and user participation. The OECD described those three as the following:

> Scale without mass impacts the distribution of taxing rights over time by reducing the number of jurisdictions where a taxing right can be asserted over a business's profits. A heavy reliance on intangible assets strains the rules for allocating income from intangible assets among different parts of an MNE group, creating uncertainties and opportunities for locating income in low or no tax entities. Data and user participation poses challenges to the existing nexus and profit allocation rules, especially in situations where the highly digitalised business that exploits the data and user-generated content has little or no taxable presence in the jurisdiction where the users are located[37].

These features (altogether or autonomously) allow for exponential use of aggressive tax planning in order to pay less tax, generating unease towards tax authorities.

Nevertheless, taxation should not determine the motto of business models or indicate which companies outperform the competition, but instead be neutral in relation to the applied business model. This seems to be the best way to ensure a level playing field between all economic operators, which rewards success, innovation and job creation, while ensuring that companies contribute their fair share to the overall tax base. Notwithstanding, many of the recently reported cases of MNE arrangements in digital business for lower taxation on profits catalysed the OECD BEPS Project (*e.g.*

[37] OECD/G20 Base Erosion and Profit Shifting Project Addressing the Tax Challenges of the Digitalisation of the Economy Public Consultation Document, p. 6).

Amazon, Google, Apple and Facebook). Several of these companies are extremely profitable and generate a significant portion of their corporate value in world markets. This, however, is not always reflected in the share of business taxes paid by these companies. In this sense, the European Commission (EC) suggests that low taxation is caused by the fact that digital economy companies operate outside the traditional rules and, by extension, that existing international tax standards designed in the pre-digital age are inadequate in accurately capturing the digital market[38]. This disparity needs to be addressed in fiscal policies, as there is a tendency for revenue to be lost in traditional markets, which are gradually replaced by the marginally taxed digital market.

Then, for practical purposes, this research will consider digital business, for taxing terms, as any relevant taxable event may arise from one of the following business models: 1) intensive innovation and greater use of new sources of finance; 2) emphasis on the importance of intangible assets[39]; 3) new business models *based* on network effects, user generated content, collection and exploitation of personal data; and 4) significant cross-border transactions through new communication channels. Other perspectives of the digital economy can still be touched on the research, because a new technology allows for an optimal allocation of available resources.

2 PRACTICAL PROBLEMS

There are many relevant perspectives to discuss in terms of digital taxation. In this sense, extensively listing the problems may not be the best approach. Instead, it is more productive to start highlighting some practical cases in order to better determine the scope of the matter.

The OECD' 2015 report illustrates a few hypothetical cases by which the base problems become exposed[40]. There are four typical arrangements: online retailer, internet advertising, cloud computing and internet app store. Considering the need of synthesis in this research, only cloud computing had been chosen to describe, as follows.

[38] EU Commission (2013). General Issues. Brussels: Directorate-General Taxation and Customs Union, p.3.
[39] Oftentimes patents, trademarks, copyrights, franchises and licenses.
[40] OECD, Addressing the Tax Challenges of the Digital Economy. Action 1: 2015, Final Report, p. 167.

2.1 MODEL CASE

The model case chosen involves online gaming service through cloud computing. According to the National Institute of Standards and Technology, cloud computing is

> a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction[41].

In essence, cloud computing is the delivery of computing services – including servers, storage, databases, networking, software, analytics and intelligence – within the Internet. Cloud computing allows the user to store data in multiple and redundant ways, usually far away from the user, leaving free memory in devices to store and process non-shared data. As users accessing more of the web through mobiles phones and tablets, the utility of cloud computing has been increasing. Nowadays, notable cloud computing services are provided by *Amazon.com*, *Google Apps* and *Microsoft Azure* to mention a few.

Considering the disruptive nature of cloud computing, it necessary to determine how and where to tax it. A typical use of cloud computing is seen in online gaming, and can be found in a previous OECD report[42]. Hypothetically, the enterprise is from a country "A", where is the R&D sector is located, as well as the original ownership of the IPR. The PE is moved to country "B", having there the IPR management and co-ordination services. In state "C", there is the software localisation, the transaction processing and the datacentre (server). Adding, in state "D" is located the marketing promotion. Finally, consumers are in state "E".

For exemplificative matters, the entire arrangement is from a sole group of companies, using internal contracts and relatively autonomous local administrations. Using inner contracts, the IPR are transferred from country "A" to "B", whereas the licencing of IPR are made from "B" to "C". Clients in state "E" pay directly to the company located in state "C" for the services provided. The company in state "C" pays a service fee to the market company in "D", in a cost-plus basis. Finally, royalties and management fees as paid to the PE in state B.

Here follows the arrangement:

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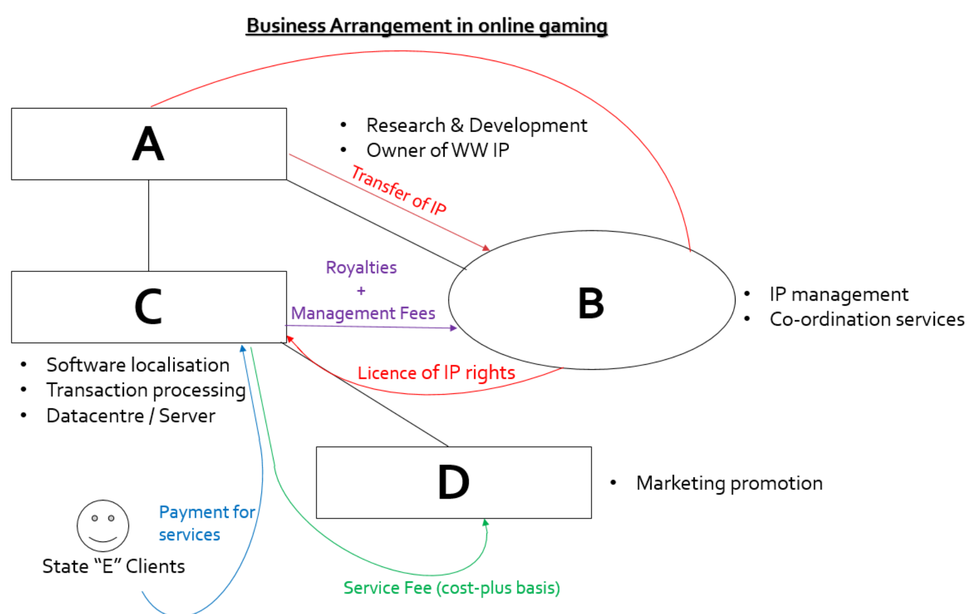
[41] MELL, Peter; GRANCE, Timothy. The NIST Definition of Cloud Computing Recommendations of the National Institute of Standards and Technology. National Institute of Standards and Technology, 2011, p.2

[42] OECD, Addressing the Tax Challenges of the Digital Economy. Action 1: 2015, Final Report, p. 167.

Figure 1



There are many reasons for such complex arrangement to exist. Most of the group of companies' profits are allocated in state "B", within a low tax jurisdiction. As there is a minimal taxable income in state "E", a local subsidiary receives no income from sales. In this theoretical case, domestic law (or a treaty) prohibits taxation of sales in the absence of a PE in country "C".

Although state "C" imposes income tax to the profits derived by "C" from sales, a large part of the local company income is offset by the royalties (and management fees) paid to the parent company for its licence of technology used, which represent cloud computing services to consumers.

In the case, state "C" does not impose withholding taxes on royalties and fees, due a tax treaty celebrated with state "A", considering the payment to be received by the parent company based on state "A".

Adding, state "B" grants benefits for PEs with a low rate in corporate tax and preferential regime for intangibles (for royalties included in taxable profits).

In state "A", home of the parent company, corporate tax is levied on a territorial basis. There is a tax treaty with state "B", ruling that all royalty income and management fee are attributable to a PE in state "B". The capital gain from the IPR transfer is not taxable under the rules of cross border transfer of assets in the "A-B" region, a free market zone. Research and development costs may be deducted

on the revenue of management fees, and finally, there is no Controlled Foreign Corporation (CFC) regime in state "A"[43].

In sum, the excessive malleability of a cloud computing service allows for the described arrangement, using the transfer of PE, in-group contracts and taking advantage of lack of multilateral rules on taxation.

As shown above, the challenges are many in taxing digital business that tax authorities have to deal with. However, the state's intention is not to increase the tax burden, but to create equal rules for all, allowing positive development to society as a whole. In this sense, the cornerstone of a prosperous economy is to grant free competition and fair conditions that favour free enterprises. According to OECD's studies[44], 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[45], if compared with brick and mortar business.

Going further, when a new digital business starts to compete with a traditional one, majority of the costs (labour, middlemen, infrastructure) are not applied to the new enterprise, which cuts general expenses and circumvent regulatory systems. There are many contemporary examples in this case: Uber, Airbnb, Transferwise, Nubank, etc. By deflecting regulation and other traditional costs of operation, they enjoy comparative advantages to other traditional products.

Adding, the digitalisation has been changing many aspects of business management. AI can make the operations of companies more efficient and faster while permitting time and cost savings to the product and service development processes. In order to improve the corporate decision-making processes, enterprises following the path of data-driven-decision-making can enjoy 5-6% output in

[43] In spite of not being the object of the research, the example also has repercussions in terms of indirect taxation. The VAT on B2B transactions will be levied either through the supplying business charging of the tax, or the recipient business self-assessing it. There may be tax exceptions on supplies. Considering VAT on B2C transactions, supplies, in state "C", to final consumers in state "E" should in principle be subject to VAT there. However, difficulties will emerge in tax enforcing cloud services acquired abroad, where are the final consumers (residents).

[44] "In the discussion on the tax policies implemented by the large multinational corporations that dominate the Internet, we are referring to large Web multinationals, such as Google, Facebook, Amazon, AirBnB, Apple, eBay, Baidu, JD.com, Alibaba, Netflix, Samsung and a few others that, under the current conditions, continue to enjoy tax privileges not available to others. With the arrival of the digital economy, the value chain has been deeply and radically changed and the dematerialization of the generation of wealth requires a totally reformed tax system, otherwise we will simply continue to fuel a bad example of unfair competition to the detriment of national financial interests and the overall health of Europe's economy. It is no longer acceptable to allow foreign companies to pay taxes in the countries where they have their registered office (obviously with a considerably cheaper tax rate) rather than in those where they operate with production and sales activities. The issue primarily concerns the huge market for the sale of goods and services online and the purchase of so-called search advertising, the advertising spaces that appear on the pages of search engines, and secondly, all activities related to online services (music, cinema, tourism and games, to name a few) and the entire sector of electronic commerce (e-commerce). This is the idea of the proposal that, in 2013, was brought to the attention of the Italian Parliament and the European political and cultural debate" (BOCCIA, F. (2016). Introduction: The Digital Economy and Fiscal Policy in the Age of E-Commerce. In F. Boccia, & R. Leonardi, The Challenge of the Digital Economy - Markets, Taxation and Appropriate Economic Models. Rome: Palgrave Macmillan, pp. 2-3).

[45] HADZHIEVA, E. (2019). Impact of Digitalisation on International Tax Matters, Study for the Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies. Luxembourg: European Parliament, pp. 13-15.

productivity gains[46], thanks to dropping prices of ICTs, big data and analytics and a constant drive for innovation. Given the reasoning above, there is no doubt that there are significant tax differences between the digital enterprises compared to the traditional ones, justifying the creation of new taxing rules.

2.2 CASE LAW ON DIGITAL TAXATION

The digitalisation effects on business administrations are vast, being impossible to enumerate all the transformations carried in tax-planning strategies. However, the EU case law gives us a glimpse of which kind of operations are currently calling tax authority's attention most. The relevance of CJEU decision's lies on the recognition of a supranational entity ruling on taxation, harmonising taxing rights. It is impossible to point out all of the domestic Court's jurisprudence, even while only including OCDE members, which leaves the matter for another research project[47].

Considering the EU case law, in *Verder LabTec GmbH & Co. KG v Finanzamt Hilden*[48], a large tech company transferred the PE from Germany to the Netherlands, being therefore taxed over unrealised capital gains. Although the Court held that there was no violation of freedom of establishment, the case showed the ease in moving the PE of the tech sector, while highlighting the problem that tax authorities of Member States are facing.

The Gibraltar Betting and Gaming Association Limited v Commissioners for Her Majesty's Revenue and Customs (HMRC), Her Majesty's Treasury and Her Majesty's Government of Gibraltar raised the discrimination in the taxation of online gambling services provided abroad. The argument of the plaintiff was the discriminatory tax regime over gambling outside UK. The CJEU rejected the case, arguing that it was purely an internal situation. Nevertheless, the case shed a light on remote gambling and its implications regarding digital taxation[49]. In *Stanleyparma Sas di Cantarelli Pietro & C., Stanleybet Malta Ltd v Agenzia delle Dogane e dei Monopoli UM Emilia Romagna – SOT Parma*, the CJEU held the legality of imposing an excise over gambling, based on data transferred in another Member State.

[46] European Parliament, Free flow of non-personal data in the European Union, Fourth Edition, 2019, p. 2.
[47] The only domestic tax law case worthy of mention is the French agreement between the *Procureur de la Republique Financier* in one side and SARL Google France and Google Ireland Limited in the other side. Originally, the *Direction Nationale de Finance Publiques* pointed out the existence of PE of Google Ireland in France, leading to tax avoidance and tax evasion charges. To settle the fiscal fraud probe, both Google affiliates signed a *public interest court agreement*, paying the respective fines. The settlement includes a €500 million fine and additional taxes of €465 million, yet less than the tax bill authorities had been accused (RFN-15 162 000 335) (https://www.agence-francaise-anticorruption.gouv.fr/files/files/190903_CJIP.pdf).
[48] Case C-657/13.
[49] Case C-591/15.

Betting operators and their clients, established in another Member State, irrespective of where those operators are established and the absence of a licence to organise betting, are liable for the payment of the excise, in respect of the freedom to provide services[50].

Another case is the one where the EC imposed fines to two Apple businesses in the EU market, Apple Sales International and Apple Operations Europe, because of tax planning on tax rulings granted by Ireland. Domestic tax rulings reduced Apple's tax burden for more than two decades - to as low as 0.005% in 2014, according to the Commission, although Apple disputes this statement. The Commission imposed a fine of €3 billion of taxes it said were owed to Ireland. Yet Apple and Ireland, whose economy benefits from hosting a number of multinational firms, are appealing against the decision at Europe's General Court[51]. The judgement is still pending, but it exposes how aggressive practices of transfer price can be while being endorsed by tax rulings yet to be declared incompatible with the EU internal market, which may generate base erosion of the revenue.

Finally, regarding taxation of online advertisement, there is the relevant case *Google Ireland Limited v Nemzeti Adó- és Vámhivatal Kiemelt Adó- és Vámigazgatósága*[52], which is still pending. The Court is concerned primarily with matters relating to the law of tax procedure, in particular penalisation of infringements of obligations to register for tax purposes. In Hungary, these penalties can reach around €3 million, in order to compel taxpayers not yet registered in Hungary to submit a tax declaration. There are certain procedural obstacles in connection with this penalisation, making difficult for taxpayers to evade the fine, by contesting it in court proceedings for example. Both aspects particularly affect taxpayers who are resident abroad and have not yet generated any revenue taxable in Hungary. A second question lies on the possibility of levying a tax on foreign (European) undertakings when those undertakings are not resident in Hungary. It must therefore be clarified whether EU law requires a territorial link for a national tax and, if so, whether this is provided by a connection to the Hungarian language. This case can bring some clarity on the limits of territoriality for tax purposes in the digital economy.

[50] Case C-788/18.
[51] COMMISSION DECISION (EU) 2017/1283 of 30 August 2016; T-778/16 Ireland v Commission and T-892/16 Apple Sales International and Apple Operations Europe v Commission.
[52] Case C-482/18.

2.3 BASE EROSION ON DIGITAL ECONOMY

The digital transformation has a significant impact on the market share. Taking the United States of America (USA) digital market by example, the market capitalization of the top four USA companies that do not strictly manufacture anything is US$ 800 billion (Google, Facebook, Amazon and eBay). Another relevant market is device manufacturing and selling, where considering giants such as Apple in the business of smartphones and tablets, reaching revenues in US$ 450 billion for the Chinese companies (Alibaba, Baidu, Tencent and JD.com)[53].

The online gaming market is also a huge field in the economy. In USA, this sector is already larger than the film and music industries combined[54]. Online games are often not controllable, and their tax base in the United Kingdom (UK) is worth more than € 80 billion, while in Germany and France it represents € 60 billion and € 50 billion, respectively[55]. Considering that they are entertainment undertakings, they are not essential services. Thus, online gaming is not a crucial sector for tax benefits, at least in terms of social development. Even though, there is marginal taxation in the sector, while music and film suffers successive crisis in terms of share market comparing to videogames[56].

Albeit there are new digital services gaining space in the market, one of the largest sectors in which is in Information and Communication Technologies (ICT) is still considered to be E-commerce (Electronic-commerce). In 2015, the value of E-Commerce in the world exceeded US$ 1,2 trillion, showing an annual increase of 25%, in contrast with the negative dynamics of consumption recorded from the beginning of the economic and financial crisis. E-Commerce is, for the countries of the EU, a major channel for the increase of its commercial potential, thereby enabling companies to reach distant markets[57]. In spite of not being as innovative as online services, E-Commerce keeps growing in a fast pace. While top 5 e-retailers expanded approximately by 32% year-over-year between 2008 and 2016, the entire EU retail sector registered only around 1% annual growth[58].

[53] *Idem*, p.5.
[54] POLO, J. (05 de 07 de 2018). ideo games market is worth more than music and movies combined so why aren't CSPs launching games services? . Source: Vanilla Plus: https://www.vanillaplus.com/2018/07/05/40093-video-games-market-worth-music-movies-combined-arent-csps-launching-games-services/
[55] BOCCIA, F. (2016). Introduction: The Digital Economy and Fiscal Policy in the Age of E-Commerce. In F. Boccia, & R. Leonardi, The Challenge of the Digital Economy - Markets, Taxation and Appropriate Economic Models (p. 148). Rome: Palgrave Macmillan, p. 10.
[56] HOLMES, Oliver (2019, 10 2). Revealed: global video games giants avoiding millions in UK tax. Retrieved from The Guardian: https://www.theguardian.com/games/2019/oct/02/revealed-global-video-games-giants-avoiding-millions-in-uk-tax-sony-sega
[57] *Idem*, pp.11-12.
[58] EU Commission (2017). COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL - A Fair and Efficient Tax System in the European Union for the Digital Single Market. Brussels: EU Commission, p. 4.

Besides regular activities, technology also allows for innovative practices in terms of tax evasion and tax avoidance. International scandals such as *LuxLeaks*[59], Panama Papers and Paradise Papers[60], 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 public debate on the need for fair taxation in the sector[61].

Previous cases of fiscal arrangements emerge as large corporations have already made use of triangulations, and fragmenting transactions in order to circumvent fiscal restrictions. Besides the publication of the avoidance practice in the media, usually there have been no penalties to the companies. In opposite, certain tax authorities acquiescence the taxpayers, tax ruling as normal operations. For instance, pre-tax profits reported by Starbucks' European parent company in the Netherlands generated only € 342,000 in tax in 2013 (for which a loss was reported, as was the case in 2011 and 2012). However, the European sales of the company were about € 92.5 million, more than 55% of which covers paid brand rights to subsidiaries based in tax havens. In spite of not being a digital business, the Starbucks' case showed a method of tax avoidance based on royalty payments, which became a paradigm for further arrangements. Moreover, besides existing in the public opinion on plenty of discussions about the company's arrangements, up until to now Europeans tax authorities did not condemned their practices, yet did recognise the existence of loopholes in EU Member's legislations[62].

A second case is that of Luxembourg-based Amazon Company, which adopted the same practices, but in this case payments for intangible services were made to a virtually tax-free subsidiary in Luxembourg (taxable profits were € 0.03 per € 1,000 in revenue). In fact, it is estimated that Luxembourg is home to 40,000 holdings, largely attributed to this low tax policy. A third case is that of Google, which used a triangulation from Ireland, the Netherlands and Bermuda (€ 0.02 of taxable profit

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[59] According to ICIJ report, in Luxleaks, more than 300 MNEs (including big techs, as Apple and Amazon) have transferred profits through Luxembourg in order to reduce their tax bills, in some cases pushing their effective tax rates on profits shuffled through Luxembourg below 1 percent. The practice was supported by tax rulings approved by the Luxembourgish tax administration, yet set up by private undertakings. The scheme included transferring revenues to Luxembourg, by transfer pricing and other profit reallocations operations. However, in many cases the company's presence in the country was merely symbolic. ICIJ, I. C. (2020, 01 22). Luxembourg Leaks - Explore the Documents: Luxembourg Leaks Database. Retrieved from ICIJ: https://www.icij.org/investigations/luxembourg-leaks/explore-documents-luxembourg-leaks-database/

[60] In both cases was revealed a generalised use of offshore companies, based on listed tax heaven countries. Albeit the operations are rather complexes, they consist on transferring money by artificial contractual relations with taxpayers and those *façade* companies. ICIJ, I. C. (2020, 01 22). ICIJ. Retrieved from OFFSHORE LEAKS DATABASE: https://offshoreleaks.icij.org/?gclid=CjwKCAiAgqDxBRBTEiwA59eENyXq8YipvDbvnFVwB4ftolYIeBGt84y5flBpdJtT3XsNzmC4Ec-A5xoC3sQQAvD_BwE

[61] HADZHIEVA, E. (2019). Impact of Digitalisation on International Tax Matters, Study for the Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies. Luxembourg: European Parliament, pp. 14.

[62] BIASCO, S. (2016). The Damages of Fiscal Competition in Europe and Alternatives to Anarchy. Em F. BOCCIA, & R. LEONARDI, The Challenge of the Digital Economy (pp. 17-38). Roma: Palgrave Macmillan., pp. 26-28. Also https://www.reuters.com/article/us-britain-starbucks-tax/special-report-how-starbucks-avoids-uk-taxes-idUSBRE89E0EX20121015.

per € 1,000 of revenue)[63]. The disproportion in the amount collected shows how unbalanced tax collection has been to those particular tech firms.

Even more remarkable is the case of Apple, which – according to USA Senate inquiry – paid about € 8 million (less than 1% of revenues) in global taxes (considering the average of the three budgets for the 2011-13 period). The same company also channelled actual profits into deductible payments to three subsidiaries of its Irish headquarters that do not have a declared physical residence anywhere in the world, one of which has never published its financial statements, something permitted by Irish law[64], yet considered an improper practice according international standards.

