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BEPS, THE DIGITAL(IZED) ECONOMY AND THE TAXATION OF SERVICES AND ROYALTIES

by

Adolfo Martín Jiménez*

1. Introduction

Arguably, taxation of the digital (or digitalized)[1] economy is one of the trendiest topics in recent years and much attention will be devoted to it until 2020, when the OECD is to release its final report on the topic, and beyond. In this debate, it is common to stress that the (old) international tax system needs to adapt to the evolution of technology and business models, and new solutions are necessary to

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1 The Final Report on BEPS Action 1 referred to 'the digital economy' (OECD, *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 5 Oct. 2015)), whereas the 2017 public consultation (OECD, OECD Invites Public Input on the Tax Challenges of Digitalisation (22 Sept. 2017), http://www.oecd.org/tax/beps/oecd-invites-public-input-on-the-tax-challenges-of-digitalisation.htm, accessed 15 Mar. 2018) and the 2018 Interim Report (OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018 – Inclusive Framework on BEPS*, OECD/G20 BEPS Project (OECD Publishing 16 Mar. 2018) (the OECD interim report on digitalization) shifted the terminology to 'digitalized economy', likely to emphasize that the digital economy is not a specific sector, but, rather, that digitalization affects the whole economy. Both terms will be used in this article interchangeably.

update tax treaties designed for a physical – and not digitalized – economy. That proposition has the curious feature of turning into old what is (almost) brand new (the G20/OECD Base Erosion and Profit Shifting (BEPS) outputs of 2015) and rejects (probably too quickly) standards that are old, but could also serve to deal with 'new situations'. Therefore, the point of departure of this article is that before throwing away what has been consolidated over many years of evolution, one must be sure that something new is indeed needed and would be better than the old tools, even if the old tools may need to evolve rather than being changed in a, more or less, radical form. In other words, the new solutions for the digital economy are necessary only if the traditional toolkit (i.e. the OECD Model Convention (the OECD Model)) and the more recently crafted BEPS principles – which have not yet been fully developed, exploited or tested – are insufficient or flawed, or if there are no other solutions in the international tax arena that could be better than the new proposals.

In line with this initial idea, this article begins in section 2. by pointing out some of the virtues (design of negative and positive source rules), biases (too much attribution of income to certain features of a multinational enterprise (MNE) group, namely risk control and certain intangibles and intangible-related functions) of the BEPS project outputs, and where the OECD/G20 BEPS project has been insufficient to end (potential) BEPS strategies (the taxation of services and royalties). This initial reflection provides a context to speculate in section 3. on whether the most popular initiatives proposed in the OECD discussions on the digital economy (the significant economic digital presence permanent establishment (PE), withholding taxes on goods and services provided online or variations thereon, such as equalization taxes) are fit for purpose, and to conclude that these 'solutions' may present a number of problems, including the abandonment of the already agreed BEPS principles and their limited impact without effectively tackling the most pressing issues left open by BEPS. It is suggested that a more natural and effective solution would be to attempt to develop already agreed principles, and further advance in the enhancement and implementation of the concepts agreed, or even to consider the effectiveness of other more traditional tools (withholding taxes on services and royalties).

As a complement or an alternative, section 4. refers to what the UN is doing in connection with the taxation of royalties and services, and ponders whether it would be better to adopt this standard rather than the new solutions devised for the digital economy. In turn, Section 5. focuses on the recently released (and, in the author's opinion) flawed proposals by the EU.

Finally, section 6. concludes that the debate on the taxation of the digital economy (a mixture of economics and legal reasoning together with policy and politics) reveals the frailty of the international tax system, as well as creates the risks of further fragmentation. The more evolutionary approach of the current international tax principles, as agreed in the BEPS project and how they are evolving in the UN context, may be a better solution for the taxation of not only the digitalized economy, but also MNEs or enterprises in general, in order to advance in aligning taxation with economic activity and to preserve the coherence of the international tax system and, eventually, make it more robust.

2. BEPS, Source Rules and 'Base Erosion within BEPS project'[2]

It is well known that the guiding principle underlying the OECD BEPS Action Plan was (and still is) aligning tax bases and economic activity,[3] as the status quo prior to

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[2] The ideas in this section were further developed in A. Martín Jiménez, *Tax Avoidance and Aggressive Tax Planning as an International Standard – BEPS and the 'New' Standards of (Legal and Illegal) Tax Avoidance* in *Tax Avoidance Revisited in the EU BEPS Context*, EATLP Conference, at 25-62 (A.P. Dourado ed., IBFD 2017).

[3] OECD, *Action Plan on Base Erosion and Profit Shifting*, at 10 (OECD Publishing 2013) ('BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place. No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it. In other words, what creates tax policy concerns is that, due to gaps in

the BEPS project greatly facilitated misalignment. In particular, the possibility to tax services and royalties derived by non-residents or, in general income derived from economic activity in the source country has been limited by:

- The PE threshold for the taxation of business profits in Article 5 and the rules on profit attribution to PEs in Article 7 of the OECD Model (1963-2014).
- Transfer pricing rules (Article 9 in connection with the OECD Transfer Pricing Guidelines (1979-2015) and the use of unilateral transfer pricing methods, such as the transactional net margin method (TNMM).
- The fact that services and royalties are not taxed at source under the OECD Model (as well as the evolution of the Commentary on Article 12 of the OECD Model since 1963), while being deductible for the payer.

All of these principles and practices have facilitated the task of tax planners and MNEs to allocate profits to low-tax countries and contributed to reduce the possibilities of taxation in the country where real activities takes place.

In order to remedy this situation, and also probably with the aspiration of closing a loophole in the international tax system,[4] BEPS Actions 8-10 attempted to define 'negative' and 'positive' source rules.[5] As such, income should be assigned to

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the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed'.).

4 As well known authors have asserted, one of the problems of the international tax system has been that source rules are rather arbitrary and easy to manipulate with 'formal' legal constructions. On this issue, *see* H. Ault & D. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in *Taxation in the Global Economy*, at 12-30 (A. Razin & J. Slemrod eds., University of Chicago Press 1991), available at http://www.nber.org/chapters/c7203.pdf (accessed 15 Mar. 2018). More recently, *see* S. Wilkie, *New Rules of Engagement? Corporate Personality, and the Allocation of 'International Income' and Taxing Rights*, in *Essays in Honour of J. Sasseville* (B. Arnold & A. Parollini eds., Canadian Tax Foundation 2018, in press).

5 OECD, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015), especially Revision to Section D of Chapter 1, sections D.1.2.1., and Revision

where significant people who control risks are located, provided that they have the capacity to bear it, or to where functions are performed, assets are used and risks are assumed in the development, enhancement, maintenance, protection and exploitation of intangibles of the MNE group. The effect of the BEPS project, however, has been more concrete in establishing the negative aspect of the source rule (where income cannot be allocated, i.e. so-called cash boxes) than in defining its positive consequences (where value accrues is still a vague principle).[6]

However, the BEPS project may have also contributed to facilitate BEPS if the taxation of royalties and services is taken into account. First, BEPS Actions 8-10 allocate too much income to risk controlling functions ('risks') and to intangibles (as broadly defined in chapter 6 of the OECD Transfer Pricing Guidelines (2017)) and such functions that are usually found in developed countries (e.g. managing positions, R&D) at the expense of other intangibles or functions that are usually located in countries where, for instance, products are sold (e.g. marketing intangibles, local data and information about such data), or of labour and capital[7] (even if the broad definition of intangibles derived from BEPS Actions 8-10 gives some leeway to countries where soft or marketing intangibles are located to attempt to tax them; *see* comments, below). As a consequence, the residual profits of MNEs may flow to places where relevant risks and/or intangibles are (deemed to be) located. However, the latter does not mean that income allocated to countries

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to Chapter 6, especially section B, of the OECD Transfer Pricing Guidelines (2017).

6 *See* S. Wilkie, *Transfer Pricing Aspects of Intangibles: The License Model*, in *Transfer Pricing in a Post BEPS World*, at 61ff (M. Lang, A. Stork & R. Petruzzi eds., Kluwer 2016). For Wilkie, BEPS Actions 8-10 have defined a negative source rule (shell companies/cash boxes can only be given a risk-free rate of return or even might not be recognized), but, in the author's opinion, it also attempts to define a positive, still high level and abstract, source rule, under which income should be allocated to where value is added, risks is controlled or development, enhancement, maintenance, protection and exploitation (DEMPE) functions with regard to intangibles are exerted and risks assumed.

7 *See also* R. Tavares & J. Owens, *Human Capital in Value Creation and Post-BEPS Tax Policy: An Outlook*, 69 Bull. Intl. Taxn. 10, at 590 (2015); M. Kane, *Labour Rents, Arm's Length Transfer Pricing and Intangibles: Still Searching for A Solution to the BEPS*, 69 Bull. Intl. Taxn. 6/7, at 371 (2015).

where relevant risks and intangibles are controlled and risks assumed, will be taxed at least once, as patent and knowledge boxes have been accepted as legitimate, non-harmful tax regimes by BEPS Action 5[8] if they meet the conditions of the modified nexus approach[9] and, furthermore, it is possible to control relevant risks from places with an attractive tax environment.

Second, if that scenario is combined with the fact that under Articles 5, 7 and 12 of the OECD Model, royalties and services are not taxed at source and, in most tax systems, if paid in connection with business activities, they are usually deductible for the payer, the likely outcome will be that royalty and service payments may ultimately be taxed nowhere or taxed at low tax rates.[10] Moreover, some BEPS Actions limiting the deductibility of income (i.e. interest)[11] other than royalties or services will increase the incentive to use the latter as tax planning devices.[12]

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8 OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015).

9 The brand new US treatment of foreign-derived intangibles income (FDII), which does not comply with the requirements of BEPS Action 5, can also produce a similar effect of no or low taxation of royalties. On the problems of the FDII and especially its interaction with BEPS Action 5 and the German royalty barrier, *see* R. Goulder, *Achtung! Tax Reform Stumbles over German Royalty Barrier*, 89 Tax Notes Intl., at 375 (2018).

10 It is probably not by chance that the UN has devoted considerable attention to the base erosion effects of services and royalties. *See* UN, *UN Practical Portfolio: Protecting the Tax Base of Developing Countries Against Base Erosion: Income from Services*, input from B. Arnold (UN 2017); UN, *UN Practical Portfolio: Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rents and Royalties*, input from B. Arnold & A. Martín Jiménez (UN 2017).

11 OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015).

12 This is also the opinion of P.A. Harris, *Taxation of Rents and Royalties*, in *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*, 2nd edition, at 653 ff, 709 (A. Trepelhov, H. Tonino & D. Halka eds., UN 2017). *See also* UN, *UN Practical Portfolio: Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rents and Royalties*, *supra* n. 10.

Third, BEPS Action 7[13] will do little to remedy that situation for two reasons: (i) the conversion of local subsidiaries of MNE groups from commissionaires to resellers (a trend already observed among the giants of MNE groups in the digital economy)[14] will bypass the consequences of the reduction of the PE threshold if expenses (services and royalties) are charged to those subsidiaries and/or (ii) the attribution of income to local subsidiaries under the new BEPS Actions 8-10 may not be high if they are stripped of relevant risks or development, enhancement, maintenance, protection and exploitation (DEMPE) functions and treated as routine service providers (e.g. they are resellers or distributors, especially under flash title models). In this context, (deductible and non-taxable at source) royalties and services payments to other entities of the MNE group will still give MNEs a very good margin to reduce their tax base in the countries where they operate. What may be added in terms of source taxation by BEPS Action 7 or even BEPS Actions 8-10, may eventually vanish as a consequence of deductible payments for services and royalties that would flow to other group entities without withholding taxes at source (provided the applicable tax treaty follows the OECD Model). This does not mean that royalties and even fees for services flowing to other companies within an MNE group will be taxed in the state of the recipient if, for instance, they benefit from patent boxes or other tax incentives or regimes that are compliant with BEPS Action 5.

Therefore, in the (post-) BEPS era, double non-taxation or very low taxation of income is a potential outcome. In fact, what the BEPS project has done is to

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13 OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 5 Oct. 2015). On the (limited) effects of this action, *see* A. Martín Jiménez, *Preventing Avoidance of Permanents Establishment Status*, in *UN Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*, *supra* n. 12, at 365 ff.

14 OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, paras. 253, 262, 273 & 309 (reporting that Amazon, Google, E-Bay, Facebook have started to change their trade structures from remote sellers to local reseller models); S. Soong Johnston, *Facebook Restructures Amid Digital Economy Tax Debate*, 88 Tax Notes Intl., at 1169-1170 (2017).

differentiate between permitted and reproachable double non-taxation, such that some forms of double non-taxation through tax planning seem to be under attack through the BEPS Actions (i.e. empty shell companies, cash boxes), while others are permitted. Unless further developments occur, the new instruments for (arguably) legitimate tax planning in the post BEPS era are 'controls of risks', intangibles and intangible-related DEMPE functions and, obviously, in connection therewith them, royalty and service payments. The BEPS project may spell the end of empty shell companies and wholly artificial arrangements, but 'principal models or structures' used by MNEs under which residual profits can and will be accumulated in entities with a bit more substance than before, may be a permitted outcome (unless the full potential of BEPS standards is deployed and expanded in the implementation process).[15]

Ultimately, the whole discussion surrounding BEPS Action 1 revolves around, and is directly connected with, the tax planning possibilities that the BEPS project leaves untouched and the scarce attribution of income to countries where MNE groups carry on their business. There is a perception by some countries that – after the BEPS project and with the brand new BEPS principles, as implemented by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the MLI), the OECD Model (2017) and the OECD

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15 For recognition of the BEPS possibilities that remain after the BEPS project, *see* OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, at para. 385 ('In addition, intangible assets may easily be shifted around within an MNE group provided there is a correlation with a certain level of physical activity (e.g., functions that control risks, functions relating to the development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE)). These concerns may potentially be exacerbated in markets of the MNE group where goods and services are being supplied, if an MNE is still able to secure a low tax base therein through a local reseller model (e.g., a distributor not performing DEMPE functions regarding intangibles who is entitled to no more than the "routine profit" otherwise expected to be earned from routine functions performed in third-party transactions)'.) One can argue that these forms of tax planning that arise post-BEPS project are linked with a specific interpretation of the BEPS project outcomes and that other forms of interpreting 'value chains', the concept of intangibles and knowledge-based capital, or the BEPS project materials are also possible and probably more fruitful. On this, *see especially* section 3., below.

Transfer Pricing Guidelines (2017) and in the context of the BEPS Inclusive Framework – income can still be accumulated in some countries (resident or intermediary countries) without significant attribution of income to other (source) countries where MNE groups have relevant business activities (represented mainly by sales of goods and services). This problem is more acute within the context of a digital or digitalized economy, where MNE business models tend to concentrate risks and DEMPE functions in a specific location (or a few of them) frequently with low tax levels (either generally or under special regimes), also avoiding taxation in countries where MNEs operate, not so much because they are engaging in illegitimate tax avoidance activities, but rather because new technologies permit businesses to interact with remote markets and clients without (or with very little) physical presence in the client's country of residence (scale without mass) and the thresholds for taxation in market countries are not triggered. In sum, BEPS Action 1 is a repetition of the recurrent debate about residence taxation versus source taxation, as well as how to allocate taxing rights among different countries, but now more focused on modern/digital or digitalized business models as the economy and technology have evolved. Digitalization does not reveal new phenomena, but simply makes them more visible, frequent and, thereby, problematic.

In addition to the perception by some countries that the BEPS Actions have not contributed to allocate sufficient income to market countries, despite the base eroding effects that payments for services and royalties can have, the role reserved to withholding taxes on these payments under the OECD BEPS project is almost negligible. In line (although with some very relevant differences) with the US Model Convention (2016), withholding taxes appeared in BEPS Action 6 only in the form of countermeasures available to source countries against special tax regimes, as they were defined in BEPS Action 6 in connection with base eroding payments of interest, royalties and 'other income'.[16] But once again, the withholding taxes under BEPS Action 6 are triggered only in some cases of double non-taxation or low

[16] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances – Action 6: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, paras. 79-81 (OECD 5 Oct. 2015).

taxation, but not in others that have been blessed as harmless tax competition by the BEPS project (i.e. BEPS Action 5 compliant patent boxes and/or tax regimes that are consistent with transfer pricing principles as derived from BEPS Actions 8-10). Apart from the complexity of applying in the source country a withholding tax that is linked to tax regimes of the residence country,[17] these types of withholding taxes do not seem to contribute to solve the problems of base erosion and insufficient attribution of income that developing and also some developed countries perceive to be at the root of the digitalization of the economy and for which the current status quo does not provide an answer.[18] Otherwise, BEPS Action 1 and its aftermath would not be necessary.

In this context, BEPS Action 1 and all the ongoing work on the digital economy seem to reveal a sort of tension between, on the one hand, the source rules identified as a consequence, especially of BEPS Actions 8-10 (income should be allocated to where value is added) and, in general, the BEPS project outputs, and, on the other, the wishes of some countries and groups to include market states within the source rules in a form not directly contemplated by the BEPS project outputs. This tension is at the heart of the unilateral solutions adopted by states in parallel and after the BEPS works.[19] Such a tension, however, threatens the whole system of international tax relations in two different, but directly linked, directions.

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[17] On the difficulties of application of the US special tax regime provisions, *see* F. Vega Borrego, *The Special Tax Regimes Clause in the 2016 U.S. Model Income Tax Convention*, 45 Intertax 4, at 296 (2017).

[18] In order to avoid base erosion from royalties paid between associated companies and due to the constraints to apply withholding taxes at source for this type of income, Germany decided to implement a royalty barrier that disallows some royalty payments between associated companies and has a high degree of similarity with the special withholding taxes of Action 6, in that it leaves outside of the scope of the royalty barrier BEPS Action 5-compliant regimes and applies where the residence country provides special tax regimes for royalties that obviously do not meet the modified nexus approach. On the general features of the German royalty barrier, *see* J. Kramer, *Germany's New Royalties Barrier Rule: Preventing Tax Evasion by Limiting Deductibility in Specified Cases*, 88 Tax Notes Intl., at 879-883 (2017).

[19] On these unilateral reactions, *see* OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, Chapter 4.

First, the creation of new taxes threatens the integrity of income tax treaties as, in most cases, the new forms of taxation, despite their names (e.g. equalization tax, special tax), are income taxes. Second, the solutions proposed, either within BEPS Action 1 or as a reaction thereto, are based on principles that do not fit very well with those identified as traditional foundations of the international tax system (the BEPS project outputs may also fall under this umbrella), while at the same time they also present some problems of their own. The remainder on this article will focus on the latter, rather than former.[20]

In this context, the recently released OECD Interim Report on Tax Challenges of Digitalization has revealed a profound disagreement between countries on how to address these issues, and it remains to be seen whether in 2020 some final agreement can be reached.[21] The remainder of this article will focus on the most popular solutions that have been considered on taxation of the digital economy in the OECD, UN and EU contexts in order to study which ones are more likely to provide useful solutions for the taxation of the digitalized economy and will be less disproportionate in a debate that is also clouded by populism, a (perceived) need for (rushed) political action and a flurry of academic ideas and publications.

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[20] On the concept of tax on income and the newly created taxes, *see* OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, para. 415 ff. On this, *see also* A. Martín Jiménez, *Controversial Issues about the Concept of Tax in Income and Capital Tax Treaties and the post-BEPS World*, in *Essays in Honour of J. Sasseville*, *supra* n. 4, which is in line with the OECD's conclusions in the interim report on digitalisation, *supra* n. 1 on the concept of tax.

[21] On the different positions, *see* OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, Chapter 6 especially paras. 387-394. The disagreement is succinctly summarized as follows at para. 387: ('On the one hand, there is broad acknowledgement of the continuing evolution of digital technologies and the need for further consideration and monitoring of how these changes are impacting value creation across the economy. On the other hand, there is not yet agreement amongst countries over the tax implications of scale without mass and a greater reliance on intangibles. Further, while data and user participation are recognised as not being present in all highly digitalised business models, where they are present, there is currently no consensus on whether, and the extent to which, they should be considered as contributing to a firm's value creation, and therefore, there is no agreement as to whether they require changes to the international tax rules'.).

3. Potential Solutions to the Problems in BEPS Action 1: Permanent Establishments with Significant Economic Digital Presence, Withholding Taxes and Equalization Levies

3.1. The most popular solutions to address tax problems of the digitalized economy

The BEPS Action 1 Final Report refers to three measures that were presented as (potential) solutions to BEPS and the allocation of residence-source country taxing rights in a digital economy context. All of them have a very relevant impact in the current debates and would encompass a very significant modification in how taxing rights are divided under the OECD Model (1963-2017).

First, a PE that is based on a significant economic digital presence (SEDP) in a jurisdiction,[22] mainly, a market jurisdiction for goods and services, as – regardless of physical presence – revenue derived from a country, combined with other (digital) factors, forms part of the basic tests that trigger this type of PE. The system of allocating profits to this PE is the Achilles heel of the proposal, and BEPS Action 1 did not accept any specific system of allocation of profits, although it seemed to express some preference for deemed profit methods based on fixed (rebuttable or not) ratios of expenses (per industry sector or line of business).[23] Basically, this

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22 OECD, *Action 1 Final Report*, *supra* n. 1, para. 277 ff. *See also* P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, IBFD Woking Paper (IBFD 20 Jan. 2015).