Majority of tax revenues tax losses occur because MNEs often use internal transfers inside group of companies to assign a low profit margin to activities in countries with high taxation and where they have a considerable market share, this practice is known as transfer pricing. According to Biasco, nowadays more than 60% of all international payments are transfer pricing[65]. Such practices causes a lowering of the taxable basis, and as most of tax revenue comes from profit taxation, multinational groups can shape easily and their cashbook to transfer profit to low-tax jurisdictions, according to formal legal standards.

There is a recurring debate about how countries should respond to this phenomenon of erosion of the tax base caused by transfer pricing. This issue involves two considerations. The first is the role of MNEs and the lack of appropriate national and international policies in response to the opportunities generated by increased transnational operations. The second is linked to the role of the Internet in providing an effective channel of operation in advertising and retail sales through the digital economy. It is in the convergence of these two phenomena – that is, MNEs operating in the digital economy – that the problem is particularly serious given the growing importance of the Internet in influencing or determining the outcome of competition between national and multinational companies and in the generation of profits distributed to shareholders.

The erosion of the tax base has been observed mainly in MNEs operating in the USA and the EU at the same time. USA companies transfer profits to Europe and vice versa, in the end, paying in the end marginal rates of income tax. Both international entities complain of positions adopted by each

[63] *Ibidem*.
[64] *Ibidem*.
[65] BIASCO, S. (2016). The Damages of Fiscal Competition in Europe and Alternatives to Anarchy. In F. BOCCIA, & R. LEONARDI, The Challenge of the Digital Economy (pp. 17-38). Roma: Palgrave Macmillan., p. 28.

other, which then leads to the recognition of the lack of a multilateral policies regarding policies of exemption and artificial reduction of profit.

In other parts of the world, the picture is even hazier, as there are multiple mechanisms for favouring foreign investment, which allows for the most creative tax arrangements. For example, in 2016 Google Inc. entered into an agreement with HMRC - the UK tax agency - to pay £ 11.3 million in taxes released between 2005 and 2009. As a result, it is estimated that profits earned by the company in the listed period, plus dividends distributed to shareholders, were taxed at approximately 3%. A great part of this tax relief is due to transfer pricing. By comparison, a British company in the same period would have paid 28% in Corporate Income Tax (CIT) if it had competed with advertising companies.

Other examples involving transfer pricing and tax evasion by USA multinational companies operating in the UK include: Starbucks, Amazon and Facebook. The latter paid only £ 8.6 million in tax for 14 years operating in the UK. Amazon, in turn, paid £ 11.9 million in taxes against a reported profit of £ 5.3 billion (approximately 2.24% of revenues were taxed). In 2014, Facebook paid only £ 4,327 in tax and still reported to the tax authorities a loss of £ 28.5 million, although in the same period it paid 365 members of the country-based team a £ 35.4 million bonus[66].

These specific cases mentioned are examples of how multinationals are extremely favoured when exploiting markets in all EU member countries, as the company's registration in that country ensures access to the entire EU market. They also demonstrate how larger companies are in advantage in terms of tax planning, if compared with small and medium enterprises. Although these tax avoidance practices are not exclusively seen in digital businesses, these aggressive stances are expanded by larger players of the sector.

2.4 NEW VALUABLE RESOURCES IN SCALE MARKET

The size itself of the digital economy is considerable large if comparable with another sector of economy. According to The Economist magazine, data is nowadays “the world’s most valuable resource”[67], which is being referred to as the new oil of the economy. In a comparative perspective, tech

[66] LEONARDI, The Digital Economy and the Tax Regime in the UK, 2016, pp. 103-104.
[67] The Economist. (06 de 05 de 2017). Regulating the internet giants - The world’s most valuable resource is no longer oil, but data. Fonte: The Economist: https://www.economist.com/leaders/2017/05/06/the-worlds-most-valuable-resource-is-no-longer-oil-but-data

giants thriving in the data economy today are therefore what Standard Oil was considered to be in the 20th century, being the core business of international trade. However, it may be challenging to assign an objective value to raw data itself, in considering the differences from the means of collection, analysing and end use of the gathered information. The outright sale of data is in fact a way to monetise data. Another way to monetise data one is by looking at the whole value of a business operation itself, having heavy reliance in collecting data. In both cases, the value analysis depends on subjective parameters in the free market. Jurisdictions are inclined to consider personal data of consumers as their property, rather than owned by a company or a public good.

Companies are able to collect data through different methods. It can be proactive, requesting or requiring from the user data and using data analytics. On the other hand, they also collect reactively, by the information provided largely within the control of user, as social media and cloud computing. Location-specific data can be collected either from customers or from devices. In both cases, companies may use servers based in a different country. This new "oil extraction" method then raises the concern of whether profit is attributable in the market country or in the server's country.

In a society with free speech, it is almost impossible to delimitate data collection, as a consequence of its value in the market. The data may be stored and processed using cloud computing, scattering its content and making the determination of the location challenging, especially in taxing terms.

The EU governments are experiencing political and media pressure, felling compelled to ensure that digital companies pay their fair share of tax where their profits are generated. The quest for fairness is indeed subjective, however it is showing what the public supports in terms of tax policies. A recent survey shows that 74 % of the Europeans believe that current taxation rules allow digital business models to benefit from specific taxation regimes and to pay lower taxes, whereas 82% believe that action to address this should be taken[68].

In sum, the digital economy undoubtedly contributes to job creation, encourages innovation and stimulates economic growth. Many digital companies are a success story, and countries and international organisations want to encourage more innovation and economic growth, granting tax reliefs to R&D. Policy favouring development is crucial for digital companies to be covered by a fiscal framework that facilitates growth, especially among start-ups, so that they have the opportunity to reach their full potential, while ensuring fair and equitable taxation for all economic sectors. However, in the

[68] EU COMMISSION, Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market, 2018.

long term digital assets will be taxed, following the economic transformation that is fostering the digitalisation of the whole market.

2.5 INTERNATIONAL LACK OF CONSENSUS ON TAXING DIGITAL BUSINESSES

Most of MNEs' headquarters of digital conglomerates are based in a few developed countries, even though they hold sizable slices of consumers around the world. This scenario tends to separate countries in two groups: on one side those having companies' headquarters and royalty's registers (PE jurisdiction), and a second group having large share markets and almost no legal control over IPR (market jurisdiction).

In consequence, there are situations where multinational technology companies are subject to derisory taxation, especially when compared to competing products – from the traditional economy –, which are regularly subject to full taxation[69]. In addition, taxation on employment contracts turns out to be a further disincentive to job creation, encouraging the search for their replacement by automation.

By way of comparison, when customs duties began in modern states, much of the wealth consisted of goods that travelled through ports and border roads. The flow of mercantile was strongly supervised by the state, which guaranteed a relatively effective tax collection. On the other hand, in the twentieth-first century economy much of the world's circulating wealth now consists of intangibles (digital goods, user data, cryptocurrencies, and digital advertising and management services, etc.). The new business models generally rely on intangible property (licenses, brands, trademarks, copyrights) and place greater importance on use of technology (cloud computing, analytics, algorithms, smart machines). This allows for a huge amount of resources to circulate with marginal taxation or without any taxation at all, due to arrangements done with aggressive tax planning in a flawed international tax system. Thus, state border surveillance is no longer satisfactorily in terms of taxes, whether as a source of revenue, or as a way to protect the national market, demanding new forms of burdening the profit generated.

[69] BIASCO, S. (2016). The Damages of Fiscal Competition in Europe and Alternatives to Anarchy. Em F. BOCCIA, & R. LEONARDI, The Challenge of the Digital Economy (pp. 17-38). Roma: Palgrave Macmillan, pp. 26-28.

Furthermore, considering the profile of a 'digital business', the idea of physical presence in a country for business realisation becomes less and less important. As digital goods are highly mobile, the physical presence of a company in the market country is often not a crucial matter, in comparison with brick-and-mortar businesses[70]. In addition, a digital company is easy to register in almost any country, while authorities consider such facilitation as a way to foster the local economy, while promoting R&D.

In financial terms, as Internet traffic is usually free, costumers pay by credit cards, registered payment companies or even by cryptocurrencies. Indeed, some restrictions on digital business may occur in the case of telecommunications regulations, financial system or even government content censorships, which could somehow limit the internationalisation of digital business. In this sense, when choosing a foreign market to operate within, the company must pay attention to public policy rules related to its activity, such as intellectual property and tax regime, in addition to specific regulations. Yet, authorities must be aware that in the innovation culture it is typical to disregard public rules, being in the nature of start-ups businesses to find "out of the box" solutions in terms of doing business.

From such considerations, it becomes more clear that sometimes it is notably difficult to track earnings from digital business. For instance, one company may incorporate in state A, have its head office in state B, sell in state C and register the profit in a bank account in state D. Considering this, the traditional way to tax income is sometimes fruitless in a total digital economic activity.

As a response to this economic transformation, national governments have been moving toward taxing digital businesses objectively, considering how they can act creatively (and sometimes abusing) in terms of legal concepts that effectively embraces the large sum earned in such activities. The debate that has been raging about what was wrongly and provocatively renamed the "web tax," "Google tax," and "Amazon tax" demonstrates how superficially the issue is understood[71]. However, some more feasible solutions are on discussion, as will be more deeply examined in this thesis.

The end of the twentieth century and the beginning of the twenty-first century were characterised by the transition from industrialism to the digitalisation of the economy, as consequence of the diffusion of new technologies, such as the Internet, satellite and optical fiber in communication networks. This technological transformation resulted in the emergence of new forms of wealth, which

[70] HADZHIEVA, E. (2019). Impact of Digitalisation on International Tax Matters, Study for the Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies. Luxembourg: European Parliament, p. 16.

[71] BOCCIA, F. (2016). Introduction: The Digital Economy and Fiscal Policy in the Age of E-Commerce. In F. Boccia, & R. Leonardi, The Challenge of the Digital Economy - Markets, Taxation and Appropriate Economic Models (p. 148). Rome: Palgrave Macmillan, p. 2.

have not been necessarily under territorial control, as the Internet had been facilitating the transfer of resources to various parts of the world.

3 THE GENERAL CONCERN REGARDING TERRITORIALITY

In order to understand the central problem involving digital taxation, a deepening on the understanding of the fundamentals of international taxation is necessary, considering territoriality as a connecting factor that centres the whole discussion. Taxing digital events may often involve more than one jurisdiction, raising some concerns in terms of conflict of law. This means that both state A and state B may impose levies on the same event, causing the phenomenon of *double taxation*. In a broad sense, this double taxation arises from the taxation of the same person with respect to the same income in two or more states. It is also called *juridical double taxation*. However, it is also possible for the same income to be taxed twice, due being in the hands of different persons. This second situation is called *economic double taxation*[72].

Economic double taxation frequently happens when affiliated or associated corporations – having seats in different states – enter into transactions with each other. Each residence state may determine the taxable base for CIT under its domestic corporate tax law. In this scenario, tax authorities of different states could assign different values to those transactions[73].

The problem emerges when two or more states are legally capable to tax the same taxable event. In this scenario, due their sovereignty, they can both tax. There is no prior international threshold in the tax rates. However, a double taxation policy would discourage the economic will to form international relations. As consequence, when taxing states understand that is to another state to tax, due the foreign nature of the source of income. If they both considerer the source income as foreign, there is a non-double taxation scenario. This latter situation may incentivise the afflux of income to abroad, causing an artificially shrinking in the domestic economy. Of course, the latter situation is less common, albeit also worrisome, leading to a *race to the bottom* scenario.

[72] LANG, M. (2010). Introduction to the Law of Double Taxation Convention". Vienna: Linde, p. 25.

[73] In this case, Lang (*Ibidem*) uses an elucidative example: "A multinational group of companies has subsidiaries in China and Brazil. The Chinese company sells products to the Brazilian company for CNY 100,000. The Chinese tax authorities consider that the CNY 100,000 price is appropriated whereas the Brazilian tax authorities are of the opinion that the appropriate price would be CNY 80,000. Income in the amount of CNY 100,000 is taxed in China, while the deduction in Brazil is limited to CNY 80,000.

While not constraining double taxation, international businesses are usually discouraged, as investors interpret the legal mismatching as additional costs to operation. Thus, a coherent understanding about the situations above is required in order to find solutions to the phenomena of double taxation and under taxation, neutralising the tax policies. Indeed, country policies have to consider the intangible nature of digital business, as unilateral measures may in the long-term harm the internal market. Moreover, unilateral actions taken by states tend to fail, in part due to in significant part to the inability of the source and residence countries to share information, while not forgetting the consequent base erosion of taxable revenue.

In fact, the power to tax comes from sovereignty, as a country has absolute power over what to tax. However if a taxable event is outside a state's own jurisdiction, it will be hardly be enforced by another state, relying only on international cooperation. In common law systems, such situation lead to the rule against foreign revenue enforcement, by which courts of one country will not enforce the tax laws of another country[74]. The principle is part of the conflict of laws rules developed at common law and forms part of the act of state doctrine[75]. In civil law jurisdictions, foreign tax claims are generally repealed on the basis that they are public laws, and therefore cannot be enforced outside of the state or territory[76].

Michael Lang confirms that states can levy taxes due their sovereignty. Yet, tax sovereignty is limited, because there must a personal or an objective nexus between taxpayer and state[77]. Such threshold is practical, as taxing some events beyond states control would lack of effectiveness. Then, a central idea is that sovereign states have the sole authority to levy taxes in their territories, in respect to other states sovereignty.

The nexus between a taxpayer and state is often a connecting factor. For individuals it frequently is domicile, residence or citizenship. In the case of legal entities, the connecting factor is usually the place of incorporation or place of effective management (PE). By using objective criteria, a

[74] Court of Appeal, State of Colorado v. Harbeck, 232 N. Y. 71, 133 N.E. 357 N.Y., Nov. 22, 1921.

[75] According to English and United States law, states that every sovereign state is bound to respect the independence of every other sovereign state. A court will not inquire into the legality of acts of a foreign state, in particular legislative acts of a foreign state and executive acts of a foreign state concerning property in its territory. Thus, courts shall not sit in judgment of another government's acts or act of any sovereign national in its own territory. CHALK, E. (23 de 01 de 2020). A Reliable Decision: Foreign Act of State Doctrine Applies in English. Fonte: DLA Paper: https://s3.amazonaws.com/documents.lexology.com/315b1de8-df72-49ff-8b66-829a697c3df9.pdf?AWSAccessKeyId=AKIAVYILUYJ754JTDY6T&Expires=1579796330&Signature=EX1HvKT5OezXKjthj8RRuprU0Ss%3D

[76] RECHSTEINER, B. W. (2012). Direito Internacional Privado. São Paulo: Saraiva, p. 21

[77] LANG, M. (2010). Introduction to the Law of Double Taxation Convention. Vienna: Linde, p. 23

sufficient factor would be those parts of the transaction or activity involving the taxing state, or somehow connected to the taxing state, therefore excluding a different state[78].

Legally speaking, identifying the prevalent connecting factor is a matter of jurisdiction. This means that an income may be taxable under the tax laws of a country, because of a *nexus* between that country and the activities that generate the income (source jurisdiction); or also a jurisdictional claim over income based on the *nexus* between the country and the person subject to tax (residence jurisdiction). In any case, the territoriality principle prevails, being the basis for bilateral treaties concerning double taxation.

The approaches of granting double taxation relief may vary from country to country. They can be precise rules in domestic law; large margins to tax authorities; or even unilateral relief due reciprocity.

Nevertheless, not all cross-border relations are covered by DTCs. In many cases, the states enact domestic rules to prevent international double taxation. According to Lang, there are three types of unilateral measures to prevent double taxation: the exemption of foreign-source income; the tax credit for foreign taxes paid on foreign-source income; and the deduction from the taxable base of foreign taxes paid on foreign-source income[79]. Usually, DTCs use a combination of the first and the second methods, following to OECD Model Convention.

In political terms, the open market favours the adoption of legal solutions to constrain the effects of double taxation. Therefore, states share a long-term tradition in celebrating tax treaties aiming to lower barriers to international trade. In this scope, it is relevant to note that direct taxation is the last bastion of a fading fiscal sovereignty (at least in Europe)[80], while indirect taxation tends to be fully harmonised worldwide. Thus, there are additional barriers to establish a multilateral system to improve efficiency in direct taxation, as will be discussed below.

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[78] Adding, Lang argues that there are no significant limits on tax sovereignty in practice. The lawmaker can even tax situations when, for example, only a "genuine link" exits. Then, the tax cannot be levied only when neither the person nor the transaction has any connection with the taxing state (*Idem*, p.23).

[79] *Idem*, p.26.

[80] About the European sovereignty losing worry: "Tax sovereignty is no longer the same, as exemplified through the ever present interference by CJEU and the fiscal measures imposed onto Member-States (Portugal is a good example). This is what makes direct taxation issues so important. The sovereignty, albeit feeble, that they still entail has great symbolic value since it represents the thin red line that separates the Union from a true Federation. For the Union to become a Federation, there are only two features missing: (i) Power of EU institutions to change the treaties (Member-States remains masters of the treaties; (ii) and tax spending capacity (Fiscal Federalism). At the end of the day, political union and fiscal sovereignty are linked and depend on each other" (RIBEIRO, J. S. (2018). An Overview of European Tax Law and Its Impact on European Member-States' Legal Systems: the Portuguese Example, in J. S. RIBEIRO, Selected Essays on International Business Law (pp. 285-303). Braga: Universidade do Minho Escola de Direito, p.294).

3.1 RULES FOR ATTRIBUTION OF PROFITS TO A PE CONTROL

There are uncountable variations in tax treaties ruling taxing rights in double taxation situations, yet they usually follow two model conventions, either from UN or OECD models. There are slight differences between them, nevertheless they tend to have the same objects, focusing on mechanisms against double taxation. The main goals of international tax treaties are to able countries to obtain their share of revenue; minimise double taxation; harmonise taxation; implement capital-export and capital import neutrality; to improve the exchange of information; to enhance competitiveness of the domestic economy; and to prevent fiscal evasion.

Nevertheless, focusing on bilateral relations is not enough to deal with global value chains, especially in case of payments for non-physical assets, as nowadays, there are methods of tax evasion that may be favoured in digital businesses, as mentioned below.

In the case of outbound payments of dividends, interest and royalties, countries usually impose withholding taxes, on a gross basis and not reduced by the deduction of expenses. The role of a DTC in most cases is to specify a maximum rate at which the source state may impose such tax, keeping the residual right to tax belonging to the state of residence. By standard, the OECD Model Convention establishes rules about this taxing system in articles 10(4), 11(4) and 12(3)[81].

Treaty abuse may be going beyond the ration of the law, generating the phenomenon known as treaty shopping. In a concise way, the commentaries on article 10 of OECD Model Convention consider abuse in some kinds of dividends sharing, gaining in intermediary establishment to circumvent withholding taxes, taking advantages of a treaty exception[82]. Nevertheless, there are traditional mechanisms to fight treaty abuse. A general anti-abuse principle of international law is in articles 26 and 31 of Vienna Convention, setting the binding force and good faith, towards parties and third parties. In 2003, the §9.5 of OECD Commentary on article 1 embodied the idea of anti-abuse principle. Not only do states establish rules to prevent tax avoidance. The domestic anti-avoidance rules sometimes are a way to harmonise anti-abuse provisions, if a party may not invoke the rule.

On the other side, great controversy exists in whether tax authorities may prevent the improper use of DTCs, especially in case of MNE arrangements. Then, the scope of discussion is, on the one

[81] OECD (2017) Model Tax Convention on Income and on Capital, p.27.
[82] *Idem*, pp.241-242.

hand, about what constitutes abuse and is thus undesirable and, on the other hand, on the efficiency of rules empowering tax authorities to grant treaty benefits[83].

3.2 THE PROBLEM OF PERMANENT ESTABLISHMENT FOR DIGITAL BUSINESS

In the global economy, mobility in business makes it difficult to identify where the actual selling is being done. As a consequence, traditional principles are in crisis, and territoriality is not enough anymore to grant tax collection in innovative business.

The OECD Model Convention was not made for multilateral relations MNE may scatter businesses easily, circumventing tax obligations. The most striking example is found in the OECD Model Convention, where the convention system relies on binomially determine whether a person is resident in country A or country B. Then, article 5 answers this question by identifying where is the PE, considering a fixed place of business through which the business of an enterprise is wholly or partly carried on.

In article 5, paragraph 4.1, the fixed place of business is where an enterprise carries business activities. In this case, there is a PE already or the overall activity resulting from the combination of the activities is not preparatory or auxiliary and the business activities constitute complementary functions that are part of a cohesive business operation. The problem is that qualification is many times manipulated in complex company arrangements, while it can be difficult to deem what is the main activity of a digital business, or if it has *preparatory* or *auxiliary characteristics*.

In the case of E-Commerce, enterprises may be considered *storage companies*, not having a PE, according to paragraph 4, "a", "b", "c", "d", "e" and "f", as long as the storage activity is classified as *preparatory* or *auxiliary*. Moreover, this criterion of PE does not fit in digital business, because of mobility nature of this kind of activity.

Moreover, it is a practical consensus to academics that the PE standard is no longer a coherent concept to deal with cross border transactions[84], especially considering the crescent relevance of the intangibles market. In OECD's commentaries on article 5, the commenters touch only the surface of the

[83] LANG, M. (2010). Introduction to the Law of Double Taxation Convention. Vienna: Linde, p. 59

[84] KEMMERN, Eric. Should the Taxation of the Digital Economy Really Be Different? Editorial of EC Tax Review, 2018-2, p.72.
SCHIPPERS, Martijn; VERHAEREN, Constantin. Taxation in a Digitizing World: Solutions for Corporate Income Tax and Value Added Tax. EC Tax Review, 2018-1, p.61.

matter, naming the whole problem as "Electronic Commerce", and proposing solutions for a few practical cases of digital business, as following.

First, there is a distinction between computer equipment and the data and software, which is used by, or stored on that equipment. An Internet web site (combination of software and electronic data) does not itself constitute as a "place of business", as there are no facilities such as premises, machinery or equipment. However, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute as a "fixed place of business"[85].

The Commentaries do not consider the possibility for a business to be split across many servers around the world, or in a cloud system with multiple fixed places holding the data. Nevertheless, the Commentaries relied on the differentiation between web site and server as a cornerstone for the matter, because "the enterprise that operates the server may be different from the enterprise that carries on business through the web site"[86].

In the OECD's commentaries, the premise is that the physical place of the Internet Service Provider is sufficient to determine a PE. In this sense, according to §10 of the Commentaries[87], the PE is a place of business any premises, facilities or installations that are being used or at its disposal, with no importance on whether it is owned or rented. In an opposite sense, if the ISP only rendered a service to the owner of the web site, there would be no fixed place of business.