23 As has been remarked by some commentators in the OECD's public consultation on the digital economy, the issue of attribution of profits has been difficult enough in the past years within the OECD so as not to open a new debate on this topic based on principles other than those already accepted; if this debate is opened again, it will be enormously difficult to achieve an internationally accepted consensus, with the consequence that different national standards will lead to controversy, double taxation and uncertainty. *See* e.g. the comments by BIAC, at 45, and Digital Economy Group, at 146 (arguing that under the arm's length principle, it is not possible to allocate meaningful income to the SEDP PE and any

system has also been advanced as a potential solution at EU level (*see* section 5. below).

Under the second measure, a broad withholding tax that would apply in the market jurisdiction to supplies of goods and services purchased online (either by business only or by businesses and consumers)[24] or a general withholding tax for all base eroding payments.[25] These withholding taxes could be a stand-alone measure or a backstop for the PE based on SEDP, as this second alternative is the one that

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profit attribution will be based on some degree of formulary apportionment principles), in OECD, *Tax Challenges of Digitalisation: Comments Received on the Request for Input – Part I* (OECD Publishing 25 Oct. 2017). As known, the debate about the attribution of profits to PEs in connection with BEPS Action 7 has also been difficult and controversial. Two (not widely accepted) drafts were presented by the OECD before the final (improved but also debatable) document was accepted. On the first draft, *see* OECD, *Public Comments Received on the BEPS Discussion Drafts on the Attribution of Profits to Permanent Establishments and the Revised Guidance on Profit Splits* (OECD Publishing 8 Sept. 2016), http://www.oecd.org/tax/public-comments-received-on-beps-discussion-drafts-on-attribution-of-profits-to-permanent-establishments-and-revised-guidance-on-profit-splits.htm (accessed 15 Mar. 2018). For the public consultation on the second draft, *see* OECD, *Public Comments Received on BEPS Discussion Drafts on Attribution of Profits to Permanent Establishments and Transactional Profit Splits* (OECD Publishing 6 Oct. 2017), http://www.oecd.org/ctp/transfer-pricing/public-comments-received-on-beps-discussion-drafts-on-attribution-profits-permanent-establishments-and-transactional-profit-splits.htm (accessed 15 Mar. 2018). For the final document, *see* OECD, *Additional Guidance on the Attribution of Profits to a Permanent Establishments: BEPS Action 7* (OECD Publishing 22 Mar. 2018). Problems are further exacerbated by the fact that not so many countries accept the authorized OECD approach defended in Article 7 of the OECD Model (2010-2017) and still apply previous versions of the article (which, by the way, can follow Article 7 of the OECD Model (2008) and the Commentary thereon and the 2008 Report or even previous ones, with relevant differences between them).

24 OECD, *Action 1 Final Report*, *supra* n. 1, para. 292 ff. On this solution, *see* Y. Brauner & A. Baez, *Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy,* IBFD White Papers (IBFD 2015). They proposed a two-rate withholding tax regime that would apply mainly to B2B payments, as application in B2C situations would be more problematic.

25 Y. Brauner & P. Pistone, *Adapting Current International Taxation to New Business Models: Two Proposals for the European Union*, 71 Bull. Intl. Taxn. 12, at 681 (2017).

seems to be better regarded by the OECD.[26] In fact, the latter is a modern version (with a broader scope) of rather old solutions that make the PE threshold easier to manage and administer, or are applicable to the taxation of services and royalties. Traditionally, the PE principle has been the way out of gross-basis withholding taxes under tax treaties that provided for this form of taxation; moreover, it is not uncommon that for royalties or services the payer withholds at the withholding tax rate and the payee shows the expenses related to the income earned in the source state in order to be taxed on a net basis and obtain a refund.[27]

Under the third measure, equalization taxes would seek to tax revenue of digital economy companies (remote sales of goods or services) in the source country.[28] Although presented as a specific category, they are, in reality, a (more or less targeted) version of withholding taxes and, therefore, share the advantages and disadvantages thereof. For example this is the case of the Indian equalization levy, where the payer for online business advertisement services must withhold the amount of the levy at the rate of 6%, but the taxpayer is the service provider.

The SEDP PE is increasing in popularity as a long-term solution, whereas withholding taxes (including equalization levies) are regarded as interim solutions or back-ups to the SEDP PE. That is to say, withholding taxes are conceived as incentives to move forward to the SEDP PE or apply simultaneously with the SEDP PE (and reinforce its effectiveness). The problems with these solutions are further

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26 OECD, *Action 1 Final Report*, *supra* n. 1, para. 301.

27 For instance, in some UK tax treaties, withholding taxes on technical services were combined with elective taxation as though the taxpayer had a PE in the country of the payer. *See* Art. 13(5) United Kingdom-Uganda income tax treaty (1992). With reference to different forms of taxing services, *see also* A. Martín Jiménez, *La fiscalidad de los servicios técnicos internacionales/ asistencia técnica en los Convenios para la Eliminación de la Doble Imposición,* 140 Revista Española de Derecho Financiero, at 901 (2008). On the different solutions with regard to the taxation of royalties, which are the same ones that can be applied to services (in fact because quite often technical services or some services are included within the royalty definition), *see* A. Martín Jiménez, *Article 12: Royalties and Technical Services*, Global Tax Treaty Commentaries IBFD, at 1.1.2.4.

28 OECD, *Action 1 Final Report*, *supra* n. 1, para. 302 ff.

explored in the two next sections, first, with a general comment, and, second, with more specific reflections on each of them (equalization taxes are in general treated here as withholding taxes, as, ultimately, they are not fundamentally or theoretically different).

3.2. Solutions or incoherent patches? The market element as a relevant factor for nexus or source of income

The problem with the options explored in BEPS Action 1 is that their interpretation of the guiding principle ('aligning tax bases and value') is based on a controversial assumption, namely that market countries cannot tax sales of digital economy companies within their territories[29] and, therefore, the structure of current tax treaties (those that follow the OECD Model) must be changed in order to allocate more taxing rights to market countries, where there is no doubt that 'value is added'.[30] In this regard, Schön, from a tax policy perspective, has criticized this assumption. In his view, (i) the argument should apply to all companies, not only to those in the digital economy,[31] (ii) if taxation in the market state seeks to remunerate for public infrastructure there, it can be funded with user fees (and one can argue that digital economy companies need less infrastructure than traditional ones) and

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[29] OECD, *Action 1 Final Report*, *supra* n. 1, para. 204 (showing this inherent bias: 'The ability to centralise infrastructure at a distance from a market jurisdiction and conduct substantial sales into that market from a remote location, combined with increasing ability to conduct substantial activity with minimal use of personnel, generates potential opportunities to achieve BEPS by fragmenting physical operations to avoid taxation'.) A similar statement can be found, for instance, in para. 246 or 253-255, 259.

[30] In the public consultation by the OECD, many comments pointed out that OECD BEPS Action 1 seems to be more concerned with shifting income to market countries than with BEPS concerns. *See* e.g. OECD, *Tax Challenges of Digitalisation: Comments Received on the Request for Input – Part II* (OECD Publishing 25 Oct. 2017), comments by Mary Bennett on behalf of the International Alliance for Principled Taxation.

[31] This is something that, at least, the OECD interim report on tax challenges of digitalization seems to acknowledge, although it also reflects disagreements in this regard. OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, Chapter 5.

(iii) the existence of a market is already taken into account by VAT and GST, which BEPS Action 1 permits to apply in the state where services and goods are consumed.[32] He, therefore, asserts that taxable nexus (the right of a jurisdiction to tax income) should be linked with 'digital tangible or intangible investment in a country' beyond the PE, which should, in turn, lead to taking into account the location-specific rents derived from a market, even if it is in a non-traditional spatial sense.[33] Under his model, the value of users might be part of the profit allocation, not so much because they provide a customer basis, but simply because they indicate investment in a specific country.

On the other hand, as the US subnational experience with formulary apportionment shows, the market, represented by sales, can be regarded as good an indicator to allocate income as any other, even if, in the United States, taking into account market elements at the subnational level, has made state corporate income taxes evolve towards single-factor sales formulas (therefore, eliminating other factors from the formula used to apportion income, notably property and payroll) as a form of competition for investment, rather than on sound tax policy grounds.[34]

However, it is not necessary to go to the United States to find market elements in the current international tax order, as withholding taxes on interest, royalties, and services are usually connected with 'payers' and, in more limited cases, 'users' under income tax treaties – which is arguably closer to the market element than to any other underlying theory. Therefore, the market element seems to be already

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32 W. Schön, *Ten Questions About Why and How to Tax the Digital Economy*, 72 Bull. Intl. Taxn. 4-5 (2018).

33 Schön, *supra* n. 32 ('If it can be shown that an Internet firm has invested capital in a specific market in order to access a specific customer base, it becomes evident that this investment can give rise to taxing rights in the respective market country, but not simply because there is a market with customers ordering goods or services, but because the company has invested into that market and expects a return on this investment'.).

34 W. Hellerstein, *A Subnational Perspective on the 'Logic' of Taxing Income on a 'Market' Basis*, 72 Bull. Intl. Taxn. 4-5 (2018). *See also* the proposals in M.F. de Wilde, *Comparing Tax Policy Responses for the Digitalising Economy: Fold or All-In*, 46 Intertax (2018) in press.

present in many tax treaties already in force (in some of them, it refers only to interest, but in many others to royalties and technical services) and is inherent to withholding taxes, regardless of whether they are connected with use within a jurisdiction or with payments from such a jurisdiction.

Therefore, in the author's opinion, the problem is not that the market is taken into account for the purposes of allocation of income (withholding taxes for specific items of income always did so), but how this parameter has been introduced in the debate in a rather incoherent and disproportionate manner. As that incoherence has been introduced in the OECD BEPS project, this section will refer first to it; only in section 4. will the issue of withholding taxes and market elements be further developed.