Following the discussion, the Commentaries state that:

> in the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.[88]

Again, with the premise is that an ISP is a fixed place of business, the problem is still unsolved, considering the actual technological stage of data storage. It is relatively easy to move a web site to a different host, in a different jurisdiction. As an analogy, a web site is like a merchant ship, and the ISP is a harbour. A change of host involves some costs indeed, but for those who operate as an online business, the know-how of doing so is implicit. Considering the quote above, it seems that the Commentaries lack an understanding of how a server operates. In a first-level tax planned operation, an

[85] OECD. (2017). Model Tax Convention on Income and on Capital, p.152
[86] *Ibidem.*
[87] *Idem*, p.57.
[88] *Idem,* p.152.

enterprise could move the server abroad just before the threshold that characterises a PE is reached, avoiding the taxation.

A second issue is whether the business of an enterprise is wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. Moreover, the presence of personnel is not necessary to consider that an enterprise carries on its business, because in many cases no personnel are in fact required to do so. Equipment may operate automatically, without direct human intervention. For instance, the support personnel is in country A, the server is split in country B and C, operating without direct human intervention with automated machines in the market of country D. Then, question of where does the enterprise operate is not easily solved, as the production chain is scattered throughout four different countries.

A third concern relates to the fact that there would be no PE where the E-Commerce operation carried on through computer equipment at a given location in a country, if the operation is restricted to preparatory or auxiliary activities covered by paragraph 4. According to the Commentaries, the following activities that are generally regarded as preparatory or auxiliary (therefore not a PE) include: a) providing a communications link between suppliers and customers; b) advertising of goods or services; c) relaying information through a mirror server for security and efficiency purposes[89]; d) gathering market data for the enterprise; and e) supplying information[90].

Considering the level of specialisation in digital services, most of these activities are usually outsourced, which means that a MNE would rather create subsidiaries to manage them better. Indeed, what appears clear, is that in the OECD perspective, digital business are not new activities *per se*, instead the organisations seem to qualify an enterprise by traditional standards (retailer, communication, storage and others), and afterwards tends to see typical technological services as auxiliary ones. In other words, the Commentaries do not go further in the discussion regarding where is the sole place for tax purpose in supplying information, gathering data, securing data and other intangible activities to be performed, relying on traditional legal concepts.

The last issue taken on by the Commentaries is whether paragraph 5 may apply to deem an ISP to constitute a PE. According to OCDE Model Convention, the place where the person habitually concludes contracts or plays a principal role is to be considered as a PE. However, there is a caveat in the case of an agency acting on behalf of a person. This exception represents a case where the decision

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[89] Mirror sites or mirrors are replicas of other websites or any network node. In cloud computing, it is not possible to determine the main server, while data is stored without direct active management by the user.

[90] *Idem*, p.153.

centre is elsewhere, leaving orders to an agent by proxy. The question here is to what extent the ISP is linked to the enterprise that performs through hosted websites. Is it to be considered an agent or not? According to the Commentaries, paragraph 5 will generally not be applicable because the ISPs will not constitute as an agent of the enterprises to which the websites belong, because they will not conclude contracts on behalf of these enterprises[91].

In sum, in spite of some progress in OECD Commentaries, the PE concept is excessively malleable, favouring tax arrangements and artificial avoidance of PE status by digital companies. There is not yet any concept in terms of PE that fits to digital enterprises, while favouring the fragmentation and, therefore, it remains difficult to understand what the main activity of a business is.

In most of the time where the digital business arises as a core operation, the Commentaries dodges to clear answer in defining the PE, alleging a *case-by-case basis* solution. However, this position is not sufficient in terms of the intentions of the OECD Model Convention, as a prototype to bilateral tax treaties. Even among OECD members, there are few consensus in terms of digital taxation[92], leaving ground for an open academic discussion.

In the digital business model, a non-resident company has the ability to interact with customers virtually everywhere, through either a website or other digital mean of communication. However, the domestic law of most countries will require some kind of physical presence before taxing business profits. Moreover, according to articles 5 and 7 of the OECD Model Convention, a company is subject to tax on its business profits in a country of which it is a non-resident only if it has a PE in that country. Thus, a non-resident company may not be taxed, even having costumers in a particular country.

Nevertheless, many companies maintain a certain level of business connection (nexus) within a country without being subject to being taxed on business profits earnings from sources within that country. This is the result of particular policy choices reflected in domestic laws and relevant DTC, not being itself a BEPS concern, being legally labelled as tax planning practices. However, while such ability to earn revenue is not exclusive of digital businesses, it is available in a large scale together with no taxation in the state of residence, resulting in situations where the revenue is not taxed anywhere, causing in fact the BEPS phenomenon. Moreover, tax in a market jurisdiction can be artificially avoided by fragmenting business' activities throughout a group of companies, aiming to qualify themselves as preparatory and auxiliary activities, being an exception to PE status.

[91] *Idem*, p. 154.
[92] As the reserves of UK, Chile, Greece, Mexico, Portugal and Turkey (*Idem*, pp. 165-166)

In the case of a digital activity, an undertaking may establish a local subsidiary or a PE, with operations structured in a way that generates marginal taxable income. Assets – mainly intangibles – may be allocated via contractual arrangements to other group members operating in a low-tax environment in a way to reduce the tax burden. An affiliated company in a low-tax environment has an incentive to undervalue the transferred intangibles or other non-liquid asset, while claiming large portions of income allocated on the basis of legal ownership.

The contractual allocation of assets and risks include using a subsidiary or PE to perform marketing or technical support, or to maintain a mirrored server to enable faster customer access to the digital products sold by the group of companies. The principal company bears the contractual risks and claiming ownerships of intangibles due the operations taken[93].

In the case of retailer online selling, a local subsidiary or PE may maintain a warehouse and assist in the fulfilment of orders. These undertakings would be taxed in their jurisdiction on the profits attributable to services they provide, but the amount earned may be limited to local selling[94].

In terms of personnel acting locally, contracts may not correspond with substantive functions performed by the staff. Local workers may not have formal authority to conclude contracts on behalf of a non-resident company, yet perform functions that deems to indicate an effective authority in the contracts. In this scenario, the *arm's length principle* in connection with the parent company is applicable there. It will be BEPS concerns[95].

Another practice is to maximise deductions in market jurisdictions, in the form of interest royalties, service fees and others. The goal is to reduce taxable income in a source country by maximising the amount of deductible payments made to affiliates abroad. An affiliate may take advantage of a favourable credit rating, borrowing money at a low rate in a low-tax jurisdiction. Next, it lends money to its subsidiaries in high-tax jurisdiction, at a higher rate, in such a way that reducing the income of those subsidiaries by the amount of the deductible interest payment. A second method is to use hybrid instruments to create deductible payments for a subsidiary in a source country resulting in no inclusions in the country of the residence of the affiliate. A third option is to pay intangibles or services rendered among the group of companies, reducing the taxable income in the market country[96].

[93] OECD, Addressing the tax challenges of the digital economy, 2015, Paris: OECD, p.80.
[94] *Ibidem*.
[95] *Ibidem*.
[96] *Idem*, pp.80-81.

Imposing a withholding tax is a traditional method to constrain tax evasion in cross-border transactions. In a broad sense, it simplifies tax collection and provides a more egalitarian position toward taxpayers. However, digital companies may avoid withholding taxes by payment of profits to a lower-tax jurisdiction in the form of royalties and interest. This is a practical application of treaty shopping, while interposing shell companies located in countries with favourable rules. Such arrangement reduces or eliminates withholding taxes[97].

Another tax avoidance practice is eliminating or reducing taxes in an intermediate country, by the application of preferential domestic tax regimes, using hybrid mismatch arrangements or through excessive deductible payments made to related entities in more favourable tax jurisdictions. In digital economies, rights in intangibles and their related returns may be assigned and transferred among associated enterprises, sometimes with low market prices, violating the arm's length rule. MNEs of the sector can easily transfer the earning of intangibles to low or no-tax jurisdiction due an application of a preferential regime, boosting the base erosion. Another way to transfer the profit is generating excessive deductible payments in an intermediate country to related entities located in low-tax jurisdiction.

The techniques used to reduce taxation in the market country can also be used in the country of the ultimate parent company, or in the PE (headquarters). The central idea is still to move risk contracts and legal ownership of mobile assets to low-tax jurisdictions, making headquarters undercompensated for their important functions. The absence of a CFC may favour tax avoidance by the ultimate parent company where it is situated. This practice can be enlarged if a parent company transfer hard-to-value intangibles to a subsidiary in a low or no-tax jurisdiction, without proper compensation[98].

4 VALUE CREATION WITHOUT PHYSICAL PRESENCE

The new technologies allowed for the reorganisation of production systems and the way contracts were concluded and performed. Consequently, tax law, as a tax collection mechanism of the state has also had to be reformulated over time, moving to an intangible taxation model, granting importance to values such as capital and income from business and from labour.

[97] *Idem*, p.81.
[98] *Idem*, p.82.

There is some hesitation within OECD reports in respect to the value creation definition[99]. However, a jurisdiction's right to tax rests on the totality of benefits and state services provided to the taxpayer that interacts with a country, and corporations, in their capacity as agents integrated into the economic life of a particular country, which ought to contribute to that country's public expenditures. Such reasoning follow the Benefit Theory as well the neutrality principle[100].

Many value chains with a great potential to reduce information asymmetries exist alongside wealth chains operating in multiple jurisdictions and fields. For instance, it happens in accounting, law, tax and supply chain management, being all addressed to protect and create wealth through mostly opaque structures and secrecy.

Considering the relevance of value creation to the economy, the non-conformity within intangibles aspects of the digital economy favours the acting of *free riders*. In this sense, market countries claim that by providing infrastructure and legal protection, consumers and users create value, whereas content producers could not make profit without the existence of a digital market. Nevertheless, it is not clear whether technological infrastructure 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[101]. On one side, the role of user participation is seen as an important driver of value creation in digitalised businesses. On the other hand, the collection is sometimes part of a transaction between provider and user, exchanging the data for financial or non-financial compensation. Thus, there is still a relevant disagreement regarding the definition od the economic nature of data collection.

Moreover, the expansion of E-Commerce poses difficulties in determining 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

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[99] 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". In its public consultation, the Commission identified four business models in which value creation is not linked to taxation according to existing rules: 1) 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; 2) the digital platform model, granting access to content for users in exchange for a fee;
3) 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 4) the distant sales model, where goods are sold via a website and then physically delivered. 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.

[100] *Idem*, p. 26.

[101] The free-rider problem is a type of market failure in which those who benefit from resources, public goods, or services of a communal nature do not pay for them. Free riders can be a considered problem when they dominate a specific market, while not paying for the product, they may continue to access it. Thus, the public service may be under-produced, overused or degraded. The core question is how to limit free riding and its negative effects in these situations.

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.

The 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 MNEs. The extensive use of data and user-generated content, which is particularly relevant for multi-sided businesses, leaves the question on whether the users contribute to value creation by providing their data to platforms in exchange for free access.

Another problem is to do with the characterisation of income, distinguishing between business income subject to corporate tax on net income on one side, and royalties/technical services subject to withholding tax on gross income on the other. New delivery channels and new business models, such as service-oriented models using software or hardware, cloud computing, three dimension printing, collaborative platforms and Blockchain, pose legal uncertainty for both taxpayers and administrations, as they are hardly matched by existing rules.

There is no doubt that the lack of specific rules legitimating aggressive tax planning is the biggest challenge in dealing with digital taxation. As shown in previous chapter, to deem a tax avoidance operation in legal terms, it is prior to have a specific intention in the law that is been avoided.

5 DIAGNOSIS OF THE BLEMISH OF PRINCIPLES

Considering the failure of tax law in the digital economy, it is relevant to remark on how certain principles are not being respected, hence how the tax system itself is under stress.

In terms of profit allocation principles (equality, proportionality, ability to pay and neutrality), there is a disproportional tax ruling over physical businesses if compared with digital ones. In spite of having some regulation in terms of remote economic activities, cross-border operations tend to be undertaxed, leaving space for aggressive tax planning. The neutrality principle means equal treatment, not favouring a specific economic sector. Then, the absence of effective rules means unfavourable treatment.

When dealing with nexus principles (home state allocation, arm's length and value creation), what is in question is the pertinence of international tax law concepts, as *residence* and *source*. Territoriality is no longer a strong connecting factor that subjugates undertaking's decisions in the free market. Therefore, all of the three principles can be easily manipulated in order to step aside domestic taxation policies.

In terms of procedural principles (simplicity, efficiency and cost minimisation) the picture is also serious. Regarding indirect taxation, there is already some consensus with the destination principle in VAT/GST operations. However, in direct taxation there are few effective international agreements efficient enough to constrain creative profit shifting practices. Beyond that, many countries still grant privacy to large companies, not exposing balance sheets and income tax return.

Indeed, there is a need to put forwards tax law reforms in order constrain tax avoidance practices and to recover the long overdue respect to tax law principles.

CHAPTER III – PROPOSED MEASURES FOR DIRECT TAXATION IN THE DIGITAL ECONOMY

The tax authorities are acknowledging the need for measures to deal with the digital economy. In recent years, national governments have been moving towards taxing objectively digital business, being creative (and sometimes abusing) in terms of legal concepts that effectively embraces the large sum earned in such activities. The debate that has been raging about what was wrongly and provocatively renamed the "web tax," "Google tax," and "Amazon tax", which unfortunately demonstrates how superficially the issue is shown to the public[102].

The countries' initiatives are divided into three categories, considering the parties involved. The first is the traditional unilateral approach, by which each country individually develops a strategy to constrain tax evasion and tax avoidance. The second is the bilateral approach, also traditional, based on the DTC and other instruments of international law that comprises transactions made between the two parties of the treaty. The third is the multilateral approach, which faces the taxation problems in a broader perspective, and whose results are not yet known from a long-term perspective. What is known is that the attempt to solve digital taxation problems using unilateral and bilateral policies have been unsuccessful thus far, leaving space for bolder proposals in a multilateral perspective, as showed below.

As the focus of this research is placed on the multilateral approach, some deepening in OECD's is required to understand what is in the forefront of digital taxation, and what is expected to change in next years in terms of international agreements. Undoubtedly, the expected progress will change many aspect of domestic legislation as well[103].

1 OECD'S RECENT DEVELOPMENTS IN DIGITAL TAXATION

In the scope of OECD initiatives, the entity has been at the forefront of dealing with tax evasion, since the London Summit in April 2009. The explicitly reason for this is goal to investigate and end bank

[102] BOCCIA, F. (2016). Introduction: The Digital Economy and Fiscal Policy in the Age of E-Commerce. In F. Boccia, & R. Leonardi, The Challenge of the Digital Economy - Markets, Taxation and Appropriate Economic Models (p. 148). Rome: Palgrave Macmillan, p. 2.

[103] Law as a whole and tax law specifically are subdue to constant transformation. Whereas international tax treaties tend to represent a more stable regulation, domestic taxation may easily change in a short period. One must realise that we are in a transition period; therefore, some "tests" may happen.

secrecy and tax havens, while also addressing tax avoidance by multinational corporations. The first intent of OECD contributions was to reform, reshape and modernise the international tax architecture aiming at artificially shifting profits to locations where they are taxed at more favourable rates, or not taxed at all. The second intent was to increase transparency between taxpayers and tax administrations and among tax administration themselves. The general concern is to end the phenomenon of so-called 'stateless income', suggesting rules to tax such income[104].

Later on, during the beginning of 2013, the OECD and the G20 met in Saint Petersburg, Russia. Leaders agreed on setting out new measures and country-specific reform commitments to boost growth and job creation. The OECD supported the G20 in designing new action plans, from the angle of structural reforms, contributing to make them more concrete, specific and assessable. Then, OECD adopted a 15-point Action Plan to address BEPS, having some advances so far, developing concrete strategies combat international tax base erosion strategies through aggressive tax planning, which has become increasingly important in international discussions tax policies.

The OECD/G20 BEPS Project is an indication of how states are unable to maintain fair taxation systems in the new age of the digital economy. OECD developed the project with support from the G20. For instance, there were updates in in OECD Model Convention, mainly from action plans 6, 7 and 14 and commentaries about tax avoidance[105].

Even before the release of the Action Plans, the OECD's Task Force on the Digital Economy (TFDE) considered the following proposals to tackle direct tax challenges: 1) modification to the exceptions from PE status; 2) alternatives on the existing PE threshold; 3) the imposition of a withholding tax on certain types of digital transactions; and 4) the introduction of an excise tax or other levy[106].

Moreover, the TFDE agreed on a framework beginning with the following principles: neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability and proportionality. These principles are strongly related to the procedure principles described in the previous chapter. Moreover, the Action Plans were strongly influenced by TFDE's proposals, which made them a base line for further considerations.

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[104] G20, Communique: London Summit – Leaders' Statement, 2 April 2009.

[105] OECD (2017) Model Tax Convention on Income and on Capital, p.11.

[106] Albeit there are many subjects in the action plans, according to Russo, the OECD reports implicitly indicates three elements of tax avoidance: 1) artificiality of arrangements, having no business or economic aims as a primary purpose; 2) secrecy as a modern feature to tax planning; and 3) actions taking advantage of loopholes in the law or of applying legal provisions. (RUSSO, Fundamentals of International Tax Planning, 2007, p.53.)

The TFDE Action Group set up to assess the value chain characteristics of the digital economy, providing for user participation, provision of data, market presence and virtual presence.

After the release of the first reports in 2015, there were other publications put forward in the same tone, as follow. In March 2018, the delivery of the *Interim Report*. In January 2019, the delivery of *Policy Note*. In February-March 2019, a *Public Consultation* document. In May 2019, the *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*. In November 2019, the *Public Consultation - Secretariat Proposal for a "Unified Approach" under Pillar One*. In December 2019, *Public Consultation - Global Anti-Base Erosion (GloBE) Proposal under Pillar Two*. And in January 2020, the *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy*.

All of the documents are part of a continuous effort to define and settle the international standards for digital taxation. Although there are still no final agreements on the matter, the developments have shown some alternatives that may be in charge in the near future.

The *corpus* produced by OECD's releases about BEPS formed a massive content pool regarding the advancements in dealing with the new intangible economy. A complete description of the documents would be unreasonable here. Hence, the most relevant aspects of the reports are described below.

1.1 OECD 2015 ACTION PLANS ADDRESSING DIGITAL ECONOMY

The main OECD action plans for digital economy taxation are in the *2015 OECD Action 1 Report – Addressing the Tax Challenges of the Digitalisation of the Economy*, acknowledging that the digital economy raises more systemic and broader challenges, summarised as characterisation, nexus and data, for tax policymakers. This report is one of fifteen work fronts on tackling tax avoidance released by OECD.

The first part of the report describes the ongoing economic transformations in economy, mainly considering the exponential growth of digital market. The report covers remote selling (*e-tailors*) and new ways of doing businesses, as use of massive data, software as a service and many others new digital products that only make sense in the Internet environment. Considering the argument that digital business are undertaxed, the report discusses possible solutions, such as new nexus, equalisation levy and withholding taxes.

In terms of a new nexus, the idea is to reform *OECD Model Convention* in order to cover business' establishments that operate mainly on the web, having no significant presence in the physical world. By setting the taxing model to clearly identify a tech enterprise, the country state can apply straightforward rules, constraining tax avoidance practices.

An equalisation levy, on the other hand, intends to tax the digital transactions, based on the income accruing to foreign E-Commerce companies acting domestically. It is a direct tax, aimed to cover business-to-business transactions.

Finally, withholding taxes represent a way for the country to impose a minimum tax to revenue transferred abroad. Although it is a more aggressive tax policy, in many ways it could be more effective in order to protect the taxable base from erosion.

On the OECD Report about digital taxation, there are three broad categories of policy in the area of direct taxation: nexus, data and characterisation[107]. Whereas enterprises find value in new forms of businesses, the intangible nature of these assets creates natural barriers for tax administrations, demanding new concepts that are able to reach these three aspects. Besides, the free traffic provided by Internet allows cloud computing to move easily to different jurisdictions at the same time, replicating the software and data gathered in as many servers as necessary.

In terms of the OECD concerns, it is not a worry that taxing rights that may lead to low taxation are not *per se* an indicator of defects in the existing system. In this regard, it is paramount to examine how companies make profit to determine whether and to what extent it may be necessary to adapt current rules to take account of the specific characteristics of this industry and to prevent BEPS.

In another sense, combating the free rider problem is a goal of OECD BEPS Project. For instance, in the Action Plan 1, of 2015, there were suggestions of the following characteristics necessary 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[108].

[107] OECD, Addressing the Tax Challenges of the Digitalisation of the Economy, OECD, Paris, p.99. The first is the continual increase in the potential of digital economy combined with the reduction of physical presence and an increasing role of network effects generated by customer interactions. It raises questions whether the current rules to determine nexus with a jurisdiction for tax purposes are efficient. The second (data) derives from the ability to gather and use enormous amount of data. The concern here is how to attribute value created from the generation of data through digital products and services. Moreover, how to characterise for tax purposes a person or entity's supply if data in a transaction. Sometimes, data derives from a participative platform fed by user-created content, making such network the value that attracts more users.
The third and latter challenge is the development of new digital products or means of delivering services, generating uncertainties regarding the proper characterisation of payments made, with a special concern to cloud computing.
In many of these cases, the users are not directly remunerated for the content they produce, however the business may monetise the content via advertising revenues, subscription, sales or licensing of content to third parties.

[108] OECD (2015). Addressing the tax challenges of the digital economy, OECD, Paris, p.66.

Although there are significant efforts in searching an agreement on the groundings, no consensus was achieved. The triad nexus, data and characterisation did not have enough support. Nevertheless, the studies kept going, resulting in the Interim Report of 2018.

1.2 OECD'S OTHER ACTION PLANS IN CONNECTION WITH DIGITAL CONCERNS

Besides the Action Plan 1, other OECD's frontlines related to digital economy are found in the other 14 concomitant action plans. For instance, preventing treaty abuse (Action 6), preventing the artificial avoidance of PE states (Action 7) and strengthening CFC rules (Action 3). Also both market and residence BEPS issues are addressed by neutralising the effects of hybrid mismatch arrangements (Action 2), by limiting deductions and other financial payments (Action 4) and by making transfer pricing in line with value creation (Action 8-10).

Following others MNEs' practices, digital economy businesses take advantage of hybrid mismatch arrangements to achieve BEPS. The practice involve stripping income from a particular market or intermediate jurisdiction or by avoiding the application of CFC rules or any other anti-abuse rule. In this case of tax avoidance, the Action Plan 2 recommends the design of domestic rules and the development of model treaty provisions to neutralise the effect of hybrid instruments and entities.

The report on Action Plan 3provides recommendations in the form of six building blocks, including a definition of CFC income, which sets out a non-exhaustive list of approaches that CFC rules could use for a definition[109].