'Value added' is identified in the proposals of BEPS Action 1 with market states – a premise that, as such, is hardly compatible with the underlying assumptions of BEPS Actions 8-10. The value chain of multinationals is structured along the productive process from an input (supply side) perspective, not from the output (demand) one, and requires the attribution of income to the place where risk/intangibles are controlled, not where the client is located (unless significant functions/intangibles are also present there). That is to say, the guiding principle derived from BEPS Actions 8-10 is aligned with the use and deployment of production factors by an MNE group, not with the market or demand side as such.[35]

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[35] Amongst others, these ideas are very well reflected, apart from Schön, *supra* n. 32, by the comments by Digital Group, at 138: ('With respect, we believe that an enterprise creates its success through its deployment of personnel and capital resources. Innovation and production create value, consumption does not. A commercial transaction between a supplier and a purchaser is an exchange of value for value (the good or the service is supplied in exchange for money or other consideration), but that transaction creates no new value'.). They also reiterate the common arguments by most comments in the OECD consultation on the digital economy that what creates value is not data in itself, but the possibility to interpret and make use of those data. The same applies for IP, which, in fact, is the result of important investments, human effort and risk. *See also* comments by Loyens & Loeff, in OECD, *Tax Challenges of Digitalization: Comments Received on the Request for Input – Part II*, *supra* n. 30, at 5 ff (arguing that the shift of jurisdiction to

This does not mean, however, that the market (and the investment or deployment of MNE groups in market jurisdictions) is completely neglected in BEPS Actions 8-10, even if some functions related to specific types of intangibles can lead to over attribution of income to some countries. As a matter of fact, the definition of intangibles in the new chapter 6 of the OECD Transfer Pricing Guidelines (2017) permits one to regard as 'valuable' and include within the intangible definition, the classical marketing/customer-based intangibles. If countries want to attribute income to their market, there is no need to resort to consumers; they can already seek value within their jurisdictions in terms of what local subsidiaries or PEs do and whether there are relevant functions and risks there connected with those customer-based intangibles and relevant functions within the jurisdiction.[36]

It is quite another thing that, in order to achieve that outcome, most countries may need to recognize and define new intangibles and functions (to which Chapter 6 of the OECD Transfer Pricing Guidelines (2017) refers in only a very broad manner), which may have no protection under classical private (and tax) law, and include them within their tax laws in order to recognize taxable events that could occur when the functions and risks linked with them are exerted within the market jurisdiction and/or are transferred inside or outside it (e.g. in the context of a restructuring).[37] No recognition of those – market-linked, customer-based – intangibles/functions may imply no taxation of value creation within the borders of a state. Although BEPS Actions 8-10 offer very relevant 'tools' to market/source states, BEPS Action 1 and its aftermath – instead of going down the road already defined by BEPS Actions 8-10 – have formulated, and opted for, different solutions without waiting to see how the effects or the potential of such BEPS Actions 8-10

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the 'market'/'destination' country would require a change in paradigm, as profit allocation rules for PEs and transfer pricing rules are based on a supply side tax, and no so much on 'demand' elements).

36 In this regard, *see* Tavares & Owens, *supra* n. 7.

37 On this issue, *see* S. Wilkie, *Intangibles and Location Benefits*, 68 Bull. Intl. Taxn. 6/7 (2014), 352 ff; S. Wilkie, *Transfer Pricing Aspects of Intangibles: The License Model*, *supra* n. 6. This idea is also recognized by M. Devereaux & J. Vella, *Implications of Digitalization for International Corporate Tax Reform*, 46 Intertax (2018)(in press).

could develop and be implemented. Even worse, some countries seem to be willing to abandon the BEPS principles derived from BEPS Actions 8-10 (some with regard to highly digitalized models, some in general), whereas others would prefer to stick to them.[38]

In the author's opinion, a fully coherent move with BEPS Actions 8-10, which are now agreed (soft law) standards, would call for really reflecting on how the new principle of value creation proposed (but not defined or fully developed) would affect the distribution or rights between residence and source (which may or may not be the same as market) states, and whether and how this development could enhance the position of source countries to apply taxes to any type of MNE group. It would require a more through study of value chain elements of digital and non-digital economy companies, of intangibles associated with companies with digital activities, without isolating any type of company or group.[39] In addition, this exercise

[38] It seems that the United States prefers to abide by the principles of BEPS Actions 8-10 and that it regards proposals such as those derived from BEPS Action 1 to be contrary to the current transfer pricing principles, as, apart from finding value, one must focus on who creates that value and to whom the value accrues (risks and capital contributions are, in this regard, fundamental). Differences between the United States and other countries will be more evident when the United States publishes new regulations addressing cloud computing. *See* J. Finet, *US Unlikely to Embrace OECD Value Chain Analysis for Cloud*, 89 Tax Notes Intl., at 756 (2018). The division of opinions between different groups of countries has been openly recognized in the OECD interim report on digitalization. OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, especially Chapter 5.

[39] As mentioned at the beginning of this article, the digital economy is an activity (digitalized economy), not specific a sector, and affects all types of companies. This idea has been stressed more recently by the OECD interim report on digitalization, as its own title shows, which does not refer to the digital economy but to 'digitalization', and by many of the organizations and commentators that responded to the OECD's public consultation on the digitalization of the economy. *See* e.g. comments by BIAC, at 34 ff., Digital Economy Group (stressing that the solutions considered by BEPS Action 1 are in overt contradiction with its principle that the digital economy should not be isolated, as all the economy is digital), at 137-138 in OECD, *Tax Challenges of Digitalization: Comments Received on the Request for Input – Part I*, *supra* n. 23. From a more academic perspective, *see* C. Spengel, M. Olbert & A.C. Werner, in OECD, *Tax Challenges of Digitalization: Comments Received on the Request for Input – Part II*, *supra* n. 30, mainly, at 317

should also take into account that business models are not equal, and even in the digital economy there can be different types of value chains, each with its own specific features.[40] In fact, a very valuable contribution of the OECD interim report on the tax challenges of digitalization is precisely to show that (i) digitalization affects all types of companies and (ii) even in highly digitalized companies, there is not a uniform business model, such that no uniform solution can be valid for all of them. This conclusion reinforces the idea that identification and development of BEPS Actions 8-10 guiding principles would permit a capturing of the nuances of all the different business models.[41] Focusing on only the digital part of the residence-source country problem, without a more holistic approach, will leave wide open routes for easy avoidance of the digital thresholds, will create distortions (*see* the comments in section 3.3. below) and is incompatible with the more general approach that BEPS Actions 8-10 suggest.

In the exercise of reaching a consensus on how to develop a common international understanding on value chains and source country allocation of income, two central issues deserve further exploration and development, namely (i) whether a less formalistic approach to the PE concept or the MNE group is possible and/or (ii) how profit-split methods can affect the allocation of income, as well as their potential. First, on the less formalistic approach to the PE concept, a reconsideration of whether the subsidiaries of certain MNEs carry out only routine functions as independent entities or are part of a (bigger) single entity and should have access too to residual profits of the MNE group merits more attention.[42] Ultimately, if some

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(they prefer to develop the traditional principles, that are identified with the value chain analysis, in connection with digital economy rather than the new options proposed in BEPS Action 1).

40 Even quick fixes based on BEPS Action 1 should take into account the different business models of the digital economy in order to keep distortions to a minimum. *See also* G. Kofler, G. Mayr & C. Schlager, *Taxation of the Digital Economy: A Pragmatic Approach to Short-Term Measures*, 58 Eur. Taxn. 4 (2018).

41 OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, Chapter 2.

42 R. Vann, *Tax Treaties: The Secret Agent's Secrets*, Brit. Tax Rev. 3, at 345, 376-380 (2006); Martín Jiménez, *supra* n. 13, at 404-405; Tavares & Owens, *supra*

of the subsidiaries of an MNE group are really dependent agents of their parents, rather than fully independent companies, and deserve separate consideration only as legal fictions, this separate entity approach is at the heart of profit shifting. Full consistency with the approach of BEPS Actions 8-10 will likely demand progress along the same line in the context of Article 5 of the OECD Model in order to recognize when a subsidiary is really economically independent and should be (in substance) regarded as such or, rather, if it is an extension of another company and should be also regarded jointly with it[43] (a side effect of this move would be that the force of attraction principle of Article 7 of the UN Model may also have more real strength to capture sales within a jurisdiction for countries that wish to effectively use this standard).[44]

Relaxation of the PE threshold may also refer to the so-called space features of the PE (fixed place), as connection with a specific place currently is not as important as

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n. 7; R. Tavares, *Multinational Firm Theory and International Tax Law: Seeking Coherence*, 8 World Tax J. 2, at 243 (2016). In their comments to the OECD call for input on the digital economy, NERA Economic Consulting in OECD, *Tax Challenges of Digitalization: Comments Received on the Request for Input – Part II*, *supra* n. 30, at 177, explained: 'Many of the entities involved in the digital economy business models, often seen as "routine", will in fact be expense centers or revenue centers. These entities may not have control of, and thus cannot carry the responsibility for, their own continuity. Consequently, they should, under circumstances, be characterized for purposes of article 5 paragraph 1 as part of the enterprise of their principal – with direct impact on their potential status of PE. The subsequent issue of attribution of a suitable remuneration to the PE can be faced following the [authorized OECD approach], with the toolset elaborated in the 2017 [OECD Transfer Pricing Guidelines]'.

43 Apart from a natural evolution of BEPS Action 7, this would, and probably should, be the ultimate consequence of the 'piercing the corporate veil' that BEPS Actions 8-10 propose with the acceptance of the value added principle and value chain analysis. On this issue, *see* Wilkie, *supra* n. 4. He argues that, ultimately, the effect of BEPS Actions 8-10 is to pierce the corporate veil when corporations are insubstantial in order to attribute income to them, and a coherent move would therefore be to pierce the veil of corporations where they are only the extension of another entity, without any economic/substantive activity of their own.

44 Ultimately, the legal independence of companies within an MNE group is a serious limit to that principle, which, incidentally, also lacks enough clarity and has other problems of its own. *See* e.g. Martín Jiménez, *supra* n. 13, at 438-439.

carrying on business within a country (even if in different places) in a permanent fashion. The latter would apply across all the different sectors, as there is no need to do so only for a specific type of business or companies (digital or not digital, small or big ones). Ultimately, this would be another element of the value chain that is worth exploring further. As value is added not only with a bricks-and-mortar presence in a jurisdiction (because new businesses do not need that type of presence), a business presence in a jurisdiction should be enough to trigger taxation in the source state (probably with some thresholds that refer to turnover rather than to type of transaction or company).

Second, on the more frequent use of profit splits, some of the activities of MNE subsidiaries (e.g. data mining, marketing, after-sale assistance), in a digital but also in non-digital context, may not currently be regarded as simple routine functions, and the application of profit splits in these cases may also warrant further consideration, regardless of whether the PE principle is extended to cover other entities of an MNE group that cannot be said to operate with full (economic and legal) independence.[45] In this process, it is essential to recognize the full potential of the intangible concepts that are referred to in Chapter 6 of the OECD Transfer Pricing Guidelines and BEPS Actions 8-10. At the moment of writing this article, the OECD's work on profit splits is not yet finished and, therefore, it is not fully known how it will affect MNEs. However, the initial aspiration of the OECD to apply more frequently the profit-split method for transfer pricing purposes that transpires from

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45 This is also the proposal of Ludovici & Partners. *See* OECD, *Tax Challenges of Digitalization: Comments Received on the Request for Input – Part II*, *supra* n. 30, at 144 ff. In the same direction, *see* Spengler, Olbert & Werner, *supra* n. 30, at 308 ff. ('activities performed by local staff, such as customer support or the technical adaptation of digital products and services to the particularities of local markets (e.g. language features, legal requirements, customer characteristics, etc.), might not be best interpreted as routine tasks from a tax perspective. Potentially new forms of the sales function of digital business models should be analyzed in more depth as to develop criteria that distinguish between important activities that contribute to customer-centric value creation and rather supportive activities'). They also argue that a profit split can be useful for the business models of the digital economy. On how to use profit-splits, *see also* M. Olbert & C. Spengel, *International Taxation in the Digital Economy*, 9 World Tax J. 1, at 3 (2017).

BEPS Actions 8-10, will probably be more limited and restrained in the final document to be released before the summer of 2018 (at least business commentaries in public consultations lean towards attempting to reduce the effects and situations where it can be applied). Currently, the problem with profit splits in the current international institutional framework is that they are likely not even appealing for (some) tax administrations outside cases where the taxpayer voluntary gives the tax administration all the information about its business value chain (e.g. in an APA or other cases of voluntary application by the taxpayer of the profit-split method and disclosure of business information). This is due to difficulties in obtaining enough knowledge and information about the value chain of MNE groups, especially for countries other than where the parent company of the MNE group is located. However, the more international tax collaboration, the easier it will be to use profit splits more frequently. The generalization of BEPS Action 13 transfer pricing documentation and country-by-country reporting, as well as increased progress on simultaneous or joint audits (an issue already on the OECD agenda)[46] will help to further advance in this direction.

Therefore, a further revision of the OECD Transfer Pricing Guidelines (2017) in the direction of fully understanding and reflecting how value is added in the digitalized economy and what transfer pricing methods should be used, together with a revision of Article 5 of the OECD Model that is aligned with the principles of BEPS Actions 8-10 might be a more promising start than the options mentioned in BEPS Action 1.[47] At least, it would be more coherent with currently accepted principles and would provide a more general solution applicable to all types of MNE groups or business activities conducted in a country. One can argue that a more direct and easier (even if less perfect from a theoretical perspective) approach would be to abandon the transfer pricing/separate accounting system in favour of formulary apportionment, which would permit the inclusion of the market factor within the

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[46] Forum on Tax Administration, *Communiqué of the 11th Meeting of the OECD Forum on Tax Administration (FTA) Oslo, Norway*, at 2 & 15 (29 Sept. 2017).

[47] Spengler, Olbert & Werner, *supra* n. 30; Olbert & Spengel, *supra* n. 46, especially section 5.2.4.

structure of the corporate income tax (as has happened in the United States).[48] However, formulary apportionment requires a level of collaboration among states and a template (common tax base) that currently does not exist in the existing international arena. An evolutionary and gradual approach rather than a revolutionary one is probably the only feasible alternative (as the long-lasting, unsuccessful, story of proposals on the common consolidated tax base prove within the EU). Under this (evolutionary) approach, 'sales and markets', and what happens within market jurisdictions, can be also taken into account, but for all types of business and MNEs, and not just for some of them.[49]

One can argue that the ideas in the previous paragraphs may reflect a long-term

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48 Hellerstein, *supra* n. 34. On the comparison between arm's length and formulary apportionment and their pros and cons, *see* W. Hellerstein, *The Case for Formulary Apportionment*, 12 Intl. Transfer Pricing J. 3, at 103 (2005).

49 Somehow, with nuances, the United Kingdom has picked up some of these ideas in connection with companies that derive their value from users in some jurisdictions. The UK reflections (position paper) go in the direction of reforming Articles 5, 7 and 9 of the OECD Model to recognize that some non-resident companies can have a PE in the 'user' jurisdiction in order to capture some of the residual profits of the group that cannot be currently taxed there. The United Kingdom also proposes to use, for that purpose, profit splits. In the view of the present author, the problem with the proposal is the separate application of the PE principle of Articles 5 and 9 of the OECD Model, as well as the reform proposed of Article 5 of the OECD Model, which seems to go in the direction of the SEDP PE. A more evolutionary approach would recognize that some of the subsidiaries in the user country are simply PEs of the group, as this would avoid the trouble of having to attribute profits to the local subsidiary in addition to the (potential) PE, and would probably be more realistic in terms of fully reflecting the real activity within the user jurisdiction and the full group. A more flexible approach to the concept of PE in itself would also be better than only for some activities. The United Kingdom also defends an interim, revenue-based, measure, but, if possible, on a consensus basis within the OECD (this agreement was not possible, as the OECD interim report on digitalization reflects in Chapter 5). OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1. The call for consensus is curious, considering that the United Kingdom was among the first to depart from it with its diverted profits tax. On the UK position, *see* HM Treasury, *Corporate Tax and the Digital Economy: Position Paper Update* (Mar. 2018), available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf (accessed 22 Mar. 2018).

goal that will be difficult to achieve in the short run. This is why a more precise reflection on the specific proposals of the SEDP PE and withholding taxes is needed in order to know whether they are *the* (long- or short-term) solutions to the problems identified by some countries, or whether they might create more problems than they solve. Then, the reasoning will again connect with the BEPS opportunities that remain after the BEPS project that have been identified in section 2.

3.3. Specific problems of the most popular solutions (SEDP PE and withholding taxes): Are they the right and most proportionate solutions?

The OECD interim report on the tax challenges of digitalization, as noted, reflects that there is no agreement or common position neither on long-term solutions nor on interim measures,[50] although countries still regard attractive the SEDP PE and the withholding taxes (including within this group equalization levies) derived from BEPS Action 1. In this context, in addition to those general comments that could apply to the market element that the SEDP PE and withholding taxes of BEPS Action 1 are attempting to introduce, both measures deserve further specific comments, as, in the author's opinion, both of them could be disproportionate and might not provide the solutions that are sought by their proponents.

First, it is no secret that the PE concept, from its inception, has comprised two opposing elements: it is a threshold permitting source country taxation, but it was also designed to operate in favour of residence state taxation. As a consequence, the PE principle has always created (together with the traditional application of transfer pricing rules) a dissociation between the idea that a state should tax substantial participation within its economic life and the taxation rights that can be claimed upon that participation. That is to say, historically, the PE threshold has not

[50] OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, Chapter 6 points out that there is no agreement on the interim measures either, and designs a framework within which those potential measures should be included and against which they could be assessed. In the author's opinion, the most relevant contribution refers to the 'clarification' of the concept of tax on income from tax treaties that derives from para. 415 ff.

operated to empower source states to tax economic activities that take place within their borders, but, rather has often acted as a break or limitation on the possibility of source countries to tax economic activity that takes place within their territory. This has occurred, for example, (i) by limiting the taxing rights of the source country to cases of a fixed place of business and the dependent agent PE test, (ii) by applying the threshold to a stream of income and not per taxpayer, with the system of attribution of profits to that stream of income; (iii) by presuming subsidiaries to be independent from their parents, or (iv) by giving priority to free trade and the elimination of double tax burdens at the expense of the application of anti-abuse doctrines and rules of the source country when the PE was avoided. BEPS Action 7 has not changed the situation that much,[51] especially if one takes into account the 'permitted BEPS' explained in section 2. above.

In this context, having yet another type of PE, the SEDP PE, may be distortive, as ultimately, the latter type of PE will coexist with physical ones – which will not be easy.[52] The principles and rules applicable to physical PEs (e.g. the geographical and commercial coherence tests, or the rules on attribution of profits) will also apply to SEDP PEs, at least, to the interaction between physical and digital PEs. This means that both physical and digital PEs will offer more possibilities to fragment tax bases in a country or take advantage of their different thresholds and attribution of profits rules (without being very clear how the anti-fragmentation strategies of BEPS Action 7, which have very relevant limits on their own, will apply in this context). Therefore, it is arguable that the SEDP PE will contribute to really having a full picture of all the activities of an MNE groups or foreign companies in the source

51 Martín Jiménez, *supra* n. 13, especially section 3.

52 Similarly, NERA Economic Consulting *supra* n. 30, at 179, ('... the concept of "significant economic presence" is not needed per se. The sought concept can be identified with a proper use of the existing toolset of the international taxation, based on value chain analysis and with a correct characterization of entities within a multinational enterprise. The current Article 5 paragraph 1 of the Model Tax Convention, based on a relevant, i.e., economic, interpretation of what constitutes an "enterprise", will then allow the systematic and consistent identification of a "significant economic presence" for purposes of international taxation. For this reason, we would suggest not introducing this new concept as it is not needed'.).

country without further modifications to Article 5 of the OECD Model. Because of this, a more evolutionary approach to the interpretation of Article 5 of the OECD Model (as explained above in section 3.2.) that holistically takes into account the value added by parts of the MNE in the source country, even if incorporated as legally (not economically) independent companies, or what is done by a company within a country, seems to be more promising in order to capture the full presence of specific businesses within a jurisdiction. Although in a very rudimentary manner, this has been the approach of some countries (e.g. Spain).[53]

Second, withholding taxes (including equalization levies), when they are proposed as either back-up or stand-alone (quick fix) solutions for the taxation of digital/digitalized economy, present some fundamental issues, as well. First, they will create distortions if applicable only to online sales of goods and services, while leaving outside their scope other more traditional means of supplying goods or services. Second, if it is a more general solution that applies to all kinds of base-eroding payments,[54] the withholding tax would require truly fundamental changes to the international tax order (although their proponents link the withholding tax with the SEDP PE, it is not very clear how it would work where there is no PE, physical or virtual) and it is doubtful whether it is really necessary to apply it to trade in goods.[55] As will be shown, the author believes that withholding taxes can be a step in the right direction, but with a more refined scope in terms of transactions covered

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53 Although Article 5 of the OECD Model can be interpreted in this economic manner, the change would be so radical and relevant that legal certainty would require a formal agreement in this regard, as the controversy with the Spanish interpretation of the PE concept shows. A. Martín Jiménez, *The Spanish Position on the Concept of a PE: Anticipating BEPS, Beyond BEPS or Simply Wrong Interpretation of Article 5 OECD MC*, 70 Bull. Intl. Taxn. 8, 458 (2016).

54 Brauner & Pistone, *supra* n. 25.

55 As the OECD interim report on digitalization warns, this is probably not the most pressing sector in which modifications are needed and the complexities and implications (legal, administrative and practical) linked with a withholding tax on the sale of goods will require a more careful thinking. OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, para. 436. A general withholding tax on goods is applied by some developing countries, so perhaps their experience should also be taken into account.

(royalties and services) and without limiting them to the digital economy, as will be explained in section 4. below. and, if the PE threshold is relaxed as explained above, with a tight connection therewith.

In addition, equalization levies (a form of withholding taxes) are frequently attempts to subvert the current international tax order, as represented mainly by income tax treaties. Most of the examples that can be found today, either in theory or already implemented (e.g. the Indian equalization levy), apart from other technical problems,[56] are income taxes in disguise that pretend to have a life outside income tax treaties, with the clear goal of recognizing more taxing rights to market states and the effect that they can cause treaty overrides (if income tax treaties follow Article 2 of the OECD Model). This is a direct attack to the current international tax order as we know it. If states are permitted to engage in treaty dodging and bypass their international obligations simply by changing the name of a tax or by insisting that it is not an income tax (regardless of its effects, its final goal and how it applies to the taxpayer), the damage to the international tax order in terms of certainty and trust are likely much higher than the benefits such a move could bring.[57] If withholding taxes/equalization taxes are regarded as a solution, their implementation can only be done as a reform to tax treaties in a bilateral or multilateral instrument.[58]

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[56] OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, Chapter 6 (on the 'limits', challenges of these taxes).