Many digital economy players act acquiring start-ups or other assets with intra-group debt operations. This is an opportunity to engage them in transactions with associated enterprises that have the base erosion effect, capitalising entities in low-tax jurisdictions. A new affiliated company may engage in lending money to high-tax operating entities. The deduction on loans from such operations can represent a BEPS concern. This is a way to create debts artificially to a parent company, reducing its taxable income in the market jurisdiction. The response is seen in Action Plan 4, which sets best

[109] They are: (1) definition of a CFC, (2) CFC exemptions and threshold requirements, (3) definition of income, (4) computation of income, (5) attribution of income, and (6) prevention and elimination of double taxation. (OECD, Designing Effective Controlled Foreign Company Rules, 2015).

practices through the design of domestic rules, intentionally reducing opportunities for BEPS via interests or any other deductible financial payments.

The work undertaken in Action Plan 5 is to constrain harmful tax practices, requiring substantial activity for any preferential regime and as a result, the existing substance factor has been elaborated and elevated in importance. This *nexus approach* is focused on ensuring that taxpayers can only benefit from IPR regimes while they are indeed engaged in R&D in that jurisdiction.

The report *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (Action 6) propose model rules for a minimum standard to address treaty shopping arrangements, aiming fictional activities made in countries to take advantage of the treaty network. The central idea is to prevent double non-taxation, allowing the domestic law to be applicable, unconstrained by treaty rules.

The Action Plan 7 suggests a new concept of PE reaching digital economy. It would not only be the recognition of a PE, but also the understanding of a main role for the company's representative in the country, with the conclusion of the contracts set in a routine way. Thus, the goal is to prevent artificial avoidance of the treaty threshold below which the market may not tax. In response of the circumventing practice, the sales should be treated as if they had been made by the parent company, even if registered by the subsidiary company. Another goal of Action 7 is to ensure that the location of where essential business activities of enterprises are carried out at a given location in a country, the enterprise cannot benefit from the list of exceptions usually found in PE's definition. It was too agreed to modify article 5(4) of the OECD Model Convention to ensure that each of the exceptions included therein are restricted to activities that are otherwise *preparatory or auxiliary*[110]. Alongside, the new anti-fragmentation rule was introduced to ensure that it is not possible to benefit from exceptions through the fragmentation of business activities among closely related enterprises. As a consequence, significant components of businesses in the digital economy stop from being considered as preparatory or auxiliary, as they will no long be entitled to an exception from PE status. A practical example of inhibition by the new proposed rule is a very large warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online by an online platform to end customers. In this case, the seller would be there constituting as a PE, most definitely discarding the argument for *preparatory or auxiliary* activities[111].

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[110] OECD, Addressing the tax challenges of the digital economy, 2015, p.88.

[111] *Ibidem*.

In the context of the work in Actions 8-10 (transfer pricing concerns), digital companies rely heavily on intangibles in creating value and producing income. Then, most of concerned activities are the transfer of intangibles or rights in intangibles to tax-advantaged locations. Such practice in coupled with the position that these contractual allocations, as well legal ownership of intangibles, justifying large allocations of income to the entity allocated the risk even if it operates with little or no business activity.

The last Action Plan, number 15, in a broader sense of international taxation, seeks to develop a legal instrument to accelerate and align the necessary implementation measures for the BEPS project, as it recognises that changes in the bilateral treaty model are not sufficient, as they do not change the treaties themselves. In the plan, the OECD projects, for the near future, a multilateral instrument to amend bilateral treaties.

Overall, the effects of the most relevant Action Points to digitalisation, such as Action 7 on PE 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 activity to low-tax jurisdictions. What is expected is a consensus-based, long-term solution in 2020, with an update to be presented to the G20 during 2019[112].

The 2018 Interim Report pointed out that countries already had come a long way in implementing several of BEPS measures, mainly considering Actions 8-10, in spite of no clear coordination in the actions. Also, in response of Action 7, many technological MNE groups changed their distribution models, from remote to domestic selling operations. Overall, the BEPS Project already contributed to realigning income from intangibles with value creation, in regard to Action 5 and Actions 8-10.

Therefore, there are correlations from the Action Plans 2 to 15 with digital taxation in mind. However, these plans did not bring concrete solutions for the matter, leaving it open to later discussions made by OECD. The advances are counterbalanced by the lack of mutual understanding in terms of digital economy, which is still underway in developing by the OECD Secretariat, as can be seen below.

[112] HADZHIEVA, E. (2019). Impact of Digitalisation on International Tax Matters, Study for the Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies. Luxembourg: European Parliament, pp. 10-11.

1.3 INTERIM REPORT OF 2018

In the year of 2018, OECD finally displayed some progress from the studies carried out to establish parameters of digital taxation. The text represents a clear advance in terms of tax architecture, albeit does not bring a final solution to the matter.

In terms of innovation, the *Interim Report of 2018* unveiled some economic classifications that help to cope with the disruptive economy today. Thus, the approach taken allows to better understand the proposals released later on.

In the OECD's *Interim Report of 2018*, specialists improved the classification of digital businesses, dividing them in four categories: multi-sided platforms, resellers, vertically integrated firms and input suppliers[113].

For clarification, multi-sided platforms are technologies, products or services that create value primarily by enabling direct interactions between two or more customer or participant groups, throughout online marketplaces. The most known examples are Uber, Airbnb and Google.

Following, resellers (or *e-tailors*) are companies specialised in selling merchandise in catalogues. They may sell directly or even act amongst other selling partners on the same website. Typical examples in this area are Amazon E-Commerce, Alibaba and Spotify.

Vertically integrated firms are businesses that acquire ownership over suppliers, integrating the whole production process (*e.g.* Amazon warehousing and logistic, Xiaomi and Netflix). In simpler terms, a vertical integration is an arrangement in which the supply chain of a company is owned by that company, which that controls the entire process. Usually, each member of the supply chain produces a different product or (market-specific) service, and the products combine to satisfy a common need.

Finally, input suppliers, in the digital economy, are undertakings that have intermediary inputs for a production in another firm. They do not act directly with the final consumer, instead their products are offered to other digital businesses, for instance Intel, Tsinghua Unigroup, software developers and other programming services.

All the models above are covered by OECD's studies, therefore demanding a coherent solution in terms of taxation. Each of them have special features that easily allow for complex company

[113] OECD (2018), Interim Report, OECD, Paris, pp.30-31.

arrangements, favouring tax avoidance practices or – in a more complacent perspective – erode the taxable base altogether.

The OECD's *Interim Report of 2018* it beacons economically what is under the scope of a tax implementation. In this sense, the report did go further on discussing the matter of value creation, while describing the main features of digital markets. It also showed how they shape value creation[114]. The study assumes three main features of digital businesses for attributing value as a digital asset: cross-jurisdictional scale without mass; the heavy reliance on intangible assets, especially IPR; and the importance of data, user participation and their synergies with IPR. However, considering the three features, "(a)mong members (...) there is no consensus on their relevance and importance to the location of value creation and the identity of the value creator"[115], because these factors are not exclusive to digital businesses.

Moreover, the interim report highlighted progress achieved regarding minimum standards (Action 5 on harmful tax practices, Action 6 on treaty abuse, Action 13 on Country-by-country reporting or CBCR[116], Action 14 on dispute settlement), which are subject to peer review within the MLI. It welcomed the onshoring of IPR by some MNEs as result of BEPS Action 5 as well as the wide acceptance of the CBCR standards.

The referred Report changes under Action 6 of the OECD Model to include an anti-abuse rule for PEs situated in third States and a principle purposes rule (PPT), which were both criticised for lack of precision, complexity and subjectivity as previously mentioned. Moreover, the most relevant actions to the digital sector, such as seen in Action 7, Action 8-10 and Action 3, were inadequate to tackle long-term issues in the digital economy, because they failed to address key problems of nexus, profit allocation and separate group entities.

According to the Public Consultation Report of 2019[117], that complements the *Interim Report of 2018*, part of the experts understood that the 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. The scepticism regarding the data/user participation from the group of studies came from the suggestion that only certain business models have the challenge of taxation, and a large change may alter fundamental principles of the existent tax system[118]. Considering such stalemate on the definition of

[114] *Idem*, pp.23-79.
[115] *Idem*, p.25
[116] Country-by-country report.
[117] OECD, Addressing the Tax Challenges of the Digitalisation of the Economy – Public Consultation. OECD, Paris, 2019, p.6.
[118] *Idem*, p. 17.

data collection, the OECD's position in the 2018 report was to consider the need for *further work* in order to reach a consensus.

Nevertheless, the results of 2018 advanced on the discussion regarding economic basic concepts, bringing more data and more arguments towards the urgency and need of a coordinated tax policy concerning intangibles. Yet, the study itself was rather inconclusive and Member States began implementing unilateral policies in digital taxation, weakening the OECD's role over the matter. The studies continued, enabling an additional two years of releases from the working group. It was only then at the end of 2019 came some more tangible proposals in tax law terms came along.

1.4 INCLUSIVE FRAMEWORK OF 2019

Considering the previous developments, in 2019, the *Inclusive Framework* was launched. In this brief report, a different approach was taken. The starting point for a consensus was set with two main topics: nexus and profit allocation. Although there was not an official document bounding the Member States, they agreed in two topics: that no physical presence is required for digital taxation; and on the need of modifications beyond the arm's length principle.

Nexus and profit allocation are the two bases for shaping a new tax framework. Nexus, in simple terms, deems which is the strongest connecting factor when more than one jurisdiction claim the ability to tax a particular event. Profit allocation, by its turn, represents which portion of profits should be taxed. That is the intention to calculate the whole liquid revenue of a MNE, no matter how broad its operations are, setting out what is the profit, and distributing it accordingly to the economic value produced.

The document is important to represent the overcoming of the question by OECD of where to start to reform digital taxation. It means that the consensus can be made in a two-dimensional argument, which axis are profit allocation and nexus. Then, mapping a solution is now less about *how to do*, being more about *how much to do*. Nevertheless, the OECD's works continued on this topic with the release of the programme of work, as below.

2 THE PROGRAMME OF WORK AND RECENT DEVELOPMENTS

During the year of 2019, the group of studies advanced in a more cohesive approach to set general rules for digital taxation, releasing in the *Policy Note Addressing the Tax Challenges of the Digitalisation of the Economy*[119], which classified the proposals with two fundamental pillars, focusing on parameters for an international income taxation. They represented a consensus of at least how the matter is classified and, up until today. This is the foremost progress in the current discussions in OECD BEPS challenges addressing digital taxation.

In May 2019, OECD launched the *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, establishing two main pillars of discussion. This represented so far the first large consensus in the developments of digital taxation. In November 2019, came the *Public Consultation - Secretariat Proposal for a "Unified Approach" under Pillar One* and in December 2019, the *Public Consultation - Global Anti-Base Erosion (GloBE) Proposal under Pillar Two*. Finally was released. In January 2020, the *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy* was released. These papers are concentrated in beaconing the two pillars approach.

3 PILLAR I – ALLOCATION OF TAXING RIGHTS

Pillar 1 deals with business presence without physical presence. The task is to determine where tax should be paid and on which basis. Moreover, focusing on determining which portion of profits could or should be taxed in the jurisdictions where customers/users are. This means that a general rule for taxing digital undertakings must have a high level of efficiency, in order to be implemented in large scale. The entire development plan of actions included within the Action Plan is based on three fundamental concepts: coherence, substance and transparency.

Then, the first pillar includes actions aimed at "closing the gaps" between tax entities, and combating situations of double non-taxation triggered by the interpretation of tax treaties. Under this

[119] OECD (2019). Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, as approved be the Inclusive Framework on BEPS on 23 January 2019, OECD, Paris.

pillar, measures are taken to counteract hybrid incompatibilities and tax arbitrage, strengthen domestic legislation to protect countries' tax bases against the transfer of profits in tax havens (technically speaking of the CFC) by limiting the deductibility of source erosion from base erosion and thereby counteracting harmful tax practices more effectively.

Initially, the Pillar 1's approach consists of two proposals: user participation and significant economic presence. Going further in the paper, they are both condensed in a unified approach, in order to reach a coherent solution with minimal distress.

3.1 USER PARTICIPATION PROPOSAL

The User Participation Proposal is in included Pillar 1. The premise here is that participation of users is a critical component of value creation in digitalised businesses, such as social media platforms, search engines and online marketplaces. Accordingly, the value generated by user participation is not identified in user's jurisdictions necessarily, yet it considers the actual international tax framework. Though having no physical presence, how the system is placed can influence the generated business value from the same jurisdiction while having a significant and engaged user base. As a result, the profits collected are usually not subject to local tax.

The proposal here seeks to change profit allocation rules, considering the value as creating activities of an active and engaged user base, which goes beyond physical presence to determine taxing rights. It is also necessary to make changes in nexus rules, granting jurisdictions the right to tax the additional profit allocable to them. However, these new nexus rules would exempt traditional business, reaching only those with heavy reliance on intangibles. There would be no change in traditional activities, keeping the precedent tax burden untouched.

In terms of mechanisms, new taxing rules will demand the allocation of profits to jurisdictions having active and participatory user bases, disregarding the check of physical presence. This method objectively considers activities and user's participation as a parameter for taxation, calculating through a non-routine or residual profit split approach[120], considering MNE as a group, rather than entity-by-entity.

[120] In a MNE group, routine profits are those under profitability threshold (*e.g.* X% on the profit before tax/turnover, it could 10%, 20% or 30%). Non-routine profits are divided among different market jurisdictions, they remain after routine activities have been allocated an arm's length return.

The idea is to grant the right to tax the local profit, putting aside the traditional verification of taxable presence, requiring only a relevant user base.

Notwithstanding, routine activities of an MNE group would continue to be determined in accordance with actual rules. The proposal only reaches the non-routine profit of the business from the entities if such profit is in user's jurisdictions.

The proposal relies on formulas to approximate the value of users, previously set by countries, though having in parallel an efficient dispute resolution system.

Adding, in order to minimise administrative costs, the proposal is to establish a threshold, excluding small and medium sized businesses from this new taxing model. Then, in terms of compliance costs, there would be no significant change in the market. Big techs will proportionally suffer with only a marginal increase in operational costs.

According to the *Update on the Economic Analysis & Impact Assessment*, an implementation of a 10% or 20% threshold in routine profits, would slightly increase CIT revenue for low, medium and high income (up to 2% in some cases), while however having a -5% CIT collection impact within investment hubs. Hence, global tax revenues would slightly increase as some shifting in taxing rights from low-tax jurisdictions to higher-tax jurisdictions. Also, most of economies would experience a small tax revenue gain, in opposition of investment hubs losses. According to the same study, in this theoretical scenario, more than half of the profit reallocated comes from 100 MNE groups[121].

The general proposal considers – in sum – that market jurisdiction would be entitled to tax non-routine income associated with intangibles and their concomitant risk. The allocation of non-routine or residual income between marketing intangibles and other income would be made under transfer pricing principle in an agreed transfer metric.

As seem in the *Appendix Proposal* in the user participation solution, there is also the *market intangibles* proposal. It would also change profit allocation and nexus rules. However, it would reach a wider scope of taxpayers, taking into account the broader impact of the digitalisation of the economy.

The user participation solution still lacks of rules that are more adequately detailed. However, the general idea is clear, and the implementation would inevitably follows transparent premises and metrics.

[121] OECD. Update on the Economic Analysis & Impact Assessment. OECD. Paris. 2020. http://www.oecd.org/tax/beps/webcast-economic-analysis-impact-assessment-february-2020.htm

3.2 SIGNIFICANT ECONOMIC PRESENCE PROPOSAL

Considering Pillar 1, there is also the possibility of expanding the concept of PE, allowing a refresh for the traditional system of many countries and within EU. The premise here is to consider the undertaking as a resident if one or more of the parameters of a bilateral tax treaty are reached.

Broadly speaking, there are crucial vulnerabilities recognised in the actual OECD Model Convention, as exposed in the previous chapter. The intention of reformers is to create alternative tests for deeming the existence of a PE.

In fact, the reform in connecting elements is not a novelty in Pillar 1. Since the first BEPS reports, OECD experts proposed taxation to have a reference in connecting elements of the significant economic presence.

Likewise, withholding tax on remittances for payment of digital transactions is a way to encompass the problem of territoriality. The Digital Equalisation Levy is foreseen as a solution, it consists in a kind of provisional tax levied on revenues from digital activities in which users are critical to value generation.

The provisional characteristic of the digital equalisation levy is relevant here, because a digital taxation – in a broader perspective – can be accrued to already existing taxes, creating a cascade effect, which can cause harmful consequences in the long term.

Elements of nexus, data and characterisation can be condensed in a new concept of nexus for net-basis taxation, which is the Significant Economic Presence, as proposed since Action Plan 1[122]. It has the intent to reflect situations where an enterprise leverages digital technology to participate in the economic life of a country in a regular and sustained manner, even without physical presence.

Within the Significant Economic Presence proposal, there could have been a withholding tax on digital transactions. It would enforces compliance with net taxation, whereas an equalisation levy could also provide an option to overcome the difficulties raised by the attribution of income to the new nexus. The idea here is not to increase the revenue by withholding taxes nor by an equalisation levy. Instead, the intention is to force the undertaking to inform actively its economic presence, while paying taxes as a resident taxpayer.

[122] OECD, Addressing challenges of digital economy, OECD, Paris, 2015, p. 107.

Considering the practical problems involving the proposal, the task of identifying where a business has significant presence is not easy. In this sense, the revenue can be a potential indicator. The country of the users and the country of the paying customers are indeed connected. Thus, the value of an enterprise's users and user data would usually be reflected in the enterprise's revenue in that opposite country. In other words, such perspective allows for considering this revenue as an important factor for establishing nexus in the form of a significant presence, whereas revenues isolated are considered insufficient to identify the nexus.

According to the Action Plan 1 of 2015[123], in developing a revenue factor, consideration is given to the following technical issues: a) transactions covered, which revenues are only from a digital platform; b) level of the threshold, considering the gross revenue, minimising the administrative burden for tax administrations as well as the compliance burden on and level of uncertainty for the taxpayer while having a basis applied over related-group rather than on a separated entity[124]; and c) administration of the threshold, introducing a mandatory registration system for enterprises that meet the factors giving rise to a significant economic presence. All of these technical issues are interesting parameters for a general rule in the OECD Model Convention, concerning significant digital presence. The reference shows that the proposal is not new, have been in consideration since the firsts gatherings of the BEPS project.

The more recent *Public Consultation Document of 2019*[125] listed the factors that are considered most relevant for constituting the kind of interaction via digital economy that represents a significant economic presence: a) existence of a user base and associated data input; b) volume of digital content derived from the jurisdiction; c) billing and collection in local currency or with a local form of payment; d) maintenance of a website in a local language; e) responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; or f) sustained marketing and sales promotion activities. The list here was extended by OECD, considering previous reports; which reveals a wider scope of understanding for what is relevant towards the significant economic presence proposal.

Some factors help to identify a significant presence in a online business. It can be a local domain name on the Internet, a local digital platform, and local payment options (compliance with banking regulations, currency controls and low penetration of international credit cards). Adding, some

[123] *Ibidem.*
[124] It would minimise the risks of artificial fragmentation, however granting a rebuttable presumption when taxpayer demonstrate no manipulation.
[125] OECD/G20. (2019). OECD/G20 Base Erosion and Profit Shifting Project Addressing the Tax Challenges of the Digitalisation of the Economy Public Consultation Document, p.16.

user-based factors can indicate a significant presence, such as the number of active users in a period of time and number of contracts concluded, and volume of content collected through a digital platform. All these factors can be taken into consideration combination in order to indicate the existence of a significant economic presence, either as a case-by-case analysis or a predetermined formula.

Regarding profit allocation, the Significant Economic Presence uses a fractional apportionment approach, by withholding mechanisms for tax enforcement. A withholding tax on payments by residents for goods and services purchased online from the Internet is an option for recalibrating the digital economy. In theory, it would be a standalone gross-basis final withholding tax on certain payments made to non-residents providers of goods and services ordered online. On the other hand, it could be a mechanism to support the application of the nexus option in deeming a Significant Economic Presence, by fostering the establishment of local a PE by the enterprise to get rid of the burden.

There are many other unsolved practical questions regarding the digital economic presence in the OECD Project. The proposal needs clarity and simplicity, however keeping the scope of similar non-digital transactions having a similar taxation, in order to discourage fictional arrangements made to avoid taxation while also respecting the neutrality principle. Imposing a withholding tax on a gross-basis must not discourage investments in R&D and within start-ups initiatives. Therefore, it is paramount to have a reasonable exception line, which includes a threshold of burden that only achieves well-established online businesses. The withholding tax proposal is in fact very controversial, while it tends to disregard the principle of ability to pay and represents a heavy burden for those businesses with a narrow profit margin.

An equalisation levy is an alternative to avoid difficulties from creating new profit attribution rules for purposes of a nexus on significant economic presence. This tax aims to ensure equal treatment of foreign and domestic suppliers, being a way to tax a non-resident enterprise's significant economic presence in a country[126]. Yet, there are pending worries remaining in terms of the practical effects in accrued basis.

The equalisation levy can be applied in different ways, one of which is to apply the levy to all transactions concluded remotely with domestic customers within border. However, the levy would only be applied where the business holds a significant economic presence. Alternatively, the scope would only consist of an automated systems of sales a contract made through a digital platform. In both

[126] OECD, Addressing challenges of digital economy, OECD, Paris, 2015, pp. 115-117.

cases, the levy would be imposed on the gross value of goods or services provided to domestic customers and users.

The original Action Plan 1 also suggests imposing an equalisation levy on data collected from domestic country customers and users[127]. The metrics could be over the number of users, contracts or volume of data gathered[128].

Since 2018, the project discharged the proposal, focusing in on taxation as previously exposed (Significant Economic Presence). It seems that the establishment of an excise as an equalisation levy is representative as much more a unilateral solution, which has already been taken in some jurisdictions. In another perspective, the allocation of profits before taxation (item 3.1) is not that different from an equalisation levy, considering that operational costs (expenses) in digital businesses are rather marginal when compared with brick and mortar businesses.

Moreover, the proposal is not considered by the Inclusive Framework group as a *safe harbour*, as it still lacks on simplicity and clarity over the instruments to put the new taxation method into practice.

3.3 THE "UNIFIED APPROACH"

More recently, the Pillar 1 panel went further on solutions for digital taxation. On November 2019, the Secretariat published a unified approach, uniting the previous subjects due their commonalities and looking for an easier consensus in the Pillar 1 discussions. In simple terms, the idea is to establish general rules for sharing taxing rights of profits between PE jurisdiction and market jurisdiction.

All the proposals under the unified approach agree on the following matters: the length of highly digitalised business (scope), the need for the creation of a new nexus, the implementation of a new profit allocation beyond arm's length principle and increased tax certainty in a three-tier profit allocation. These advancements represent a clear concept on what is crucial in terms of tax law reform.

[127] *Ibidem*.
[128] *Idem*, p.137.

This division above is a condensed result of the previous topics of Pillar 1, they also allows in a future taxing framework a clear understanding of what would be each kind of taxing right, which is in general granting some taxing rights to market jurisdiction.

The first three subjects are self-explanatories, whereas the last one requires a deeper analysis for further understanding. According to the *Public Consultation Document - Secretariat Proposal for a "Unified Approach" under Pillar One*, the three-tier mechanism split taxpayer's profit in the following sections:

> Amount A – a share of deemed residual profit allocated to market jurisdictions using a formulaic approach, i.e. the new taxing right;
>
> Amount B – a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction; and
>
> Amount C – binding and effective dispute prevention and resolution mechanisms relating to all elements of the proposal, including any additional profit where in-country functions exceed the baseline activity compensated under Amount B[129].

This division is a response to the new proposed rules, combined with existing transfer price rules. The general idea is to grant an agreed quantum profit to market jurisdiction taxation. According to the Secretariat, this would be simpler, and would avoid double taxation while improving tax certainty relative to actual circumstances[130].

In broader terms, the deemed residual profit would be the profit that remains after allocating what would be regarded as a deemed routine profit on activities to the countries where the activities are performed. Indeed, it requires a prior consensus on what is the extent of routine profit, both in level and proportional terms. Such agreement could be made through a convention.

The amount due to the market jurisdiction would be allocated to meet the new nexus rules, according to a formula based on sales. It is important to note that all of the rates would be a part of the consensus-based agreement between the Inclusive Framework members.

The second and third type of profit (Amounts B and C) would only apply in reference to the presence of a traditional nexus in the market jurisdiction (a subsidiary or PE), and not in the case of a taxable presence resulting from the application of the new non-physical nexus rule (which would give rise to Amount A). This means that the maintenance of the principle of arm's length and profit allocation according Article 7, of OECD Model Convention, either in a fixed remuneration or in case of a

[129] OECD. Public Consultation Document. Secretariat Proposal for a "Unified Approach" under Pillar One. 9 October 2019 – 12 November 2019. OECD. Paris, p.6.

[130] *Idem*, pp.8-9.

dispute resolution. Thus, it would be more easy to predict the results of disputes, because of existence of fixed parameters, than increasing certainty and reducing dissatisfaction with current transfer price rules[131].

Instead of reshaping the whole international tax system, the Unified Approach promotes inclusion of new rules, while adding new tools to complement pre-existing treaties. The proposal leaves open the option for a country to domestically keep a withholding tax to a non-resident taxpayer, in order to grant the collection of *Amount A*[132].

Moreover, by introducing a threshold based on profitability and targeting deemed non-routine profit, the proposed method is designed to materially limit the disruption of the conventional transfer pricing that is applied to routine activities[133], tackling the BEPS practices that are nowadays the core problem regarding aggressive tax planning from MNEs.

In the scope of MNEs, the proposal in the Unified Approach to set a € 750 million threshold[134], charging only larger tech companies, while still fostering the development of new digital businesses in an international scope.

Considering the distinguishing process to identify the taxable amount, the profits regarded as rewarding routine functions are excluded from the calculation of the pool of profits from which the allocation to market jurisdictions would be made. The level of profitability deemed to represent such "routine" profits could be determined using many different methods, but a simplified approach would be a *fixed percentage*. If that portion of routine profit is x%, then x% would be ignored for the purposes of the calculation of the profits reallocated to market jurisdictions, with only the excess (total profit -x%) being the subject of further consideration.

In a second step, the non-routine profit has to be split between market jurisdiction and the portion that is attributable to other factors such as trade intangibles, capital and risk, etc. In this case, an agreed multiplication factor may rebalance the tax due. Comparing, amount B follows a simpler method, establishing a fixed return for certain baseline or routine marketing and distribution activity.

Finally, recalling the previous observations within the *Public Consultation Document - Secretariat Proposal for a "Unified Approach" under Pillar One* still does not represent a consensus view of the Inclusive Framework nor the Committee of Fiscal Affairs, in neither subsidiary bodies.

[131] *Ibidem.*
[132] *Idem,* p.10.
[133] *Idem*, p.13.
[134] *Idem*, p.7.

Nevertheless, this last unified approach proposal is headed for the secretariat and has yet non-commitment from the G20/OECD Member States. In conclusion, it is uncertain if the framework will be followed.

4 PILLAR II – GLOBAL ANTI-BASE EROSION PROPOSAL

The Pillar 2 establish the need to set a stop mechanism for profit shifting to low or no tax jurisdiction, considering the new business models. The idea is to ensure a minimum level of tax is paid by MNEs, balancing traditional and digital companies. In general terms, the proposal includes a *Global anti-base erosion system* (GloBE), giving countries a "tax back" profit that is currently taxed below minimum rate[135].

In this sense, the proposal involves a co-ordinated set of rules to deal with ongoing base erosion due the excessive use of profit shifting practices. The GloBE proposal is based on an effective tax rate (ETR) test it must include rules that stipulate the extent to which the taxpayer can mix low-tax and high-tax income within the same entity or across different entities within the same group.

According to the Public Consultant document, the four component parts of the GloBE proposal are:

> a) an income inclusion rule that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate;
>
> b) an undertaxed payments rule that would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate;
>
> c) a switch-over rule to be introduced into tax treaties that would permit a residence jurisdiction to switch from an exemption to a credit method where the profits attributable to a permanent establishment (PE) or derived from immovable property (which is not part of a PE) are subject to an effective rate below the minimum rate; and
>
> d) a subject to tax rule that would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty benefits on certain items of income where the payment is not subject to tax at a minimum rate[136].

[135] OECD. Update on the Economic Analysis & Impact Assessment. OECD. Paris. 2020. http://www.oecd.org/tax/beps/webcast-economic-analysis-impact-assessment-february-2020.htm

[136] OECD. Public Consultant Document Global Anti-Base Erosion Proposal ("GloBE") (Pillar Two). OECD. Paris, 2019, p.6.

The GloBE would operate as a "top-up" tax, having the option to go up to the minimum rate, either being applied either on global MNE profit or on jurisdiction-by-jurisdiction basis. The rate of the minimum rate is not set yet, depending or results of a future *Inclusive Framework*.

Pillar 2 shows for the need of cooperation among and between States. The multilateralism is necessary for a balanced outcome. It is the only way to set a backstop to situations where the first pillar is not respect, or when taxation of digital economic goes below minimum rates. Notwithstanding, all jurisdictions remain free to determine corporate rates, whereas other jurisdiction are still able to tax income at a minimum level. Therefore, the second pillar includes actions to strengthen existing international standards, by revising tax treaties and transfer pricing rules, which work well in many cases but fail in many others.

In order to grant a minimum rate, the new rule could deny tax treaty benefits provided to business profits, associated enterprises, dividends, interests, royalties and capital gains. Of course, the parties of the treaty would have to commit to the new GloBE rule previously enacted.

There is a prevision for a reduce in profit shifting intensity by MNEs, which may yield some low-tax jurisdiction increasing their minimum CIT rate[137], allowing them to collect part of the gains of the minimum tax rate. Hence, the expectation is to stop the race to the bottom in terms of CIT rates, in rebalancing investments in the global economy.

Comparatively speaking, Pillar 2 is much simpler than Pillar 1. The general idea is to solely establish a comprehensive minimum rate, granting tax back in case of under taxation. This approach works when considering the neutrality principle, because it balances taxation neutralising apparent advantages offered by investment hubs.

The global tax estimate gains, from Pillar 1 and Pillar 2 altogether is up to 4% in terms of CIT revenues, which is around US$100 billion per year. Important to note that according to the same OECD group of studies considerations, the implementation of Pillar 2 without Pillar 1 would generate almost no results in terms of an increase on revenue[138].

One question regarding Pillar 2 that remains unsolved is how to deal with *permanent differences*, which signifies countries classify dividends received from foreign corporations and gains on the sale of corporate stock. Under a worldwide blending approach, the consolidated financial accounts

[137] OECD. Update on the Economic Analysis & Impact Assessment. OECD. Paris. 2020. http://www.oecd.org/tax/beps/webcast-economic-analysis-impact-assessment-february-2020.htm. The OECD exemplify with a 12,5% rate.
[138] *Ibidem*.

should eliminate dividends and stock gains in respect of entities of the consolidated group without additional intervention. The permanent difference is also a concern between the unequal treatment of corporate acquisitions under financial accounting and tax rules. In a stock sale, the carrying cost of the acquired corporation's assets may not change for tax purposes but will regularly be adjusted, upwards or downwards, to fair value under the accounting standards. Permanent differences also arise due domestic policy reasons, while the taxable income base excludes certain types of income or disallows certain deductions.

Besides permanent differences, the proposal also covers the temporary differences, which "are differences in the proper time for including items of income and expense in the calculation of net income"[139]. These temporary differences can be the sole cause of a low cash ETR at the beginning of the temporary difference and a high cash ETR upon reversal when the tax liability in the ETR computation is based on the tax liability. The calculation of net income usually takes account of long-term factors, which many times take more than one fiscal year to conclude.

Three basic approaches to addressing the problem of temporary differences emerge from Pillar 2 proposal: a) carry-forward of excess taxes and tax attributes, b) deferred tax accounting and c) a multi-year average ETR.

Any of these three approaches are typical for CIT or income taxation, both on a domestic base. However, there is no specific detail in the report on how to implement a multilateral system. What is most mentioned is the call for the exploration of different *blending options* ranging from blending at the entity level to blending at global group level with a particular focus on blending at the jurisdictional and global level. In a way, this approach is a more subtle way to propose harmonisation in direct taxation. In the *Public Consultant Document Global Anti-Base Erosion Proposal ("GloBE") (Pillar Two)* there are suggestions involving allocation of profit to a transparent entity, tax credit in another jurisdiction and adjustments to for dividends and other distributions from group members.

The need to adjust the tax base for dividends may depend, in part, upon the level of blending ultimately adopted in the GloBE proposal. In this sense, the financial accounts of group entities in different jurisdictions would be prepared on a separate company basis and dividends received from a "separate" corporation ordinarily would be included in the shareholder's financial accounting income. On a different level, MNE still remains able to take advantage from the hybrid mismatches.

[139] *Idem*, p.12.

In the final part, the secretariat recognises the risk of carve-out operations as a way to circumvent the GloBE system. However, operations are more difficult to design and increase complexity as well as compliance and administration costs much more than objective tests. The difficulty of design and complexity often increase the more targeted the carve-out is intended, which would represent a strong factor in company's management.

Beyond the two fundamental pillars, the group of studies also propose actions aimed at ensuring greater transparency between companies and tax administrations, as well as greater security overall. The Action Plans as a whole provide for mandatory disclosure of aggressive tax regimes and a CBCR form to tax administrations about their worldwide profit allocation. It also requires greater transparency between governments, with the additional need for countries to disclose decisions and other tax benefits to their partners and to make dispute settlement mechanisms more effective. Finally, it provides mechanisms for collecting better data so that you can measure BEPS and perform relevant economic analyses.

The agreement so far is only about what to discuss. Considering the lack of time as well the current scenario of recession due COVID-19 pandemic, it is difficult to predict a consensus among the Inclusive Framework members until the end of 2020, when the work mandate expires. However, it is clear that a concrete advance in terms of shaping a new tax architecture to cover digital economy in a multilateral approach now exists.

5 OTHER INITIATIVES TOWARDS DIGITAL ECONOMY

Not only is the OECD is studying ways to deal with under taxation within the digital economy. Here follows some attempts on the matter. First, there is a brief analysis of the EU's proposals (which remains a multilateral approach), after some unilateral solutions were already in practice within some large economies.

5.1 EUROPEAN DEVELOPMENTS

According to the EC in a 2013 study, companies operating in the digital market had an average tax burden of 9%, while companies in the traditional economy have 23%[140]. In practical terms, it is not new that digital business are under taxed in the EU single market. Nevertheless, it is also clear that the EU has long been discussing regulation of the digital economy. Such worry brought to the table an intricate matter that is far from consensus in the European Parliament.

In Europe, unified tax policies are a thorny theme. Though indirect taxation is already harmonised[141], there are still many challenges in terms of ideation and implementation of direct taxation[142]. In this sense, João Sérgio Ribeiro[143] previously speculated a distributive justice approach[144] through taxes at the European level. This distributive policy has to have a set of conditions considering *fiscal sovereignty*, *political community*, *welfare model* and *personal taxes*, which must be present at the EU level. Such perspective includes the observation of the principles of equality, proportionality and ability to pay.

Even though, a decade later from the publishing of the quote above, those requirements are still not in place, and the development of a unified tax policy. However, some attempts have been done in the *Anti-Tax Avoidance Directive* (ATAD) and MLI[145] to combat tax evasion and tax avoidance.

There are specials concerns regarding taxation within the EU that should be listed here. Firstly, domestic and community law cannot infringe on fundamental economic freedoms. A second aspect is that the 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[146]. Thirdly, within the EU, some harmonisation already exists within CIT in the EU, and is not considered to be in an early stage from a regulatory perspective.

[140] EU Commission, (2013). General Issues. Brussels: Directorate-General Taxation and Customs Union.

[141] In VAT of EU common market, each Member State has its own tax rate, in spite of having a harmonisation system set by Thirteen Directive. The collection goes directly to the countries, and EU law only requires that the standard VAT rate must be at least 15% and the reduced rate at least 5% (only for supplies of goods and services referred to in an exhaustive list). Actual rates applied vary between EU countries and between certain types of products. In addition, certain EU countries have retained other rates for specific products.

[142] Up today, EU revenue is essentially: 1) agricultural levies and duties; 2) common custom tariffs; 3) a percentage of the VAT, calculated on the basis of the common harmonised basis; and 4) transfers from Member States calculated on the basis of Gross National Income. Only the first two are considered as European taxes, even though they do not express a real power to tax in terms of aiming the revenue, but instead a restraint role. The third is a harmonised national tax and the fourth is not a tax at all.

[143] RIBEIRO, J. S. (2006). Distribution Justice through Taxation: European Perspective. Jurisprudencija 2, 80–89.

[144] According to the author, in this sense, *distributive justice* is a normative principle that determines how wealth must be distributed amongst taxpayers, following the principle of equality. This latter principle is understood in a material sense, broader than the liberal conception (*Idem*, p.80).

[145] Not an EU initiative properly. Laws known as a General Anti-Avoidance Rule (GAAR) statutes which prohibit "tax aggressive" avoidance have been passed in several countries and regions including Canada, Australia, New Zealand, South Africa, Norway, Hong Kong and the UK.

[146] HADZHIEVA, E. (2019). Impact of Digitalisation on International Tax Matters, Study for the Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies. Luxembourg: European Parliament, p. 13.

For instance, there is the Parent-Subsidiary Directive[147], which deals with the elimination of economic double taxation arising within a group of companies, including withholding tax on the state of the subsidiary and the corporate tax levied in the hands of the parent. There is also the Merger Directive[148], that makes merging operations neutral from a tax point-of-view, and the Interest and Royalty Directive[149], setting that these kind of payments between associated companies should not be subject to less favourable tax conditions than those applicable domestically in a Member-State.

Currently two proposals for Digital Business Taxation Directive are on standby in the European Parliament: Proposal 2018/0072 and Proposal 2018/0073. The first deals with the taxation of companies with significant digital presence; the second establishes a 3% tax on the revenues of large companies operating on the Internet. What is especially sought by taxing such sectors is a Union action with transparency and harmonisation, is to avoid the erosion of the tax base. As a caveat, small and medium-sized digital companies would be considered as outside of the scope of the norm.

Adding, a third proposal – not exclusive for the digital economy – focused on a Common Consolidated Corporate Tax Base (CCCTB) is also in discussion within in the European Council[150]. The idea in that it is to switch the methods for income allocation from the arm's length method to a formula apportionment method, considering factors as labour, assets and sales[151]. There are rules against debt bias, and a super-deduction is given for R&D businesses. Consolidation is envisaged by a separate proposal for a Directive, due for examination at a second stage, after the elements of the common base have politically been agreed upon. Until then, the proposal for a CCCTB also remain pending for further examination in Council.

The CCCTB is similar to the USA federal income tax model, addressing a tax harmonisation at the European level, with the distribution of consolidated profit from a single corporate tax base of the company. In short, what is sought for is to combat tax evasion, especially in the form of aggressive tax planning that is currently identified by means of the erosion of the tax base of corporate profits. In this sense, the European Directive 2016/1164 (ATAD) establishes rules for limiting interest on loans (20% of Earnings before Interest, Taxes, Depreciation and Amortization. or EBITDA); exit taxation; general

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[147] Council Directive 2011/96/EU of November 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member-States and subsequent amendments.

[148] Council Directive 2005/19/EC of 17 February 2005, amending Directive 90/434/EEC 1990 on the common systems of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member-States.

[149] Council Directive 2003/49/EC of 3 June 2003, on common system of taxation applicable to interest and royalty payments made between associated companies of different Member-States.

[150] COM (2016) 685 final of 25 October of 2016, Proposal for a Council Directive on a Common Corporate Tax Base and COM (2016) 683 final of 25 October of 2016, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB).

[151] RIBEIRO, J. S. (2018). An Overview of European Tax Law and Its Impact on European Member-States' Legal Systems: the Portuguese Example. In J. S. RIBEIRO, Selected Essays on International Business Law (pp. 285-303). Braga: Universidade do Minho Escola de Direito, pp. 291-292

anti-abuse rules; CFC rule; and the recognition of hybrid asymmetries. Regarding exit taxation, the aim of CCCTB is to control the transfer assets from the headquarters to a foreign base company of the same group of companies; transfer of assets from foreign company to headquarters or other foreign company in the same group; transfer of assets from tax residence; the transfer of activity exercised by the company; and avoid double taxation.

The objective of the CCCTB is to reach the situations of hybrid asymmetry, which are the asymmetries between tax rules of different states. For example, a certain payment considered a dividend by one state and regarded as interest by another country.

The scope of European law also encompasses the exchange of information and cross-border cooperation between tax authorities. Such instruments work along with domestic law, and thus do not conflict with the EU law. In opposite, they render cooperation to fight against tax avoidance.

None of these proposals have been adopted yet, mainly because of lack of consensus among Member States. Some of them are eager to tax digital business as they see the erosion of tax base, but others rely heavily on the benefits of a favoured regime to attract digital companies to establish inland, allowing an inflow of capital derived from such businesses. As seen below, usually larger European economies want to tax, whereas smaller Member States rather to adopt low corporate taxation.

5.1.1 DIRECTIVE PROPOSAL 2018/0072

As in the previous chapter, those who are non-residents for taxation purposes become liable to tax in a country only if they have a presence that amounts to a PE there. However, such rules fail to capture the global reach of digital activities where physical presence is not a requirement anymore in order to be able to supply digital services. New indicators for significant economic presence are therefore required in order to establish taxing rights in relation to the new digitalised business models.

For this matter and following the reasoning of OECDs recent reports, the EU Commission released a proposal identifying digital business by means of the *digital significant presence*. Then, according to the Directive Proposal 2018/0072, for the purposes of corporate tax, a PE shall be taken to exist if a significant digital presence exists through which a business is wholly or partly carried on.

In the scope of the first proposal from the EU Commission, companies would have to pay tax in each of the Member States where they had a significant digital presence if one of the following criteria were met: a) annual digital service revenue of over € 7 million; b) more than 100,000 users per fiscal year in a Member State; or c) more than 3,000 business contracts involving digital services per fiscal year.

According to article 4, paragraph 5, concluding contracts for the supply of digital services are considered if a business contract if the user concludes the contract in the course of carrying on business. A second option occurs when a user is located in a Member State within a tax period if the same user is a resident in that tax period in that Member State for corporate tax purposes. A third application is to when a user is resident for corporate tax purposes in a third country but has a PE in that Member State in that tax period.

The proposal is to tax over the attribution of profits, taking into account the following market values: a) profits arising from the use of user information, such as the placement of advertisements; b) user connection services, for example: shared economy platforms; and c) other digital services, such as streaming subscription. In short, it is a Profit Tax or Digital Profit Tax, with tax rates to be determined.

Taking into account article 5, the profits that are attributable to or in respect of a significant digital presence in a Member State shall be taxable within the corporate tax framework of that Member State only. Then, if a taxpayer has significant digital presence in more than one Member State, he or she will have to attribute the amount correspondent to the profit of that market jurisdiction to each tax authority. In other words, to deem a digital presence, a taxpayer must perform the same or similar activities under the same or similar conditions, in its dealings with other parts of the enterprise, taking into account the functions performed, assets used and risks assumed, through a digital interface.

According to the respective explanatory memorandum of the Directive Proposal 2018/0072, the proposal affects corporate taxpayers that are incorporated or established in the EU, as well as enterprises that are incorporated or established in a non-Union jurisdiction with which there is no double taxation treaty with the Member State where a significant digital presence of the taxpayer is identified.

Adding, it does not affect enterprises that are incorporated or established in a non-Union jurisdiction in which there is a double taxation treaty in force with the Member State of the significant digital presence, as to avoid causing any breaches of those double taxation treaties.

Finally, the new taxing rule would not affect or limit the application of any other test under Union or national law for determining the existence of a PE in a Member State for the purposes of corporate tax, whether specifically in relation to the supply of digital services or otherwise. The caveat that is important to reinforce is the idea that the new significant economic presence is not an abandonment of the traditional PE test. Instead, it represents a new test that aims to update the current system to a new scope of economic activity.

Considering the problematic implementation of PE rules to digital business, the Commission's proposal is definitive, and provides a simple answer to the matter. It may even be considered a model for a broader implementation of the same method in large economies outside of the EU internal market.

This proposal is still under discussion in the European Parliament; however, it represents a considerable advancement in terms of OECD-BEPS project. The general idea may have inspired part of Pillar 1's approach, regarding the similar *significant economic presence*. Nevertheless, the European proposal is simpler in terms of implementation if comparing to OECD's recent Pillar 1 proposal ("Unified Approach"). There are much less caveats, thus it requires much less in terms of compliance costs and understanding of the taxing systems. However, the discussion involves much less participants than the OECD Inclusive Framework, also been more consistent in terms of goals and principles to comply with.

To sum up, the Directive Proposal 2018/0072 itself is bold, but could solve the problems of under taxation and double taxation simply and clearly, basing it in a strong obedience to the neutrality principle, as well home state taxation and procedural principles (simplicity, efficiency and cost minimisation).

5.1.2 DIRECTIVE PROPOSAL 2018/0073

The second EC's proposal made in 2018 established a Digital Service Tax (DST), which represents is a type of "European Digital Equalization Levy". It is a 3% provisional tax on revenues from three types of core services, where the core value is generated through user participation, namely: 1) online placement of advertisements; 2) sale of data collected from users; and 3) digital platforms that facilitate user interactions. In addition, such services must be provided only by companies with total

worldwide annual revenues of over € 700 million and total annual revenues from digital activities in the EU of over € 50 million.