[57] On this issue, *see* Martín Jiménez, *supra* n. 20. It is not a coincidence that, in view of these dangers, the OECD interim report on digitalisation felt the need to define the concept of income tax covered by tax treaties in paragraph 415 ff.

[58] Introducing withholding taxes (or even the concept of SEDP PE) within the current international tax system by 'interpretation' does seem to be a viable or even good solution in terms of legal certainty (*but see* Brauner & Pistone, *supra* n. 25). In a different move, countries like Austria have opted to terminate and renegotiate their most problematic treaties (e.g. the treaty with Ireland). *See* International Tax Plaza, *Taxing Digital Companies: The Austrian Government Takes It to a Different Level* (23 Sept. 2017), available at http://www.internationaltaxplaza.info/homepage/news-archive/news-archive-2017/news-archive-september-2017/3910-taxing-digital-companies-the-austrian-government-takes-it-to-a-different-level (accessed 20 Mar. 2018).

More significantly, however, the new proposals are not BEPS-proof either, which makes them more popular (or even populist) than effective. The SEDP PE threshold can be avoided with a local subsidiary because final sales/revenues are entered into within the jurisdiction where the subsidiary is located and users can be linked to such a local subsidiary instead of a non-resident company. Income attribution to that subsidiary will be minimal if traditional transfer pricing techniques are used (routine functions and one-side transfer pricing methods) and/or payment of royalties and service fees to other MNE group companies are charged to the subsidiary. The effect of the withholding/equalization tax solutions can also be bypassed if the withholding is linked with digital transactions and base eroding payments to non-resident companies.[59] Recent restructurings of so-called digital economy giant MNE groups suggest that they are preparing for the consequences of these patches or interim solutions, as well as reacting to BEPS Action 7.[60] However, as mentioned, restructuring to have a local (market) presence will not mean that base erosion will end in the post-BEPS project era, as royalties and service fees will continue to be deducted with the only limit of the arm's length principle, and one-sided transfer pricing methods will also be used. Likely, legal uncertainty surrounding how the new measures (SEDP PE and new withholding taxes) will apply and the conflicts they will trigger is also a powerful reason to turn digital presence into a physical one (subsidiaries), as MNEs are more familiar with managing these types of risks and (in many cases, successfully) resolving conflicts in this area while limiting tax exposure in the source country. However, one might wonder about the need or economic efficiency of this move if, ultimately, a local structure is not needed at all, and MNEs are simply creating them to avoid the risks associated with new digital economy solutions and conflicts associated with BEPS

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59 It can be said that a more general withholding tax applicable to all base eroding payments will also apply in these cases and avoid this problem (e.g. the subsidiary will purchase goods or services from other companies of the group). The problem again is that a more general withholding tax that also applies to goods will present the difficulties and issues noted above.

60 OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, paras. 253, 262, 273, 309 (reporting that Amazon, Google, E-Bay and Facebook have started to change their trade structures from remote sellers of goods and services to local reseller models); Soong Johnston, *supra* n. 14.

Action 7.

If the current international tax system and corporate income taxes do not work well, it is legitimate to contemplate and eventually implement a new, more perfect, system.[61] But what seems risky is to completely denaturalize the current system and agreements (the outcomes of the BEPS project) by introducing elements which are inconsistent with longstanding or recently accepted principles, which depart from them, without its being very clear whether the new patches are really general, satisfactory or proportionate solutions to the (old and new) problems of base erosion, especially those that remain after the BEPS project. This is a reflection that should be taken into account by countries that are in favour of the new patches (either in the form of the SEDP PE or withholding/equalization levies for digital transactions).[62]

3.4. Why not giving a chance to more traditional thresholds for business taxation at source?

Apart from the issues noted above, what seems strange in the new proposals on the SEDP PE and withholding taxes/equalization levies (patches) is that they seek to be revolutionary at the expense of disregarding not only some of the BEPS principles (BEPS Actions 8-10 and how they could evolve), but also other

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[61] These are the conclusions of the comments by Loyens & Loeff, *supra* n. 30, at 142-143. In this regard, *see* the destination based cash-flow tax (DBCFT) proposed by A. Auerbach, M. Devereaux, M. Keen & J. Vella, *Destination Based Cash-Flow Taxation*, Oxford University Centre for Taxation WP 17/01 (27 Jan. 2017). For criticism of the DBCFT, with special reference to the US context and proposals, *see* D. Shaviro, *United States: Goodbye to All That? A Requiem for the Destination-Based Cash Flow Tax*, 72 Bull. Intl. Taxn. 4/5 (2018). On another system of corporate tax, *see also* De Wilde, *supra* n. 34. Gathering enough international political consensus to implement these options seems the main and truly fundamental obstacle to implementing radical new solutions.

[62] OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, Chapters 5 and 6 (revealing the division of position of countries, some of them more in favour of using the traditional tools and others in favour of the new solutions).

thresholds that have been used historically by countries to tax business profits and may be more effective, proportionate and less problematic. In the sections above, the author has explained that the current system (after the BEPS project) can be further developed without altering its foundations. It should also be taken into account that, apart from revolutionary or evolutionary approaches, the PE principle, as embodied in the OECD Model, is not the only threshold for taxing business profits in the current international tax system. In this context, the UN Model and its evolution (which also reflects the position of other countries) also deserve careful consideration to reflect on its potential to tax the digitalized economy or close the loopholes that the BEPS project has left open.

4. The UN Threshold for Taxing Business Profits and Withholding Taxes

When, as occurs with Article 12 of the UN Model, tax treaties permit source countries to tax royalties, the outcome is that the specific tax treaty has two different thresholds for the taxation of business profits, namely the PE principle, which requires some presence in the source state (through a fixed place of business or an dependent agent) and withholding taxes on royalties, which do not require such a presence within a country in order to tax the profits of an enterprise (business profits).[63] In the past, the latter threshold for royalties was applied to combat base erosion and profit shifting long before these terms were known. At least in connection with the taxation as royalties of payments for the use of industrial, commercial and scientific (ICS) equipment, history shows that, in the works towards drafting Article 12 in the 1963 Draft OECD Model, the inclusion of

[63] On this issue, more generally, *see* UN Committee of Experts on International Cooperation in Tax Matters, *The Character and Purpose of Article 12 with Reference to 'Industrial, Commercial and Scientific Equipment' and Software-Payment Related Issues*, Discussion paper prepared by S. Wilkie for the 11th Session, Geneva, 11-23 Oct. 2015, E/C.18/2015/CRP.6 (13 Oct. 2015), available at http://www.un.org/esa/ffd/wp-content/uploads/2015/10/11STM_CRP6_Article12_Royalties.pdf (accessed 20 Mar. 2018).

payments for leasing of equipment within the royalty definition was directly linked with the possibility of companies in the leasing sector to establish in countries where there was no taxation without, simultaneously, having a PE in the country where the ICS equipment was used.[64] For that reason, due to the mobile nature of leasing activities, companies and the tax planning opportunities for companies in this sector – which did not need local infrastructure to carry on their business where the ICS equipment was used by their clients ('scale without mass' in modern terminology),[65] withholding taxes on royalties and the inclusion of leasing of equipment in the royalty definition were regarded as the most appropriate means to combat base erosion (even if, later on, in 1992, for other reasons, the reference to ICS equipment was removed from Article 12 of the OECD Model, but remained in Article 12(3) of the UN Model).

Moreover, in this initial stage (the 1950s and 1960s), withholding taxes on royalties – apart from being the most efficient tool to combat tax base erosion and overcome the 'cliff effect' of the PE threshold – had the side effect of sourcing income where the payer of the royalties was located. This form of taxation is not very far from the ideas of the advocates of the market as a jurisdiction or the ideas of proponents of the 'destination-based cash flow tax'. Ultimately, both groups propose that taxation be approximated to where 'consumers' are, as they are less immobile than corporations.[66] It can be said that the concept of 'payer' is not the same as 'user', even if they most frequently will be the same person, but, in cases of dissociation of 'payer' and place of 'use' (as may happen with some digital companies and platforms where, for instance, the purchaser of the advertisement is in a different

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64 Martín Jiménez, *Article 12 (Royalties) and the Technical Services Articles*, *supra* n. 27, section 5.1.6.1.

65 OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, para. 131 ff.

66 Obviously, 'payer' is not equivalent to 'consumer' as such in some cases, but the misalignment is easy to resolve: if the payment of the royalty/service fee is connected with a foreign PE, the 'consumer' is the PE and not the head office; if the payer is a subsidiary of the group that acts on behalf of other companies, transfer pricing rules will permit a correction of the mismatch between payer and final consumer.

location than the user), traditional withholding taxes already provided for potential corrections.[67]

Therefore, history shows that there is another form of dealing with BEPS problems, namely withholding taxes for royalties as a threshold for taxing business profits of companies that are not physically present in a market, but still carry on business in the source country where the object of the transaction, the equipment and, more significantly, the user or ‘consumer’ are located. In fact, dissatisfaction with outcomes of the BEPS project and the traditional division of residence-source taxing rights has lead the UN to significantly expand the threshold for taxation of business profits at source by using withholding taxes in an expansive manner, departing as a consequence from the OECD consensus. It can even be said that there is an alternative approach to BEPS in the UN context, in comparison to that of the OECD, which is based on another threshold for taxation of business profits that does not require physical presence and largely relies on where the ‘user’ is located and can usually deduct the payments from the tax base. Most interestingly, this threshold does not take into consideration the form of the transactions (digital, physical), but rather considers categories of transactions, which, although this may lead to the usual problems of classification and characterization of income,[68] also has the advantage of permitting a more targeted approach in the use of withholding taxes (to categories where greater risks are singled out).

The most significant steps in the definition of this alternative threshold for the taxation of business profits, beyond the traditional Article 12 of the UN Model (2011), are the following.

First, the adoption of a technical services article in Article 12A of the UN Model

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[67] See, on this solution, *UN Model: Commentary On Article 12* para. 19 (2011).

[68] On this issue, *see* A. Martín Jiménez, *Article 12 OECD/UN Models: Definition of Royalties and ‘Overlapping’ between Articles 7, 12 and 13*, in *Taxation of IPs under Domestic Law, EU law and Tax Treaties* (G. Maisto ed., IBFD 2018) in press, section 6.7.