This proposal was considered by the EC as a temporary measure aimed at revenues resulting from digital activities in the Union that would remain outside of the scope of DTCs. Moreover, the Recitals and the Explanatory Memorandum explicitly refer to the proposal as interim solutions to further measures aimed at the problem considering that the current corporate tax rules are inadequate for the digital economy[152].

The threshold is meant to catch companies that are able to engage in aggressive tax planning schemes and was set at this level to match the threshold used in the EU Proposal for a CCCTB. In addition, the tax does not include start-up companies and entities in process of digitalisation.

The EC presents the DST as an easy-to-implement measure targeting the revenues stemming from the supply of digital services where users contribute significantly to the process of value creation.

Before discussing the two proposals of taxing digital economy, important questions arise about the used financial screens. Is there an empirical basis for them or are numbers targeted at hitting tech giants? It is not yet known how the calculation of the first proposal will be made in terms of the tax rate on profit, but it certainly approaches the figure of a corporate tax.

Regarding the second proposal, in the same sense, what is the parameter for establishing a 3% tax rate on sales? With respect to Digital Equalization Levy, India has set a similar tax rate of 6%. Being included on invoicing, would this tax be legal in nature? In the case of the first proposal there is no doubt that it is a corporate tax, given its impact on profit; but in the second proposal, it is possible to think of cascade effect with VAT.

The question remains whether the proposed DST is a VAT or a CIT. The classification will depend on the possibility or of non-accumulation of the tax and access to tax credit of future transactions. As both projects are stationary, the application parameters and empirical analysis of the effects of a DST end up with the Member States as they adopt the tax domestically and unilaterally, as shown below.

As a possible answer for the question above, it is also important to consider the deduction system. The new version of the preamble states that "*[t]his Directive should not prevent a Member*

[152] Notwithstanding, it is possible that something, planned to be temporary, end up being permanent. Then, it would be wise to consider the use of a DST for a long period, mainly its consequences for the economy.

State from allowing businesses to deduct the DST paid from the corporate income tax base in their territory, irrespective of whether both taxes are paid in the same Member State or in different ones". By allowing deduction, the DST is closely related with CIT[153]. Thus, it is possible to set a legitimate tax planning in consideration of the extension of deduction, choosing the most favourable Member State to install a digital business.

In terms of deduction of DST, Nogueira believes that ECJ would take the same position as in *Brisal*[154]*.* Then, the Court would not likely consider any advantages eventually obtained by non-residents. The reasoning is because of unfavourable tax treatment contrary to a fundamental freedom which cannot be regarded as compatible with EU law, taking in consideration the potential existence of other advantages. In addition, the Court would also would dismiss any claims regarding the balanced allocation of taxing rights, given the lack of a direct link between the denial of the deduction and the exercise of the taxing powers by the state. Still in this case, CJEU would have probably consider lawful double deductions, whereas the Court would be fighting a tax evasion arrangement, while even having difficulties to ascertain double deductions[155].

Another problem to deal with is regarding the limited effects of DST deduction. While it is not granted full deduction, there is a risk of the cascading effect. The VAT Directive, in other way, grant full deduction, which could be repeated in the DST proposition.

Nevertheless, the DST generated considerable controversy in the EU, placing on one hand the host countries of technology companies, and on the other, the holders of consumer markets largely affected by digital services. Against the implementation of the DST include: the Netherlands, Ireland and Luxembourg. Germany and Belgium are still undecided. With DST, the biggest economies strengthen their positions in the EU. Traditional businesses are better protected against disruptive and more innovative business models.

According again to Nogueira[156], aside from not meeting the requirements set by its legal basis, the DST proposal is an infringement of the subsidiarity and proportionality criteria. It fails to meet its

[153] "Most EU tax systems allow residents to deduct (non-)corporate income taxes and other levies from the corporate tax base. In the Impact Assessment, the Commission confirms that 'the new tax is an expense for a company that arises in the course of it[s] business. As such, it is natural to allow it to be deducted from the corporate tax base'. This mechanism does not eliminate double taxation, but 'in the absence of the possibility to credit the new tax against corporate income tax paid on the same revenue [...], allowing the deduction of the tax from the corporate tax base would contribute to a fairer outcome overall'" (NOGUEIRA, J. F. (2019, February 18). The Compatibility of the EU Digital Services Tax with EU and WTO Law: Requiem Aeternam Donate Nascenti Tributo. Intl. Tax Stud. - IBDF Journals, pp. 3-4).
[154] Case C-18/15 - Brisal – Auto Estradas do Litoral SA, KBC Finance Ireland v. Fazenda Pública.
[155] *Idem,* p. 7.
[156] *Ibidem*.

underlying goal of aligning taxation with value creation, particularly in which what concerns the taxation of digital advertisement services. In sum, its negative impact would outweigh any advantages.

The core of DST's proposal is not focused on the revenues from a given state, but rather the potential this particular state has as a market jurisdiction, considering the investments it makes in its human resources and infrastructures. The general concern is that DST would compensate the states for providing access to their markets. This line of reasoning has yet to be decided in order to understand the tax design and the allocation of revenues among the Member States, particularly in the case of advertisement services[157]. Yet, there is still some lack of clarity for non-residents deductions[158]. As most digital service providers are located outside of the EU, one could argue that the proposal (particularly considering its high thresholds) leads to a systematic disfavouring of cross-border (non-EU) business as result of covert or *de facto* discrimination.

Still, in Nogueira's view[159], the DST would not be considered covert discrimination. In fact, in certain cases, not even a full match would lead to deeming a measure to be discriminatory. This would be the case of taxes levied on external products or non-resident producers because the same products or producers cannot be found in the territory. For example, the mere fact that there is no oil extraction or refinery in a given state does not prevent it from (using its tax sovereignty to) levy a specific tax on oil-derived products, even if these products are in direct competition with products not subject to that tax, such as electricity. Discrimination would only occur if the measure fulfilled the "vast majority of cases" criterion, which seems to be AG Kokott's interpretation of the Court's approach in *Hervis*[160].

There are some critics in the sense that the proposal distorts competition between digital service companies due to the (high) thresholds used. While there is no continuity in the tax response, also known as the "cliff effect", the thresholds would distort the competition in favour of smaller-sized competitors[161]. However, favouring small companies complies with the ability to pay principle, because it grants a better treatment to this category of company. This is a quite traditional policy in the field of competition law, because it contains capital concentration and generates other benefits as jobs creation, social inequality and innovation.

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[157] *Idem*, p. 3.

[158] The deduction system is not part of the proposal and is merely mentioned in its preamble. Due to the way corporate tax systems are structured, income tax deductions are only granted to resident companies (in order to determine the real profit of a company). Non-residents would need to offset the DST in their countries of residence, so this deduction would be granted by residence states only. For EU law purposes, this limitation may be problematic (*Idem*, pp. 5-6).

[159] *Idem*, p. 7.

[160] C-385/12. Opinion of Advocate General Kokott, supra n. 58, para. 38 in fine.

[161] NOGUEIRA, J. F. (2019, February 18). The Compatibility of the EU Digital Services Tax with EU and WTO Law: Requiem Aeternam Donate Nascenti Tributo. Intl. Tax Stud. - IBDF Journals, p. 12.

By recovering competitive advantages to traditional economy versus MNE (tech giants), the DST definitively goes beyond a mere tax intervention, that distorts competition in favour of non-digital services. The new tax shall compensate the natural advantages of digital business, in terms of using local infrastructure, with minimal business' investments in local development.

Moreover, the DST will not deter R&D. On the opposite, there exists a caveat that protects smaller innovators, exempting from taxation. In case of larger tech companies that invest in R&D (as they usually do), a basic tax planning can transfer the whole research sector to a smaller company, as we have been seeing in GAFA investments.

The legal basis for the DST proposal is found in Aarticle 113 of the Treaty on the Functioning of the European Union (TFEU). This special legislative procedure only allows for the harmonisation of indirect taxes and relies on the qualification of the DST as a proper turnover tax, which can be challenged. Moreover, it needs to have one of the two goals: the functioning of the internal market or avoiding the distortion of competition. Any EC directive proposal, like any secondary legislation can be questioned in the CJEU. Any directive has to comply with EU primary law. Indeed, if the directive proposal is adopted and implemented by the Member States, it will be hard for a Member State to claim infraction of its EU law obligations, while complying with TFEU and other mechanisms. Therefore, the implementation of a directive is essentially for the fulfilment of its EU law obligations.

According to CJEU case law, any acts of the EC are EU law-compliant, having a *juris tantum* presumption of lawfulness, except in extreme cases in which it is evident that the act does not exist or that it blatantly infringes EU law[162]. Then, the directive can be challenged by any Member State, the European parliament, the European Council or the EC in the framework of an action for annulment. Notwithstanding, in respect to Article 267 of TFEU, anyone affected by the measure can challenge its legality in the court of the country applying it, while the local Court has the possibility of assessing the admissibility of the measure.

Moreover, any tax policy that aims to a certain economic sector must comply with Article 107 of the TFEU, which states that only specific discriminations are allowed, according to the fundamental freedoms. As a general rule, discrimination of any kind towards states are forbidden in the single

[162] "It should be remembered that acts of the Community institutions are in principle presumed to be lawful and accordingly produce legal effects, even if they are tainted by irregularities, until such time as they are annulled or withdrawn. However, by way of exception to that principle, acts tainted by an irregularity whose gravity is so obvious that it cannot be tolerated by the Community legal order must be treated as having no legal effect, even provisional, that is to say that they must be regarded as legally non-existent. The purpose of this exception is to maintain a balance between two fundamental, but sometimes conflicting, requirements with which a legal order must comply, namely stability of legal relations and respect for legality" (Case C-137/92, Commission / BASF and others , paras. 48-50).

market. However, the Commission's proposal is not a State aid itself, yet a general policy covering the entire EU market.

At first glance, the EU fundamental freedoms are respected. The Commission considers that the interim solution would not infringe the internal market freedoms of establishment (article 49 TFEU) and to provide services (article 56 TFEU) as interpreted by the CJEU. The scope of the tax includes both non-resident and domestic transactions and companies. Cross-border activities and companies will be not taxed heavier than similar domestic ones. In the light of the ECJ, only one rate will apply[163]. Then, directive fulfilment of the requirements are as such according to the EU legal basis.

In opposite, Nogueira[164] argues that it is not possible to ascertain the reasons that support the Commission's conclusions. The establishment of high-revenue thresholds for the delimitation of the taxable entities would amount to *de facto* discrimination against third-country companies and, as such, would be incompatible with EU law. In line with the Commission's preliminary work, the thresholds have to be set as to not systematically exclude domestic companies from the scope of the tax[165].

In this sense, non-EU situations must be taken into account for EU purposes, since the TFEU liberalises capital movement from and to third countries. However, this is the sole exception, as all other freedoms restrict the geographic scope of protection of these freedoms to the EU. Moreover, if case has two or more fundamental freedoms involved, the CJEU may consider freedom of capital a secondary freedom related to third countries[166].

In this sense, it is relevant to comprehend the following reasoning. The DST fits quite well with regards to the free movement of services. Then, even if one considers that it also affects the free movement of capital, the CJEU would likely only examine it under the freedom to provide services, not the former. As the latter does not have an external dimension, discrimination against third-country service providers would be therefore lawful.

Considering subsidiarity and proportionality, they have to be respected in any EU rule. Subsidiarity is required in areas outside the exclusive competence of the EU. According to this principle in Article 5(3) TFEU, EU action can only take place if it cannot be appropriately carried out at the Member State level. Proportionality, by its turn, requires any EU action to not exceed what is needed to

[163] COMMISSION E. , COMMISSION STAFF WORKING DOCUMENT IMPACT ASSESSMENT Accompanying the document Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence and Proposal for a Council Directive on the common system, 2018, pp. 148, annex 1

[164] NOGUEIRA, J. F. (2019). The Compatibility of the EU Digital Services Tax with EU and WTO Law: Requiem Aeternam Donate Nascenti Tributo. Intl. Tax Stud. - IBDF Journals, p. 5

[165] COMMISSION E. , *Ibidem.*

[166] NOGUEIRA, J. F. (2019).*Ibidem.*

achieve the goals of the EU Treaties. In determining a policy, EU institutions should choose measures that, while allowing them to reach their goals, are the least restrictive to Member States' interests.

5.2 UNILATERAL TAX POLICIES

As multilateral negotiations are still occurring, some countries do not hold their policies towards digital taxation. They may withdraw their tax laws over intangibles if a cooperative action rises at the same level. However, there is no guarantee in such sense.

At the forefront of digital taxation on July 24, 2019, France enacted Law no. 2019-759, introducing a digital services tax, and modifying the CIT base (*impôt sur les sociétés*), by amending the *Code Général des Impôts*. The new tax applies to groups operating within the digital economy with an annual worldwide turnover of over € 750 million and with at least € 25 million of the turnover generated in France. The tax rate has been set at 3% and there is a possibility of retroactive effect from the date of the announcement of the measure.

It is expected to raise up to € 500 million per year and the main concern regarding this topic of the French state was the under-taxation of the so-called "GAFA" (Google, Amazon, Facebook, Apple), the group of large-scale technology giants in the country. From the French lawmaker perspective, this is an express provision of the law in its Article 1: "*Taxes sur certains services fournis par les entreprises du secteur numérique*"[167], which explicitly indicate from whom collect taxes.

The new law reflects the controversy of a case study where Google France sold advertising space on its websites. These legal deals were conducted through preliminary contracts, and to enter into definitive contracts, the client was referred to Google Ireland, the company that had the legal powers to sell that space. Then, payments were made from customers in France to the company in Ireland, and the income tax due was cleared there. At Google France, there was only a small amount of revenue for the support the local company gave to its Irish associate. Despite this arrangement, the French tax authorities found that in the country everyone accessed the Google France site, generating business, but the tax paid locally was very low. According to the French tax authority, such transaction made no sense, since the market exploited was essentially French. Therefore, so the profit for the sale

[167] BOMMIER, A. H. (2019, august 07). Taxe GAFA : une occasion manquée de repenser les règles de territorialité de l'impôt sur les sociétés. Retrieved from La Tribune: https://www.latribune.fr/opinions/tribunes/taxe-gafa-une-occasion-manquee-de-repenser-les-regles-de-territorialite-de-l-impot-sur-les-societes-825346.html

of advertising space should be determined locally. According to the local tax authority calculations, the tax due on the operations was € 1.1 billion. However, the French courts took a different view compared to the tax authorities, as they did not identify sufficient connecting elements in light of the rules in local law; they considered the respective international tax treaty between countries[168]. In short, the only recognised (but not fully sufficient) connecting factor was that of the revenue source. The result of the case generated strong political pressure to tax digital services in France, in order to maintain part of the business revenue in the national territory, while exposing the clash between revenue source and value generation as the main taxable digital vector. Notwithstanding it prompted public investigations of tax avoidance and tax evasion practices, while pointing out the artificial use of PE.

In the case of the UK, a more generalist stance was originally taken regarding the business of multinational companies, with no emphasis on digital companies. The first step taken to combat tax evasion in the UK was to regulate notifications addressed to multinational companies to inform the tax authorities about their transactions between countries. In April 2015, the UK introduced the Diverted Profits Tax (DPT) institute, imposing a tax presence in the country and the ability to identify when profits are split between tax jurisdictions without economic substance. That is, an official conclusion that nothing is actually transacted or taken into account for the purposes of production or management of the company. Such a move was justified in combating a number of companies that claimed to be based in Ireland, where income tax was only 12.5%. In practice, the tax was unpaid due to the fact that profits were transferred to other parts of the company' payment for the use of patents or repayment of loans with high interest rates. When profits were reported, tax rates were 18%, but if the revenue direction were discovered by the tax authorities, it would rise to 25%[169].

Another British innovation was the shift from the focus of taxation from place of production to place of destination. Therefore, in addition to requiring a tax presence in the country, VAT is now charged at the place where the transaction takes place. In the case of an Irish supplier selling in the UK, VAT is now required by HMRC and not by the Irish tax authorities. To be effective, however, such measure depends on an agreement with the EU as well as its Member States. Such practice could help USA companies repatriate their profits due to the global tax system adopted in the USA.

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[168] EBAG, G. (2019, april 25). Google Wins Again in French Court Fight Over $1 Billion Tax Bill. Retrieved from Bloomberg: https://www.bloomberg.com/news/articles/2019-04-25/google-wins-again-in-french-court-fight-over-1-billion-tax-bill. See also the French agreement between the *Procureur de la Republique Financier*, SARL Google France and Google Ireland Limited (RFN-15 162 000 335) (https://www.agence-francaise-anticorruption.gouv.fr/files/files/190903_CJIP.pdf).

[169] LEONARDI (2016), The Digital Economy and the Tax Regime in the UK, p.106.

Faced with the European digital services tax scenario, the UK has announced a measure for digital taxation, starting on April 1, 2020. The provisional rate is placed at 2% and the tax design continues to be under study. It will focus on revenue from specific digital services such as search platforms, social media and online markets. Such revenues are linked to the participation of UK users. The UK DST is not a tax on online sales of goods, so it only applies to income earned through the intermediation of these types of sales, not to the sale itself. Subject to tax liability are companies that have global revenues in excess of £ 500 million and more than £ 25 million of revenue in the country. As incentives, the first £ 25 million of relevant UK revenues will not be taxed. There is also a reduction in the tax burden for low margin businesses. With international consensus, the possibility of revoking the national forecast remains. Finally, regarding the legal nature, as it does not concern the sale of goods, but rather revenue, the tax is considered a type of corporate tax, not VAT[170].

A third European case shown as an opposite political approach. In March 2019, a vote was imposed on the Assembly of the Portuguese Republic to impose a tax on digital services. The proposal was rejected by the parliament, contrary to the tendency of other southern countries of of the EU, and, with respect to BEPS, Portugal has not yet faithfully followed OECD guidelines. However, it is possible that the country will consent to the adoption of a European DST[171].

Although Portugal usually aligns with EU policies, it has not followed the unilateral initiatives of other Member States. Far from being a politically accurate conclusion, it is believed that the under-taxation of intangibles is understood domestically as a business attraction in the country, following the model of comparatively small European economies.

Spain announced its *Impuesto sobre Determinados Servicios Digitales* in April 2018, to enter into force in the first half of 2019, to be included in the *Presupuestos Generales del Estado* project for 2019, with a rate of 3%, with retroactive effect from January 1, 2019. Yet the project was defeated in the Spanish Congress, being considered as the trigger for calls for new elections within the country. Such a framework may lead to further discussions, as a new parliament may revise the issue[172]. Its impact would be on gross income (excluding VAT) arising from specific digital services, such as

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[170] Customs, H. R. (2019, julho 11). Introduction of the new Digital Services Tax . Retrieved from Gov.Uk: https://www.gov.uk/government/publications/introduction-of-the-new-digital-services-tax/introduction-of-the-new-digital-services-tax In addition, it should be remembered that the outcome of the June 2016 British referendum, deliberating on leaving the EU, created an environment of uncertainty in the national economy. Financial market reactions have not been positive, and prospects for foreign investment tend to wane and the diaspora of off-island companies has begun. In any case, the OECD commitments to BEPS remain in force, even considering that there will be significant economic asymmetry between the UK and the EU.

[171] LOPES, M. (2019, March 20). Direita e PS rejeitam imposto sobre serviços digitais proposto pelo Bloco. Retrieved from O Público: https://www.publico.pt/2019/03/20/politica/noticia/direita-ps-rejeitam-imposto-servicos-digitais-proposto-bloco-1866168

[172] MUÑOZ, R. (2019, July 17). El Gobierno se plantea retomar la 'tasa Google' española si no hay acuerdo en la UE. Retrieved from El País: https://elpais.com/economia/2019/07/16/actualidad/1563268913_048006.html

providing digital interfaces (brokerage services), which allow users to interact with each other, or facilitate the provision of underlying supplies of goods and services directly between users; as well as selling user generated data.

In the Spaniard project, the taxable person would be multinational groups that have net overall revenues in excess of € 750 million. There would be incentives similar to the British model: the first € 3 million of relevant revenues obtained in Spain would not be taxed, which is considered a very low limit by national standards. The tax would only apply when the user's digital devices are located or used in Spain, via confirmation via IP address. Finally, the sanctions would be potential fines of up to € 400,000 per year for non-compliance with tax avoidance[173].

Italy also announced a DST on January 1, 2019, and the enforcement decree was published on April 3, 2019, with a 60-day *vacatio legis*. Italy has made a previous commitment to implement the tax with the EU, in line with its guidelines. The 3% rate was also adopted, with a focus on gross income - excluding VAT - arising from specific digital services, such as online advertising with digital interface for its users; multilateral digital interface that allows interaction between users, including to facilitate the provision of goods or services; and the sale of user generated data. In terms of territorial base, the user needs to be located in Italy and have a high degree of involvement in value creation. It is interesting to note the focus on the user, Business-to-Consumer (B2C), excluding Business-to-Business (B2B). The taxable person is the company with total revenues of over € 750 million, of which at least € 5.5 million comes from digital services in Italy.

On the other side of the Atlantic Ocean, the USA used to maintain a firm stance on not taxing research and innovation, while the digital market is often understood to be essentially an area of innovation (R&D). In terms of the digital market, what is taxed domestically are royalties, or patents. So much so that it has become common practice for large national technology corporations to, officially, relocate their central business establishments to other countries with milder taxation.

However, in 2017, as an effort to constrain base erosion, the USA Congress approved the *Tax Cuts and Jobs Act of 2017*[174], creating the Global Intangible Low Tax Income (GILTI), a new category of foreign income added to yearly corporate taxable income. It is a tax on earnings exceeding a 10% return on a company's invested foreign assets. GILTI is subject to a worldwide minimum tax of between 10.5

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[173] Camara de Diputados, (2019, January 25). Boletín Oficial de Las Cortes Generales. Retrieved from http://www.congreso.es/public_oficiales/L12/CONG/BOCG/A/BOCG-12-A-40-1.PDF

[174] Pub. L. 115-97.

and 13.125 percent on an annual basis and it is supposed to reduce the incentive to shift corporate profits out of the USA by using IPR.

Moreover, with respect to groups of companies, the USA follows the arm's length principle, whereby the subsidiary is considered as part of the parent company, if there is a minimum interest in the controlled company's capital.

The subject of digital market taxation in the USA is extremely broad, dealing with income taxation, patents (royalties), tax incentives, customs tariffs, services tax, among others. The traditional USA policy of incentives R&D, coupled with other factors, has enabled the world leadership of USA technology companies.

CHAPTER IV – CRITICS TO THE MEASURES TAKEN

1 MULTILATERAL MEASURES

As shown in the previous chapter, the current stage of OECD BEPS Project has a two-pillar approach. In synthesis, the first combines significant economic presence with an equalisation levy, whereas the second pillar consists of a *de minimis* corporate tax, considering global standards.

In terms of OECD actions, it is notable that the previous MLI is far too complex instrument, taking into account the aims in digital taxation, and having low adhesion in terms of global economy. In this sense, the two pillars approach has the same flaw, by being too complicated as well. The *blending approach*, by covering so many possibilities, end up making the proposals uncertain and difficult to grasp. Adding, the BEPS measures are still inconclusive within the OECD's framework.

The MLI and others multilateral solutions are having low adhesion, therefore lacking of effectiveness. The efforts in terms of multilateral negotiations are too large, and the results appear too feeble. In terms of tax revenue, there are no reliable arguments that confirm that the methods are being efficient in tackling tax avoidance.

The provisory results in OECD Action Plan follow the same pattern. The strategies taken are too complex in order to be applicable on a multilateral level. What is implicit however within the successive OECD reports is that work groups do not reach consensus whatsoever.

Even with the advancements in reforming the OECD Model Convention, it is still required to individually reform the tax treaties, otherwise the changes will not be bound, having a marginal repercussion in the real amount of tax collected. Nevertheless, the reasoning of the delimitation of abusive practice is not held by a considerable part of member states. For instance, in the context of EU law in *N Luxembourg 1 v Skatteministeriet*[175] the application of the article 5 of EU Directive n. 2003/49 was prevalent in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse. For the OECD panel, the EU is considered one party, then its

[175] C-115-16, see also C-265-04.

"domestic" legislation overcome OECD's premises. Thus, EU law is interpreted autonomously and independently of the commentaries on OECD Model Tax Convention[176].

In an opposite viewpoint, the EU directive proposal of *digital significant presence* (Directive Proposal 2018/0072) keeps only the essential in terms of splitting taxing rights of income taxation. The proposal goes straight to the point (lack of proper taxation) and pleases market jurisdictions, which represent the absolute majority of interested countries on the matter. Only countries that are investment hubs would lose revenue due the decrease of international remittances.

1.1 REFORMS ADDRESSING PERMANENT ESTABLISHMENT

The erosion of the PE institute is a consensus. In this perspective, both OECD and EU have proposals to consider resident as an undertaking that has heavy reliance on intangibles and acts in the domestic market.

The EU *digital significant presence* (Directive Proposal 2018/0072) would represent a comprehensive solution in the internal market, as all Member States would have to comply with the new rule. Thus, it would be a reasonable solution for the EU economy.

On the other hand, the OECD proposal of significant economic presence must have strong mechanisms to constrain low tax jurisdictions to circumvent the new rule. One option is to impose a withholding tax, granting some revenue domestically. Then, it is paramount to adopt one of two solutions: resident due significant economic presence, or imposing withholding taxes higher than PE's rates, encouraging the taxpayer to be resident.

Albeit the PE system has many vulnerabilities, the requirement to incorporate domestically is not feasible, as it would lead to undesirable economic restrictions towards the free market. Some countries indirect drive companies to do so, but it is justifiable in case of existing an attractive internal market.

In terms of proposed solutions by OECD, the intent is to grant the allocation of income within a multinational group of companies more directly in line with the location of the economic activity that

[176] *Idem*, Opinion, §109: "For a restriction of freedom of establishment to be justified on grounds of the prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory".

generates such value. In this sense, there are three main approaches taken in the report: a) *transfer and use* of intangibles including hard-to-value intangibles, and cost contribution arrangements; b) delineating the actual transaction and business risks and c) global value chains and transactional profit split methods[177].

The first approach involves the transfer of intangibles and right of intangibles at non-arm's length prices, either in connection with licensing arrangements, cost contribution arrangements or tax structures that separate deductions relevant to the development of the intangible from the income associated with it. Such transfers are beyond arm's length because of difficulties in valuing transferred intangibles at time they are transferred, unequal access to information relating to value between taxpayers and tax administrations and hidden or unidentified intangibles without payment[178].

This situation mentioned exposes the need of a clear definition of intangibles for transfer pricing purposes, moreover to consider that, when transferring an intangible between entities, there would be necessary to beacon what the compensation is. The idea is grant that entities within a group that contribute value to intangibles either by performing, managing or simply bearing risks would be appropriately rewarded. This requirement makes the situation more clear regarding tax administration on the size of value involved in an operation, and resizing fictional transactions performed among those companies. A proper valuation technique is used in determining arm's length transfer prices when comparable transfers cannot be beaconed[179].

Following, the second approach deals with allocation risks. According to the OECD guidance in Action Plan 6, risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over the risks and does not have the financial capacity to assume the risks, will be allocated to the party that does effectively control and have the financial capacity to assume the risk. In a company law perspective, the proposed solution is quite similar to the Piercing the Veil Doctrine, while a parent company may be liable to a conduct from the subsidiary.

Thirdly, there is the transactional profit split method in global value chains. In the case of highly integrated processes (mainly ICT). Although it raises concerns in terms of BEPS, the value creation is indeed scattered amongst different jurisdictions. In a more realistic approach, this is the case of

[177] OECD (2018), Interim Report, OECD, Paris, p.91.
[178] *Ibidem.*
[179] The proposition is to provide tax administrations a guidance to measure such hard-to-value transfer, yet the lack of standards are too strong of a tool in the hands of authorities, which can then violate the rule of law in a broader sense.

legitimate tax planning, not a tax avoidance, because the allocation of steps in the production is in line with value creation splitting. In this case, only a multilateral tax policy can minimise the effects of BEPS.

Another critic is about revisions in the concept of PE in the Action Plan 7. The revised OECD Model Tax Convention of 2017 already 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 concept of *Service PE*, endorsed by the UN, which differs from the OECD approach because it is less focused on physical presence.

It should be noted that the OECD, when addressing action plans 1 and 7, did not specifically mention changes to the concept of PE. Comments 42 and following are not modified, they are simply reproduced from Action Plan 1. In Action Plan 7 there is concern about fragmentation and recognition of ancillary activities within paragraph 4 of Article 5 of the OECD Model Convention, but there are no significant advances to this either. Not even the MLI has definitive solutions in this regard. On the other hand, it is first necessary to re-discuss the definition of establishment, followed by the PE, in order to know whether or not a digital service fits objectively because of a connecting element.

Regarding Transfer Pricing (Action Plans 8-10), 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 a multinational enterprise (MNE) could still book profits in low tax jurisdictions by relocating their senior employees.

Finally, the Action Plan 3 on CFC Rules, following BEPS amendments, will be entitled to tax 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 the shift of partial MNEs income in subsidiaries corresponding to at least a risk-free return.

After all, while the OECD's 117-Member Inclusive Framework is aiming to find consensus on digital taxation, some countries demand targeted solutions, while others are calling for a general reform without ring-fencing the digital sector and a third group seeing no need for further reform following BEPS. This generates an undesired unilateral scenario of taxation, causing more damage to the

international economy. New reports continue to be publicised, but OCDE does not have enough political strength to convince large economies to adopt the plans, mainly because some countries are more concerned about favouring their respective internal market by granting non-regulated international fields for their own MNEs established inland.

Nevertheless, there are relevant criticisms of the conclusions reached by the OECD BEPS report. Hosuk Lee-Makiyama and Bert Verschelde[180] argue that the proposed reforms essentially seek to create a tax regime aimed at the digital economy, despite the fact that the text itself claims otherwise. Such measures not only contradict the principle of tax neutrality, but also the principle of free movement of services within the EU's single market. According to the researchers, the search for a "cure" can lead to the aggravation of "disease". Initially, the very idea that the erosion of the tax base is a consequence of aggressive tax planning of multinational companies is questioned. For Lee-Makiyama and Verschelde, the evidence of such erosion is ambiguous, as the OECD itself recognises that further research would be needed to delimit it; Moreover, there is no evidence that corporate tax in EU Member States has lost revenue in recent years, and in most cases they have remained stable[181].

Another questioned conclusion is that large technology and E-Commerce companies would in fact have very low tax rates. The underlying economic reasoning is that the Internet has increased the ability of businesses to engage in different jurisdictions without necessarily having a physical presence; but either way there would be no causal relationship between the rise of E-Commerce as a selling platforms and the tax base of corporate taxes, contrary to what is commonly reported by the media[182].

Regarding transfer pricing operated by multinationals, this phenomenon is not something new, being much older than the Internet itself; In addition, transfer pricing and hybrid incompatibility (double non-taxation) are consequences of increased international capital mobility and the liberalisation of capital accounting, *i.e.* the expected consequences within the free market. Moreover, online businesses would not represent a new challenge in itself, but the natural consequence of international transactions made by multinational companies[183].

Another critic was made by Russo, saying that OECD is not fully clear regarding the identification of elements of tax avoidance. The three elements (artificiality, secrecy and loopholes) leave some room for discussion due to general definitions, *e.g.*: "almost invariably", "secrecy may", "tax

[180] LEE-MAKIYAMA, H. &. (2016). OECD BEPS: Reconciling Global Trade, Taxation Principles and the Digital Economy. In F. &. BOCCIA, The Challenge of the Digital Economy (pp. 55-68). Roma: Palgrave Macmillan, pp. 55-56

[181] *Idem,* pp. 55-68.

[182] *Idem*, pp.57-59.

[183] *Idem*, pp.61-62.

avoidance often…". In the OECD's framework, the aforementioned definition of "tax avoidance" is unclear. Thus, there is no clear guidance on what should be considered tax avoidance and tax planning at OECD level[184]. However, in the previous years, much progress has been made in the OECD Model Convention, especially regarding the adheral of concepts as anti-abuse measures.

Usually a tax avoidance practice is legally identified due a domestic court decision. However, such practices must have basis in law changing or general anti-avoidance principles. A mere recognition of a tax purpose arrangement is not enough to frame it as tax avoidance. In case of a succeed case in court, favouring taxpayers, the government's remedy is to seek a solution by changing the law.

1.2 THE TWO PILLARS PROPOSAL

As previously mentioned, the OECD Programme of Work is divided into two pillars: Pillar 1 addresses the allocation of taxing rights between jurisdictions and considers various proposals for new profit allocation and nexus rules. Pillar 2 ("Global Anti-Base Erosion" or "GloBE" proposal), on the other hand, aims for the development of a co-ordinated set of rules to address ongoing risks from structures that allow MNEs to shift profit to jurisdictions where they are subject to no or marginal taxation.

From a speculative perspective, there is an implicit risk of having accrued basis in charging the new equalisation levy. In other words, regarding the equalisation levy proposed initially in Action Plan 1[185], and improved later on, there is a risk that the same income would be subject to both CIT and the levy, leading to a cascade effect. In a practical scenario, a foreign entity end up being subject to the levy at source and to CIT in its country of residence, or in the situation of being subject both to CIT and the levy in the country of source. Moreover, the levy would be unlikely creditable against that tax. A possible solution to avoid this cascade effect would be to allow a taxpayer to both CIT and the levy to credit the levy against its domestic CIT.

Considering Pillar 2, on average, the CIT is not considered very low world-wide. Nowadays just a few countries have a CIT rate lower than 10%. In the BEPS Project, there is no structural reform in view so far, allowing digital MNEs to still take advantage of loopholes in international taxation[186].

[184] RUSSO, Fundamentals of International Tax Planning, 2007, pp.53-54.
[185] OECD (2015), Addressing challenges of digital economy, OECD, Paris, pp. 115-117.
[186] OECD, Addressing challenges of digital economy, OECD, Paris, 2015, p. 132.

In the EU, the proposals have not yet been voted on, but the significant economic presence and the DST are – in a comparative perspective – simple and effective. Adding, the studies in EU case law shown the limitations of subjective approaches when judging taxpayer behaviours, while it is necessary to characterise the intentional circumvention of the law. Therefore, as straightforward measures seem to be a better response to the economic transformation overall.

As said before, there is not yet an agreement about the outcome of the two pillars approach. This means that it may be the dead-end of OECD's project. However, any country or international organisation my take the approach as a model for implementing more standardised tax measures, representing an undeniable advancement in terms of tax harmonisation.

1.3 OMISSION ON M2M TAXATION

The OECD Action Plans did not develop the matter of taxing automated business transfers. Such silence is in a way eloquent, because the ruling on M2M is in the early stages, and the taxation can already be made over the operators (or owners) of the digital undertakings.

It is uncertain whether AI should have legal personality. In a modest critic about the matter, the legal personality concept is abstract *per se*. Then, it is theoretically possible to include another type of personality (a similar discussion is happening regarding "animal rights"), though the implications in terms of liability remain open.

Once again, it is clear that the main problem is not regarding the creation of a new legal status; instead, it is regarding the economic consequences of doing so. For instance, in M2M, who will be liable in case of non-performance? Would it be applicable to pierce the veil in case of tax debts? Before any advancements occur in AI rights, these questions must have answers.

2 DIGITAL SERVICE TAX AS A STRAIGHTFORWARD RESPONSE

On the opposite side of the current OECD proposals is the adoption of a direct service tax (DST), which is a new tax over the payments carried out through digital businesses. The idea is not to tax a digital transaction, instead only those derived from the digital economy at large.

This new tax is much simpler than any other proposed multilateral measure. The argument of the negative impact to final prices is valid in an economic perspective. However, any effective taxation within the digital economy will have consequences in terms of costs. Moreover, the effectiveness of a DST would have fewer compliance and implementation costs, having little difference between being either considered unilateral or multilateral. Evasive practices would be easily characterised, having virtually no grounds for challenging any tax inspection.

In fact, imposing a unilateral DST is the least harmful solution, because in case of failing, the country can easily withdraw the taxation, without violating international agreements. In this sense, Ana Paula Dourado argued that the unilateral introduction of specific digital taxes or answers to the current system is a good solution, mainly from a perspective of international justice, even if it is not from an economic perspective[187].

Considering Dourado's critics, it is possible consider the possibilities for a new economic balance derived from the unilateral positions of countries in terms of taxing or not taxing digital business payments. Indirectly, the market jurisdiction would be able to protect its tax revenue, alleviating the pressure over complex MNEs business' tax arrangements.

Albeit aggressive, the DST is a clear tax, and it has positive consequences in investment analysis. Investors would be able to easily calculate the amount taxable for future business, weighting in on whether apportionment is better considering more than one tax jurisdiction.

[187] DOURADO, A. P. (2018). Digital Taxation Opens the Pandora Box: The OECD Interim Report and the European Commission Proposals. Intertax, 565-572, p.568.

3 PASSIVE STANCE REGARDING DIGITAL TAXATION

A last general political position is to take no measure regarding taxing digital businesses specifically. Even the largest economies are reticent in adopting such stance. The betting on the "invisible hand from the market" is a risky stance, and no large economy will consciously adopt this position.

Even the USA, as seen above, ruled over the capital outflow in the digital economy. Such unilateral measures are a response not only to the current trade war with China, but to internal concerns about job generation, with respect to IPR of national companies and to the protection of the internal market.

To do nothing would definitely worsen BEPS effects, causing a collapse in public funding. Indeed, the only beneficiated public undertakings would be considered as the investment hub countries, as shown in the OECD conference taken[188].

4 BALANCING PRINCIPLES

Indeed, in juridical terms, it is relevant to test whether the proposed measures of digital taxation are committed with tax principles. In most of cases, the OECD and EU proposals are in line with tax principles. Even domestic legislation are so far under the same scope.

In terms of profit allocation principles (equality, proportionality, ability to pay and neutrality), although having a linear base, the proposals on Pillar 1 and 2 improve the commitment within these principles, because they restore some proportionality ruling over physical businesses when compared to digital ones.

According to Hosuk Lee-Makiyama and Bert Verschelde, the establishment of sector-specific taxation would imply a violation of the fundamental principles of neutral international taxation, namely that corporate taxation would occur when functions or assets were allocated and business risks were consequently assumed. First, the new concept of digital presence is justified by the assumption that the

[188] OECD. (2020). Webcast: Update on Economic Analysis and Impact Assessment. Fonte: OECD: http://www.oecd.org/tax/beps/webcast-economic-analysis-impact-assessment-february-2020.htm

jurisdiction, which has the right to determine corporate tax under domestic rules, relinquishes its rights in the event of registration asset allocation in your jurisdiction. However, Lee-Makiyama understands that this is unlikely to happen, either with double taxation or with the withdrawal of the service provider from foreign markets. Second, it is assumed that the data itself has a value as a form of asset. The ability to monetise market data is not the same as that of an asset, which would constitute a physical presence or a PE. To illustrate the criticism made: in a hypothetical situation, a European financial information provider would be taxed in China because it partially uses market data there and reports via the Internet; given the size of the Chinese market, such a rule would discourage service expansion in the latter market. Thirdly, the concept of digital presence and the idea that online services should always be seen as establishing a local presence are in complete contradiction to international trade in services. Preventing the provision of services in this way is an interpretation that violates the commitments under free trade agreements of the World Trade Organization (WTO), whereby the EU has allowed full market access to various online processing services, generally interpreted as new ones Internet services[189].

Notwithstanding, the neutrality principle is observed by other perspective. As digital taxation aims to restrain tax avoidance, an equal treatment is possible in practical terms, even if a ring fence solution is not totally made.

Territoriality is no longer a strong connecting factor that subjugates undertakings and decisions in the free market. Thus, in the case of nexus principles (home state allocation, arm's length and value creation), the answers are driven to embrace the new international tax law concepts, improving the *residence* and *source* duality with the significant economic presence.

Considering the OECD proposals, it lacks the necessary commitment with procedure principles. In this sense, the OECD's BEPS project, above all, must grant attention to the implication of increasing integration of MNEs and the spread of global value chains. It is necessary a simpler and straightforward guidance on the application of transfer pricing methods, including profit splits in global value chain.

[189] *Idem*, pp. 63-64.

5 ECONOMIC CONCERNS

The natural evolution of business models has resulted in a digital economy where non-resident companies may operate in a market jurisdiction in a fundamentally different way when compared to the models at the time international tax rules were originally made. ICT and liberalisation of trade policy rendered the traditional model of doing business as obsolete.

There is an undeniable fear of the consequences of reshaping taxing systems. That is the reason for why only punctual measures have been taken thus far. It is more feasible to focus on an economic sector, rather than looking for a solution for the wholly taxing frameworks as a whole.

Nevertheless, the OECD reports exposed the antagonism between market countries and investment hubs. In an integrated market, the lower costs of a small country make attractive the influx of capital, while on the other hand large countries have to deal with infrastructure costs (higher taxes) and political instability. Market countries have to find solutions for the loss of revenue and the tax equilibrium in order to keep the economic functioning. This is all considered to be an aftermath of the free market, and an undeniable commonplace concern.

To decide what to tax can be a very sensitive political concern. Firstly because taxpayers tend to dislike such decision of increasing their burden. Second, the object of taxation has to be feasible, otherwise the taxation shall have no practical effect. Thus, it is necessary to understand what has value in the particular market in order to properly tax it. Of course, monetary value itself can be easily measured. However, some other assets, like immobile property, goods, IPR, intangibles in general, depend on a prior evaluation to be fairly taxed.

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 have to manage, maintain and protect customers and user data. The 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 in order 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).

From an economical perspective, that added value originates from a place where the individual adds the intellectual element. Then, taxing digital assets could be attributed according to the current

system based on the arm's length principle and people functions. 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. This new asset should have substantial weight in the functional analysis of purposes of profit allocation, for instance taking into account the number of days that an individual works in a country[190].

To some extent, criticism thrives, for while it is true that the era of globalisation and economic interdependence has linked civil and commercial freedoms to the domain of liberalisation, they have also placed a constraint on the political space for domestic regulators. The challenge for the sovereign state is to govern to maximise operational advantages, even though they are irreversible processes, and should not be to maximise its own controlling power in the marketplace. In this respect, the results of previous attempts in the 1930s and 1970s are seen as negative: Attempts in isolation from European economies have always led to productivity losses and produce unwanted results, leading to market outlets and loss of production in the European market. According to Lee-Makiyama, contrary to common belief, globalisation and digitalisation of the economy have not caused unemployment or structural deficits, but make the costs of poor governance and inefficiency more visible[191], exposing which sectors of the economy are no longer competitive.

The BEPS Project measures have been presented, but there is still a need for calibration as the agency's other actions have not been able to solve the challenges of taxing the digital economy. Concerning the same plan, the April 2018 report reflects on the lack of consensus among countries to seek long-term solutions, leading to the adoption of unilateral measures. The MLI is insufficient as a mechanism for the digital economy, and a specific multilateral instrument is needed to address the peculiarities of this economy.

Nevertheless, one must recognise that the convergence of tax systems is not always positive. Although it favours a simpler and more clear taxation, harmonization or unification of tax rules does not always lead to balanced taxation. To be desirable, normative convergence needs to be organized with objectives or general rationality, as to move away from the discussion about the loss of the tax base, as well as to favour job creation and development of the economy as a whole.

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[190] HADZHIEVA, E. (2019). Impact of Digitalisation on International Tax Matters, Study for the Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies. Luxembourg: European Parliament, p.19.

[191] LEE-MAKIYAMA, H. &. (2016). OECD BEPS: Reconciling Global Trade, Taxation Principles and the Digital Economy. In F. &. BOCCIA, The Challenge of the Digital Economy (pp. 55-68). Roma: Palgrave Macmillan., p. 66.

The traditional international tax model is not sufficient enough to address the peculiarities of the large-scale digital economy. It is urgent to rethink the structure of tax treaties in the light of the tax arrangements derived from aggressive tax planning. The ultimate goal of a reform in international taxation is to recover the loss of revenue generated by competition between taxing states (tax war), and compensating for the weaker countries - which benefit from the dispute. Another objective to be achieved is to substantially reduce labour market taxation, allowing the wealth generated by the new economies to be distributed equitably across the market itself.

6 OVERCOMING THE BILATERAL BIAS IN TAX TREATIES

Through this research, it became clearer that OECD is the best forum to discuss a multilateral solution for BEPS. This is because OECD has been working towards a worldwide tax reform in view of the changes wrought by the digital economy, and several papers have been published on the topic, as shown below.

Another multilateral attempt includes the two of the EU Commission proposals for taxation of the digital economy, published in March 2018 (2018/0072 and 2018/0073). As the OECD initiative, the directive proposals remain inconclusive.

The preliminary results of OECD's meetings comprise three value creation processes: value chain, value shop and value network. The latter represents the strongest case for value creation in the market and accounts for online advertising and intermediation services[192]. Following this premise of multilateralism, a helpful remedy to the problem of tax evasion in the global economy would be *OECD's* MLI[193], even with its difficulties for implementation globally. It establishes a tax morality, ensuring non-double taxation parsimoniously. The treaty is already in force, having up today 89 signatures, but there are important absences: Brazil and the USA have not signed it; Portugal has signed but not ratified. For those who ratified, in case of the reform of bilateral tax treaties, the preamble must contain the goal to fight against tax evasion.