(2017) that extends to technical services those withholding taxes that Article 12 of the UN Model traditionally applied to royalties.[69] This article can easily encompass some of the most frequent remote digital services (e.g. use of software as application, cloud computing, and even advertising) provided from outside a state,[70] and has the advantage of not treating differently online or physical provision of services (even if it has the disadvantage of the traditional need to define 'technical services', as a different category of services in general with the inevitable problems of classification).[71]

Second, the new definition in the Commentary on Article 12 of the UN Model (2017) of 'use' of equipment may reflect the fact that 'use', for some countries (not only developing countries, but also for some developed ones, such as Germany), does not involve physical possession of the equipment – which may produce the outcome of giving countries that follow Article 12 of the UN Model and defend that position the right to tax payments connected with the use of, for example, satellite capacity, cables, pipelines and networks that the payer does not operate.[72]

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69 As is well known, Brian Arnold is the person who was most directly involved in the drafting of the new article 12A of the UN Model. On this article, *see* B. Arnold, *The New Article on Fees for Technical Services*, in *ITP@20: 1996-2016: Celebrating Twenty Years of the International Tax Program of the New York University School of Law*, at 170 (H.D. Rosenbloom ed., NY University School of Law 2016). *See also* B. Arnold, *Taxation of Income from Services*, in *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*, *supra* n. 12, *at* 104.

70 The OECD interim report on digitalization recognizes that 'While this definition is not specifically targeted at digital products and services, it generally includes a broad range of cloud computing services (e.g. IaaS, SaaS etc.)' (citing Brazil as example of a country that applies this broad interpretation). OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, chapters 5 and 6, para. 357

71 On the advantages and disadvantages of this approach, *see* J. Li, *Protecting the Tax Base in the Digital Economy*, in *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*, *supra* n. 12. On the problems of classification, *see* Martín Jiménez, *supra* n. 68.

72 At the time of writing, the final version of the UN Model (2017) had not yet been published. In connection with options to tax payments for use of equipment that is not in the possession of the payer, *see* UN Committee of Experts on International Cooperation in Tax Matters, *Possible Amendments to the Commentary*

Needless to say, this concept of 'use of equipment' without physical possession can also have the effect of expanding the rights of source countries that utilize this concept in connection with 'digital transactions' (e.g. infrastructure as a service in cloud computing, use of servers or digital platforms).

Third, although they have not yet been accepted, there have been proposals to modify the Commentary on Article 12 of the UN Model in order to include within the scope of the royalty definition any payment for the use of software (standard or not, and regardless of whether the right to exploit software is conferred on the holder of the right to use it), therefore departing from the OECD consensus and broadening the scope of the royalty definition.[73] These proposals are mainly justified by the fact that enterprises, as noted above, have an increased ability to directly interact with customers through the Internet, and there is virtually no longer any need to transfer to source country distributors the rights to copy and distribute software. If the Commentary on Article 12 of the UN Model is ultimately expanded to cover any payment for software (or only base-eroding payments or a more limited formula), this would be a significant departure from the OECD consensus. It is common also for countries, and the UN proposal has the potential to capture it, as well, to regard 'software as a service' or 'platform as a service' transactions as royalties instead of services, which means that, if reformed, Article 12 of the UN Model will capture many of the most frequent and valuable online transactions.

As a consequence of the changes in the UN Model in 2017 (Article 12A) and the Commentary on Article 12 (those already accepted or proposed), it seems that the UN is addressing the problem of base erosion with more withholding taxes for

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on Article 12 (Royalties), Note by the Coordinator, Ms Pragya Saksena for the 12th Session, Geneva, 11-14 Oct. 2016, E/C.18/2016/CRP.8 (5 Oct. 2016). The concept of 'use' will also be clarified to differentiate between 'use' and 'sale' of equipment in a similar form as Article 12(9) of the OECD Model, although with a bit more precision and in line with IAS 17.

[73] *See* UN documents *supra* n. 72; UN Committee on Experts on International Cooperation in Tax Matters, *Software Payments as Royalties under Article 12*, Discussion paper prepared by S. Chongbanyatcharoen for the 15th Session, Geneva, 17-20 Oct. 2017, E/C.18/2017/CRP.25 (5 Oct. 2017).

(technical) services and (a broadened concept of) royalties that also reinforces the position of source countries (a similar expansive interpretation of the royalty definition can be observed in some specific countries).[74] Ultimately, besides the OECD solutions (already established or being discussed), the international scene is witnessing a progressive expansion of the thresholds to tax business income beyond the traditional PE test. These thresholds rely on a certain degree of activity of foreign enterprises (MNEs or not) within a specific market (where the payer or user is) and provide a solution to BEPS problems.

This is a very different approach to the SEDP PE and/or withholding taxes for all digital transactions or equalization taxes for some digital activities. This approach has five main advantages: (i) it is more evolutionary than revolutionary, as no experiments with new concepts are needed, (ii) it is neutral and more general than specific, as it is not focused on some companies or types of transactions (digital – non-digital), (iii) it is addressed at the core of one of the BEPS problems noted at the beginning of this article, to which more radical solutions are vulnerable (base erosion with royalties and services), (iv) it is simple and easy to administer (if, and only if, the same withholding tax rate applies to royalties and technical services; otherwise, classification issues will be very relevant and troublesome) and an attractive solution for less developed tax administrations (for which PE attribution of income and transfer pricing issues are difficult to handle) and (v) withholding taxes are frequently preferred by companies as an alternative to protracted litigation regarding transfer pricing or attribution of income disputes to PEs, especially if a credit is granted for withholding taxes in the residence country.

It is common hear criticism of withholding taxes for not permitting a deduction of expenses, for being easy to shift to the payer and/or for being difficult to implement with regard to customers. However, these criticisms can be easily put to rest if the following are taken into account.

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74 OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, para. 356. Spain has usually tended to interpret royalties expansively.

First, the fact that a tax treaty permits a country to apply withholding taxes does not mean that it always must levy them if the country would like to grant incentives for specific transactions or sectors so as to avoid burdening its own taxpayers wishing to have access to technology or services. Treaties that include withholding taxes simply give countries the possibility, if they so wish, to levy withholding taxes; they do *not* force them to do so. Quite another thing is that as countries evolve, they usually move to nil withholding tax rate policies in their tax treaties in order to protect from taxation in the source country their own exporters of technology or services, but this change in tax treaty policy has the side effect of exposing countries to BEPS without giving them the possibility to react.

Second, as many countries do (e.g. in the EU, due to EU law requirements), withholding taxes can also be applied in a form that takes into account expenses directly linked with the income derived from the source state (either at the level of the withholding agent, in withhold-and-refund procedures or with some form of presumption of expenses or adjustment of rates).

Third, if market jurisdictions want to increase their taxing rights, withholding taxes on royalties and services are certainly an option, as they are ultimately applied in the payer (individual, business) jurisdiction. If countries want to apply withholding taxes on royalties and (technical) services upon all enterprises deriving income from a market country in order to preserve neutrality, the common argument that they cannot be applied to consumers will lose weight in the near future due to advances in technology, as the same solutions that have been proposed in the field of VAT on consumer-centric collection systems can be easily transferred to withholding taxes on royalties and services.[75] More targeted but still effective approaches would be (i) to apply the withholding tax to B2B payments or (ii) to limit the effects of the

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[75] On the application of VAT consumer-centric solutions to the proposals for a destination-based corporate tax, *see* M. Lamensch, *Destination Based Taxation of Corporate Profits: preliminary Findings Regarding Tax Collection in Cross-Border Situations*, Oxford University Said Business School, WP 17/16 (July 2017). The same ideas can be transferred to withholding taxes.

withholding tax to payments of royalties and (technical) services to associated companies without any regard being taken of the tax regime applicable to recipient.[76]

Should that withholding tax also be extended to deductible payments for goods, as the proponents of withholding taxes in the context of the digital economy claim? That would be appropriate in terms of neutrality/avoiding conflicts of classification, or even moving to a minimum tax levied at source.[77] This would be too radical a change in the current international context, and, for the moment, even at the expense of neutrality and being aware that this leaves open some potential issues (of classification and tax planning, that are probably easier to control than with services and royalties), a gradual approach would probably be more desirable. It would be enough to have a minimum tax on royalty and (technical) service payments or a more targeted one that applies only to such payments between associated companies.[78] The withholding tax for royalties and technical services, especially for payments between associated companies, would also be more targeted than other withholding tax proposals (i.e. on digital transactions, on all

[76] Again, this is not a new solution. Under the London Model of 1946, royalties paid to associated companies could be taxed in the source state (or state of exploitation of the right) on a net basis (including depreciation in the deductible expenses) without any rate limitation. For the London Model (1946), *see* League of Nations, *London and Mexico Model Tax Conventions – Commentary and Text*, C.88.M.88.1946.II.A., at 59 (Nov. 1946).

[77] Regarding how withholding taxes can be a more realistic evolution of alternatives such as the destination-based taxation of corporate profits or to 'inverted systems' of source-residence taxation (taxation in the place of sales with credit for taxes paid in other states), *see* S. Wilkie, *An Inverted Image Inspires a Question Comments on Professor Ulrich Schreiber's 'Sales-Based Apportionment of Profits'*, 72 Bull. Intl. Taxn. 4/5 (2018). In favour of a similar solution to the one proposed here, *see also* A. Baez, *A Note on Some Radical Alternatives to the Existing International Corporate Tax and their Implications for the Digital(ised) Economy*, 46 Intertax (2018) in press. This present author also already advanced this solution in Martín Jiménez, *supra* n. 68.

[78] Even in structures of MNE groups that sell goods, this proposal will have an impact, if, as mentioned above, BEPS Action 7 has had the effect of making some groups implement reseller models as long as the reseller subsidiary makes royalty and service fee payments to other foreign companies of the group as a means of limiting its tax liability in the market state.

transactions including sales of goods), which makes it less revolutionary and more evolutionary, as, ultimately, it simply applies an already known threshold for taxing business profits that does not rely on physical presence with a direct impact on the possibilities of tax planning that the BEPS project has left untouched.

Adoption of this standard worldwide would also require changes in tax treaties, but these changes are probably less traumatic than other solutions, as their effects are better known and more familiar. In view of its advantages and the fact that this threshold has the potential to close the BEPS loopholes identified in section 2. of this article, the question comes to mind as to why new, radical standards and changes are needed in the works of BEPS Action 1. The answer is probably that, if the UN standard is adopted, the shift of income to source/market countries will have more impact than with the radical new alternatives considered in BEPS Action 1. If this is the reason, but, ultimately, it contributes to reduce the BEPS problems that the BEPS project left untouched, it may mean that this is an adequate solution for countries (market countries, developing countries) that want to preserve their tax bases in an efficient manner, and it represents an interesting tax policy alternative that, at least, can be attempted to be enforced unilaterally (regardless of whether the specific States have the political power to actually impose that solution on other countries). One must bear in mind, however, that, ultimately, states that are exporters of services and technology – even if they are emerging economies – may not have an interest in the taxation of royalties and services at source (like the state of residence of digital economy or digitalized giants may not have an interest in solutions that could affect these companies).