[192] HADZHIEVA, E. (2019). Impact of Digitalisation on International Tax Matters, Study for the Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies. Luxembourg: European Parliament, p. 13.

[193] In the article 7 of the MLI there is the PPT, whereby a simplified benefit limitation is adopted, yet detailing specific anti-abuse measures. With the MLI, PPT becomes a guiding principle, ensuring the most favourable fiscal position (subjective element); and verifying whether the advantage is contrary to the object and purpose of the applied norms (objective element). The PPT is the "B" example contained in OECD comments on article 29 of the Model Convention. It is also applicable to example "C", which deals with forum shopping.

Conversely, Leonardi understands that multilateral agreements are not viable within the UN environment or even within regional economic blocs. He argues firstly that the UN has no mandate to make decisions on financial and economic aspects, and securing such power would be very uncertain without any guarantee of a satisfactory result. Secondly, operating in regional economic blocs would face the same problems relating to lack of powers to deal with taxation issues and lack of effective oversight of multinational corporations. According to Leonardi, free trade areas existing in countries lack a mandate to act on such comprehensive international agreements. Thus, only by acting through the G20 would it be feasible to harmonise digital taxation rules, because the combined economic blocs would contain the largest consumer market at the international level[194].

A disclaimer here is necessary in order to clarify that unilateral measures are not useless in digital economy. Countries can introduce a sort of domestic laws as additional safeguards against BEPS, resulting in short term gains in practical experience with the applications of the options given in the action plans.

A second disclaimer is regarding the necessary consistency with bilateral treaties, ensuring the commitment with their obligations. In this sense, any measure (unilateral or bilateral) has to compromise with previous agreements, making the new policy only applicable from residents of non-treaty countries or in case of multilateral anti-abusive rules covering both parties of the treaty.

In sum, it is still necessary to deal with countries that have low or non-existent taxation, as they become preferred destinations for low-tax digital businesses (investment hubs). Moreover, it is paramount that large economies take a central role in celebrating multilateral treaties. Therefore, the MLI has to reach the G20's economies in order to prevail.

An intermediate solution would be the conclusion of a multilateral treaty capable of altering the content of bilateral treaties already concluded in the OECD or UN framework. Regardless, some countries are already implementing the changes themselves, concluding amendments to bilateral treaties[195].

As explained above, under the MLI, acceding countries are required to revise their international tax treaties to comply with BEPS guidelines. The contracting countries of the bilateral treaty must seek out the other party to do so, or to do in bloc. Recently, many countries started to review their positions

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[194] LEONARDI, (2016) Conclusions: Taxation and the Future of the Digital Economy, pp. 115-116.

[195] RUSSO, R. (2016). Base Erosion and Profit Shifting. In F. &. BOCCIA, *The Challenge of the Digital Economy* (pp. 39-54). Roma: Palgrave Macmillan, p. 46.

in DTC, in order to comply with new premises. It may not be practical, nor the best solution, but it is still better than no change at all.

6.1 UNITARY TAXATION AS A POLICY DRIVEN TO DIGITAL TAXATION

According to Biasco[196], in essence, the idea is to rethink the entire international tax system of global profit distribution based on bilateral double taxation treaties. While continuing to work towards solving double taxation in the pre-existing manner, the same chronic problem will remain, and possibly will worsen in the near future.

A large-scale solution to the problem of direct tax evasion is based on an institutional design that allows for the legal recognition of unitary taxation for MNEs. This uniform law or, unit of taxation, shows the application of a CIT to a company's overall profit on an international basis, *i.e.* the taxation of an enterprise's integrated global income. This new principle makes it possible to achieve an effective and organic way in overcoming of the previous international tax standard.

The contents of tax treaties were elaborated on over a hundred years ago, when the current reality of multinational companies did not exist and there was no free movement of capital. Such corporations are not made up of a series of local units to be taxed separately at different locations considered as if they were independent units, nor as the current double taxation convention tends to see them. Instead, they together form a tightly connected business unit that derives its competitive capabilities by combining economic activities in individual locations as well as exploiting the technology and knowledge that belongs to that unit.

If they were a single body of which each branch is considered as an organic part, then as a single body they must be treated. Therefore, the benchmark for taxing them should be in considered their worldwide-consolidated budget. This is similar to CCCTB, yet worldwide accepted. MNE would require filing their profit statements in all countries in which they operate, and then their integrated profits must be taxed on a unit basis, according to an agreed formula for income distribution that would reflect their actual presence in each country. Considering the technology available today, it is not something too difficult to imagine nor set; moreover, the costs of data management are quite insignificant comparing to the raise of tax paid.

[196] *Idem*, p.30.

To calculate the tax burden, Biasco suggest a formula taking into account the distribution of 1) physical units (or costs) of the employed workforce; 2) physical assets used (excluding intangible assets); and 3) sales made in each country[197]. Such solution would eliminate internal transactions, making the establishment of tax havens or the movement of profits around the world through transfer pricing meaningless. If a single centre is recognised in the conglomerate, the establishment of or subsidiaries becomes irrelevant. Given the maturity of EU integration, this would be the ideal laboratory for the implementation of a new global regime, based on the support of Canada and the USA. Considering the provisions of the Dodd-Frank Act, many USA states already are adopting some provisions of fiscal competition (tax war) by themselves.

In the digital economy sector arises the opportunities also for the taxation of digital businesses, taking in consideration the international market and having to carry out foreign exchange operations to settle the payment of operations. Financial institutions and central banks could tax such transactions at source, facilitating supervision and collection. Such practices could be implemented in B2C operations as well as B2B.

There is currently considerable tax revenue not covered by the digital economy, especially from available service applications, as well as music, videos, and other downloadable content. As seen above, there is a huge tax loss remaining unsolved by the PE model, and a harmonised corporate taxation for MNEs is a reasonable solution. Indeed, there shall have exemptions to R&D and to small companies, due the unarguable advantages in development and employment.

With regard to exemptions from participation in the corporate regime, the Netherlands adopted an intention test, a declaration test and a subject-to-tax test. Whereas there are other relevant innovations in Luxembourg, Malta and Spain, especially concerning preferential arrangements.

6.2 LIMITS OF LAW ENFORCEMENT IN TRANSNATIONAL BUSINESS

The global economy can be split in three distinct phases. The first one in which everything is economically tangible, therefore taxable by traditional means. The second as a transitional phase in which technological instruments allow telecommunication and, consequently, the conclusion of

[197] BIASCO, S. (2016). The Damages of Fiscal Competition in Europe and Alternatives to Anarchy. In F. BOCCIA, & R. LEONARDI, The Challenge of the Digital Economy (pp. 17-38). Roma: Palgrave Macmillan.

business without physical presence (virtual catalogue purchases, instant messages, services provided by videoconference). In a final stage, the very object of the business relationship is entirely intangible, such as a digital file. Each of these phases demands a different tax structure.

The national states have already recognised the flaw in taxing MNEs using outdated legal concepts. Because of the digital economy, the modern state is becoming weaker in terms of tax effectiveness. However, this statement is only partly true, as states integrated into economic blocs (such as the EU) have not lost their power to tax, instead they voluntary restricted their right to tax, fostering commercial integration.

As previously mentioned, the EU does not have a harmonised income tax regime, maintaining member states the autonomy to set rates, benchmarks and incentives for direct taxation. In practice, European countries still make extensive use of bilateral tax treaties to establish circumstantial parameters for PE, exemptions and tax credit allowances. As a result, bilateral international policy favours tax planning for MNEs, especially those acting in the digital sector. There is a large margin in treaties for large companies to share their value chain to reduce tax costs. Tax planning gained prominence with the internationalisation of the economy operated by large technology companies. Therefore, at the heart of the problem, therefore, are artificial business arrangements that establish "convenience activities" in low-tax jurisdictions from advantageous triangulation. Thus, as each country seeks unilaterally to generate investment attractiveness by lowering its tax burden, well-structured MNEs take advantages of such policies.

On the other hand, multilateral entities as OECD, UN and WTO, are still in their early stages of dealing with digital economy, having few concrete solutions to minimise the damages in the taxable base. In general, the difficulty in taxing digital businesses lies in the effectiveness in ascertaining and receiving the due amounts, because, as stated above, the Internet is usually not restricted to the same physical borders of countries. Considering the nature of tje Internet, parties are generally allowed to perform economic activities in a fractional way around the world. A practical difficulty in this matter is that tax authorities may have to deal with millions of daily transactions throughout the world, having a feeble control of them.

Another important concern derived from digital technology is that it is currently causing a number of transformations in the job market: as new job areas emerge, many traditional service sectors are experiencing a crisis due to lack of jobs. However, the problem of labour was already a reality

before the emergence of the IoT, which was aggravated in relation to the idleness of labour due to the automation of services.

There is another difficulty of determining in which jurisdiction the value creation occurs. If one deals with a two-sided service, the payment and the value recognition is relatively easy to identify (even so having disputes in terms of double taxation, as showed below). Multi-sided business models have a much more complex frame, acting in many countries at the same time. Moreover, sometimes the product offered is apparently free, but the value lies on the information given by consumers. Therefore, to capture value from externalities generated by free products is one of the biggest challenges in terms of digital taxation. As seen, traditional national policies are no longer able to tax businesses that mainly have digital assets. It is then paramount to change the way MNE are taxed, especially those operating mainly with intangible assets.

In sum, 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[198]. The central tax problem related to the taxation of digital companies concerns patent taxes (royalties) combined with the existence of low tax jurisdictions. Licensing or administration costs are often provided between companies within the same economic group to reduce profit margins in the highest taxing countries by directing revenues to holdings in low or no income tax countries. This practice leads to the so-called erosion of the tax base (BEPS) due to loss of revenue in countries whose market is effectively exploited.

7 POINTING SOLUTIONS FOR THE MATTER

This extensive research provided a broad perspective in terms of solutions for digital taxation. Each proposal has strong and weak aspects. Thus, there is no worthless suggestion, neither a perfect one.

Nevertheless, it is possible to rank the most suitable proposed solutions, indicating parameters for law-making process in the near future. Even so, such evaluative analysis is a contribution to the discussion and must not be considered a final argument in the matter of digital taxation.

[198] HADZHIEVA, E. (2019). Impact of Digitalisation on International Tax Matters, Study for the Committee on Financial Crimes, Tax Evasion and Tax Avoidance, Policy Department for Economic, Scientific and Quality of Life Policies. Luxembourg: European Parliament, p. 16.

The nuances observed in the main proposals allowed the researcher to rank the DST as the easiest, simplest and most favourable solution, considering those analysed. The DST includes the following features: it grants tax collection to market jurisdiction; it does not rely on international agreements, being implemented solely by domestic legislation; it has already been ruled in some countries (France, Spain and India, for instance), enabling an economic analysis in the near future; and – finally – the DST may be subdue to tax deduction. The deduction would constrain the cascade effect, being ruled through a bilateral treaty or a domestic tax ruling.

Usually, the critics over DST are based on the arguable lack of value in the market jurisdiction[199], or even political arguments[200]. However, this argument can be used to any tax, being not exclusive to DST. Moreover, there is the possibility to use the new tax to rebalance the international market in order to save jobs, while maintaining traditional brick-and-mortar businesses. A liberal argument must not discard the consequences of a large-scale crisis in people's well-being.

Moreover, the interim character of the DST proposal is a captious feature. Something that is promised to be temporary can become permanent if countries reach no further agreement in digital taxation. Due sovereignty, a unilateral DST implementation may be warranted for countries that aim for a minimal taxation in digital assets. Then, there is no certainty that a multilateral tax ruling would be granted in a large perspective.

The significant economic presence (or the EU equivalent *significant digital presence*) is a second option, in terms of advantages. Either OECD or EU models of taxation start from the same premise of granting a minimal taxation. Depending on the rate established and the definition of non-routine taxable events, the tax revenues may be mere symbolic.

Moreover, the model proposed by OECD in the Unified Approach is not a consensus in the Interim Framework, which means that there would be resistance in a world-wide implementation. If the significant economy presence is in force only in part of the economy, it is probable to have a diaspora to non-committed countries. It is a soft law, relying on already known means of collection from the OECD Model Convention. Then, any improvement to the model would take years to be effective.

The GloBE proposal, from OECD's Pillar 2, has the same flaws of the Unified Approach from Pillar 1. Both depend on a coordinated action involving a collaborative stance of all major economies,

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[199] KEMMERN, E. (2018-2). Should the Taxation of the Digital Economy Really Be Different? *EC Tax Review*, 72-73 (Editorial)

[200] NOGUEIRA, J. F. (2019). The Compatibility of the EU Digital Services Tax with EU and WTO Law: Requiem Aeternam Donate Nascenti Tributo. Intl. Tax Stud. - IBDF Journals.

otherwise it would lack effectiveness. The GloBE proposal is based on a *de minimis* taxation over digital assets, granting tax back to harmed countries. The difficulty here is regarding the need of transparency towards the topic of remittance to third countries, requiring an impracticable cooperation to ring-fence the profit.

The least recommendable solution is to ignore the digital economic features, keeping international taxation as it is in the present moment. Due the current transformation in the economy, digital assets has an exponential increase in value. Furthermore, the actual pandemic crisis of Corona Virus Disease of 2019 (COVID-19) will boost even more such transformation even more. If no changes occurs, taxation would be heavier in labour costs, infrastructure and social development each day.

CONCLUDING REMARKS

Indeed, we are now facing a tax war on intangibles, and something has to be done to stop it, otherwise the loss of revenue will cause a large imbalance in budgets around the world. Moreover, domestic policies regarding income taxation are limited in terms of outcomes, and traditional bilateral tax treaties do not currently covers third countries' tax sheltering, therefore there should have a coordinated (multilateral) system put in place that excludes for good no-compliance countries for good.

On the other side, it is pointless here to try to prove that digital business are poorly taxed. Considerations of this kind are more economically focused than legally focused. More prudent, however, is to note that society desires a more balanced tax burden, even though the result is a heavier burden on digital MNEs. There is a political interest in imposing a heavier burden in this sector. The idea is – in theory – to compensate the losses generated by the ongoing digital revolution. This is not an economical neither political study, rather a legal one. Nevertheless, the posed question requires a transversal approach, bringing general concepts and recent consensus to frame feasible solutions to tax fairly the digital business.

In terms of international taxation of the digital economy, the challenges that must be overcome are mainly to in relation to tax evasion practices by MNEs, which favours the existence of tax havens and secret bank accounts. These two circumvention tools have been the subject of intense debate in the EU, and several regulations and directives have already been approved to combat such phenomena. As a result, secret accounts were revealed in Cyprus, Luxembourg, San Marino, Switzerland, Cayman Islands and Bermuda[201].

Progress in the field depends not only on the goodwill of the companies involved, but also on the transparency of the information provided by the companies at the end of their tax years, as well as the ability to exchange information between tax authorities.

In overcoming the issues related to the digital economy, all the measures mentioned throughout this thesis also seek to solve the dilemmas faced in broader fiscal situations involving: stable establishment, transfer pricing and CFC rules. The idea is that taxpayers can no longer effectively establish structures that separate income from value added from their activities, which is particularly

[201] LEONARDI, The Digital Economy and the Tax Regime in the UK, 2016, p.105.

exacerbated in the digital economy. Crucially, VAT rules have been changed to apply in the country where consumption changed more dramatically.

The situation is acute in B2C relations and has large-scale effects on domestic and international trade in inputs. Experiences are extremely positive in terms of tax collection in countries that have instituted a simplified VAT registration system[202].

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 have already 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.

However, any solution that seeks to address nexus must also address the closely related issue of profit allocation, or it is bound to fail – with likely increases in uncertainty and controversy without a meaningful increase in income allocation. This can easily be demonstrated by developments already taking place on the ground. In response to the BEPS package (including Action 7), some MNE groups with highly digitalised business models were able to establish local affiliates in market jurisdictions, especially in those jurisdictions constituting the businesses' larger markets[203].

Finally, the principle of fiscal neutrality has been put aside, because the proposals directed to tax digital assets are specific tax rules created only for the digital world, which is still a changing economy. It is paramount to realise that the development of which may eventually be constrained by the implementation of tax costs for technological innovation.

Small and midsize businesses are increasingly taking part in the digital market and they cannot be treated the same as large ones. In short, we seek a fairer model of tax sharing among the revenues of countries involved in the digital economy.

In addition to tax collection in consumer markets, we also seek to give due protection to data collected in these countries, which is a value today, generating direct or indirect revenue to the company that collects them. Today there are new assets, as big data, algorithms and digital services. These assets constitute a new form of value, by which a country may be interested in taxing.

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[202] (RUSSO, Base Erosion and Profit Shifting, 2016, pp. 51-52)

[203] OCDE. (2019, august 06). Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS. Retrieved from OCDE: https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm, p.8.

Recently, many countries introduced unilateral measures to tax more effectively digital businesses, *i.e.* France's new GAFA tax, Hungary's advertisement tax, the UK's 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, but it does not recommend any uncoordinated action prone to ring-fence the digital economy[204]. Nevertheless, in March 2018, the EC proposed a 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.

Several technical and political problems surrounding the proposal put into question its adoption prospects. For example, it is difficulty to implement uniform measures to different digital business models without double taxation. There is 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. Moreover, possible impediment to growth and technological progress and fear of a USA backlash are amongst arguments voiced against the Commission's digital tax reform.

EU 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 USA as well as the CCCTB in the EU led to discussions on destination-based models, which promise a structural solution as opposed to sheer avoidance measures, regardless of them being more or less legitimate than origin based taxation or the CCCTB. One example is found when considering 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, doubt are raised in terms of double taxation risks in the absence of its global application.

The EU Commissions proposals (2018/0072 and 2018/0073) are in standby in the EU Parliament. Even with the exposition of tax losses due GAFA's actions and others, there is a strong resistance in taxing digital assets more directly. The lack of consensus generates a wave of unilateral measures that may cause disturbance in the fragile political balance within the continent. Even so, the

[204] *Ibidem.*

pursuit of the “digital free-riders” is a paramount question in combating BEPS. One may say that some response is better than no response at all.

Beyond the EU market, the internationalisation of digital companies is still bureaucratic and a huger challenge for lawmakers. The actual model in place now favours aggressive tax planning at considerably lower costs than traditional MNEs. Therefore, it is necessary to change the model of international tax treaties so that multilateral agreements establish more harmonious criteria for foreign business facilitators, covering traditional and digital businesses.

Companies are strongly opposed to a digital tax because of the difficulty of crediting in future transactions. For them the criteria of PE must be maintained to avoid chaos in international taxation. Again, developed countries prefer the residence criterion, except in sectors where most of the wealth generated comes from foreign sources, such as the digital economy.

The concept of PE is being put in check, especially in account of the equalisation tax (turnover tax in Europe), satisfying itself with gross value taxation. Nevertheless, one has to ask whether the advances made in the EU in terms of fiscal governance relate to a long-term vision of what the bloc will be like in the future.

Such advancements include the elimination of unfair competition among member states, the fight against so-called “tax havens” and the establishment of the so-called CCCTB for corporate taxation. This uniformed system to tax MNEs is probably the best solution to grant transparency to the public. There are no more technological barriers in this sense and a multilateral system of international corporate taxation could once in for all put aside tax heavens, whereas obliging larger private actors to contribute with a fair share of their profit.

There are proposals made from OECD releases, in terms of tax reforms. The first is a CIT on the net income generated from remote sales of digital goods and services to in-country customers by an entity with no PE. The second is to impose an equalisation levy on the remote sales of digital goods and services to in-country of the same provides. The third a withholding tax on the gross receipts from the remote sale of digital goods and services to in-country customers by the same providers.

Some proposed solutions to this issue have been tough to move forward, and just a few have been implemented so far. This leads to an ambience of speculation in terms of tax policies in the near future. Thus, it is necessary to list and analyse the most relevant legal tools addressed to tax digital

economy, while also comparing themselves and identify premises and reasonable measures to be replicated.

The conventional general anti-avoidance tax policies are also important to deter the erosion of taxable income, however – as understood by developed economies – they are not enough to solve all of the challenges of the digital economy brings altogether. Therefore, in respect to the previous advances in the field of international tax law, the main attempts to implement a fair taxation have also had some analysis in the study here.

The economic relevance of this subject is common sense and the lack of academic approach reveal the importance of advancing in the area. Many countries continuously suffer public debts derived from the loss of tax revenue. In most of the cases, the losses are a result of economic changes, eliminating – for instance – middlemen in daily basis transactions. This causes greater unemployment and changes a considerable share of the economic value to the digital market.

The main tax challenges in the digital economy remain, despite of the current efforts to improve. There are no consensual concepts and regarding of immaterial products and services (qualification). Adding, the absence of physical presence, make it difficult to identify the parties involved in the intermediate B2B and B2C businesses, for tax purposes, as well as being difficult to control financial flows, payments and tax collections.

In an attempt to solve these problems, the OECD launched the BEPS Actions. Though setting minimum standards, and being subject to peer review in the framework of the MLI, they are still not well accepted within the global economy. The impact of some BEPS measures can already be observed, with the modified nexus approach linking IPR regimes to R&D activities. Some progress has been made on CFC rules with the adoption of the *Tax Cuts and Jobs Act*, the EU's ATAD and similar measures in Japan, Chile and Colombia. Even so, the measures above are legislations aiming to eliminate high returns to cash boxes but not focused on the cash boxes themselves. Thus, the digital taxation persists, and few has been done to tax effectively adjust the intangibles in a balanced way.

The technological changes of recent decades have transformed the global economy. After the computerisation of industrial processes, it is now services that suffer this same transformation. Given this, the need arises for political actors to find viable solutions to fair taxation, favouring competition within a free market environment, as well as seeking the stability of the social economic relations in question.

The politicians have been moving in recent years, proposing changes in tax systems to cover revenues generated by digital companies. Given this, it is relevant to analyse such measures in law, as a way to seek better solutions for digital taxation. Thus, the present work seeks to compare the measures adopted by the main relations with the theme, as well as the attitudes adopted by bodies such as the OECD, the G20 and EU.

In a proactive stance, this research concluded that implementing a DST is the best option to deter the loss of revenue, in the short term. Long-term solutions, as digital economic presence is deeming as a PE, are positive measures. Yet, they require an impracticable consensus today. In any case, it is better an attempt than to not attempt at all.

The main perspective gained is that without a digital taxation, there will be an exponential increase of BEPS in the next years. As consequence, market jurisdictions will suffer with low cash flow for infrastructure and social welfare.

Finally, it is important to note that changes in fiscal policy regarding the digital economy are at an early stage. Further changes are expected in the coming years, although the uncertain environment in the world economy still prevails. Something has to be done to deter this trade war. Otherwise, people would be under less public services, as state authorities become obliged to shrink budgets.

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