5. The EU Standard: A Flawed and Populist Option?

Right before submitting this article to the journal, the proposals from the EU Commission on the taxation of the digital economy (two proposals for a Directive, a Recommendation and a Communication) were released.[79] The proposals, which the

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[79] The specific proposals and documents can be found in European Commission, *Fair Taxation of the Digital Economy*,

Commission hopes will be effective as from 1 January 2020, revolve around two familiar ideas.

First, the concept of an SEDP PE for the provision of digital services into a State with some thresholds (more than EUR 7 million annual revenue in a State, more than 100,000 users of digital services within a Member State or more than 3,000 business contracts for the supply of digital services with users in that Member State). Initially, the SEDF PE would apply in intra-EU relations. For third countries, it would be effective only after the income tax treaties with those countries are modified. The proposal not only regulates the concept of SEDP PE but also includes general rules on the attribution of profits to such a PE, which general rules are mainly based on the authorized OECD approach on the attribution of profits to PEs, taking into account the functions of the non-resident enterprise that refer to the country where the presence is maintained. Preference is given to the profit split method unless the taxpayer proves that another internationally accepted method is more appropriate.

Second, an equalization levy or interim tax (digital sales tax) that is not designed as a withholding tax (the payment system resembles the one-stop-shop in VAT) and applies only to targeted services: revenues created from activities where users play a major role in value creation, such as those revenues created from (i) selling online advertising space targeted at users of a digital interface, (ii) digital intermediary activities which allow users to interact with other users and which can facilitate the provision of goods/supply of services between them and (iii) the transmission of data generated from user-provided information linked with their activities on digital interfaces. Some exemptions apply for multisided digital platforms that supply

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https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en (accessed 25 Mar. 2018). They are more radical than the UK proposals (*see* HM Treasury, *supra* n. 49), as the latter was more willing to achieve consensus solutions within the OECD framework (even if the United Kingdom was among the first to depart from that consensus with its diverted profits tax, and probably by the time the UK paper was published it was already known by the UK tax administration that consensus in the OECD interim report on digitalization was difficult to achieve).

contents to users either as IT solutions or online retail activities (e.g. Netflix, Spotify);[80] services to users of platforms for financial trading and crowdfunding; and the provision of services to associated entities or entities of the same consolidated group. The interim tax will apply in connection with Member States and third-country providers of the targeted services as long as the SEDP PE is not operative and applicable (for EU countries, with the adoption of the SEDP PE threshold; for third countries, with the revision of the tax treaties of the Member States with those countries). Because it is presented as an indirect tax, it is believed that it does not interfere with income tax treaties. There are also thresholds (it would apply only to MNEs with a worldwide turnover exceeding EUR 750 million or EUR 50 million in revenues within the EU) and the suggested tax rate is 3%.

The EU proposals share a number of flaws with the general proposals noted in section 3., above, and indeed have some of their own.[81]

First, the SEDP PE threshold is easy to avoid and will cause both uncertainty and administrative burdens.

- As already noted, some of the companies potentially within the scope of this threshold have already changed their business model, and fragmentation is easy. Thus, the effectiveness of this test is, to put it mildly, dubious.
- The rules in the proposed directive assume that all Member States apply the authorized OECD approach, which is not true (the question arises as to

80 The exemption for these companies is probably linked with the fact that under EU VAT legislation and the OECD Guidelines on VAT/GST derived from BEPS Action 1 (which are being implemented by many countries), B2C cross-border supplies of services and intangibles are taxable in the place of consumption. Early data show that there has been an increase of VAT revenues from these transactions. OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, paras. 256, 293 ff.

81 From another perspective, but largely sharing the most relevant conclusions expressed below with regard to the digital sales tax, *see* the criticism by Becker and English. J. Becker & J. English, *EU Digital Services Tax: A Populist and Flawed Proposal*, Kluwer International Tax Blog (16 Mar. 2018), http://kluwertaxblog.com/2018/03/16/eu-digital-services-tax-populist-flawed-proposal (accessed 22 Mar. 2018).

whether physical PEs will apply in the same country different profit attribution approaches). Furthermore, the rules also rely on a DEMPE approach, which could probably be more easily applied without any need for the SEDP PE to two companies of the same group, especially if the PE threshold is interpreted in line with BEPS Actions 8-10 and if marketing and other intangibles in source countries are somehow taken into account, as commented in section 3., above.

- The interaction of the SEDP PE with physical PEs is also unclear. From the perspective of attribution of profits to different presences, the SEDP PE and traditional PEs do not consolidate their respective attribution of profits, which will give companies two different models (three, in fact, if subsidiaries are also added) to choose how to do business in a country. From an administrative perspective, this could create considerable burdens when non-resident companies must file returns, although this issue is left to the Member States.
- It is unclear how much profit (if any) can be attributed to the SEDP PE if one takes into account the methods and allocation keys defined in the proposed directive. The profit split method will apply with the allocation keys defined in the proposal unless other methods are deemed more appropriate, and, as a matter of fact, it will not be that difficult for the taxpayer to assert that methods other than the profit split are more appropriate (especially if comparables are identified for the functions attributed to the SEDP PE).[82] Even if profit split is applied, unless cooperation is enhanced, it may not be easy for the tax authorities to obtain all the relevant information to apply it (except through the rough numbers of the country-by-country report). In addition, above all if profit split is not used, it also may not be difficult to reduce to a meaningless figure the tax base of the SEDP PE with expenses

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82 On when and under what circumstances the profit-split could apply in general to PEs, *see* e.g. OECD, Ctr. for Tax Policy & Admin., *2010 Report on the Attribution of Profits to Permanent Establishments* (OECD 22 July 2010), part. 1, para. 185 ff., or to enterprises carrying on global trading in financial instruments, part. 3, para. 115. *See also* OECD, Discussion Draft, *BEPS Action 10: Revised Guidance on Profit Splits* (OECD Publishing 22 June 2017).

(e.g. services, royalties) that can be attributed to the PE.

Second, the interim tax (digital sales tax) – regardless of what the Commission asserts and its flaws in defining its objective scope (its arbitrary, not well targeted design)[83] – has the substance of an income tax or a tax on elements of income (it targets revenue, seeks to reach a person, i.e. mainly US high-tech companies, and not only a specific service, is directly connected with the SEDP PE Directive)[84] and, therefore, if adopted, will lead to uncertainty and litigation, as it can be regarded as falling within the scope of income tax treaties (Article 2 of the OECD Model, even in cases where Article 2(1) and (2) of the OECD Model are not included, the 'substantially similar taxes' clause equivalent to Article 2(4) of the OECD Model may be able to capture this new tax).

In addition, the asymmetric application of the SEDP PE and the interim tax may make it easier to avoid its application (the interim taxes should cease to be applied to non-EU Member States and EU Member States when they apply the SEDP PE), although the elimination of the interim tax upon deployment of the SEDP PE standard is a suggestion by the Commission, and the Member States may decide to turn it into a permanent one. If the SEDP PE excludes the application of the interim tax, it seems that this may only happen for those non-resident companies that can be protected by tax treaties with an SEDP PE threshold and, therefore, reverse discrimination for domestic business may be a consequence (i.e. a non-resident

83 Becker & English, *supra* n. 81.

84 On the features of an income tax for tax treaty purposes, *see* OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, *supra* n. 1, para. 415 ff. From an EU law perspective, it is also difficult to maintain that the interim tax/DST has the features of an indirect tax. *See* e.g. ES: ECJ, 20 Sept. 2017, Joined Cases C-215/16, C-216/16, C-220/16 & C-221/16, *Elecdey Carcelen SA*, ECLI:EU:C:2017:705; IT: ECJ, 18 Jan. 2017, Case C-189/15, *Istituto di Ricovero e Cura a Carattere Scientifico (IRCCS) - Fondazione Santa Lucia v. Cassa conguaglio per il settore elettrico and Others*, ECLI:EU:C:2017:17, para. 36 ff.; BE: ECJ, 14 Jan. 2016, Case C-163/14, *Commission v. Belgium*, EU:C:2016:4, para. 39 ff.; DE: ECJ, 4 June 2015, Case C-5/14, *Kernkraftwerke Lippe-Ems GmbH v. Hauptzollamt Osnabrück*, ECLI:EU:C:2015:354, para. 55 ff.; BE: ECJ, 22 Mar. 2007, Case C-437/04, *Commission v. Belgium*, ECLI:EU:C:2007:178, para. 44.

with an SEDP PE will not pay the tax, but domestic companies will). US companies, the ones mostly affected by the interim tax, are placed at a disadvantage due to the fact that the US Senate has almost blocked renegotiation of old and new tax treaties (even if treaties are renegotiated and approved, they will not be effective on the same date in all the Member States, which creates further asymmetries).

The collection system of the interim tax shares the same problems as the VAT one-stop-shop[85] (increased with the difficulties of apportionment of revenue among the Member States)[86] and there is no guarantee that, if not declared by non-residents, especially third states will provide assistance in recovery if they perceive the tax as a tax treaty override (even if the tax is regarded as an indirect tax, not all countries provide assistance in the collection of indirect taxes in bilateral or multilateral treaties).[87] Only guarantees (e.g. liability of resident entities of the group) designed by the Member States will be effective to collect the tax.

Moreover, the Commission expects that Member States will permit the deduction of the new interim tax from the tax base of the corporate income tax, but this aspect is not regulated in the proposal, and double taxation may ensue as a consequence.

In sum, the EU proposal, also if judged against the background of the OECD interim report on taxation of the digitalized economy, seems poorly designed and targeted, as well as completely outside the framework in that document for interim measures (i.e. compare the EU interim tax / digital sales tax proposal and the limits for interim measures of chapter 6). But the most problematic features of the EU proposal are

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85 Lamensch, *supra* n. 75, has extensively explained why the VAT one-stop-shop does not work as well as it seems or appears.

86 Becker & English, *supra* n. 81.

87 For example the United States has a reservation for assistance in recovery of tax claims with regard to the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters and it has signed the 2010 Protocol (although it is not yet in force in the United States). Council of Europe, *Reservations and Declarations for Treaty No. 127 - Convention on Mutual Administrative Assistance in Tax Matters*, available at https://www.coe.int/en/web/conventions/search-on-treaties/-/conventions/treaty/127/declarations (accessed 20 Mar. 2018).

probably that, in view of the divergent position of the countries, as reflected by the OECD interim report on taxation of the digitalized economy, the EU is attempting to impose a solution on the other countries that are part of the OECD and the BEPS Inclusive Framework. One that has in mind a handful of mainly non-EU (US) companies (which raises the problem as to whether there is de facto discrimination that could be assessed against international trade obligations)[88] and, at a political level, will affect the already difficult US-EU trade relations. It is unclear, as well, how the proposals (if ever approved) would affect the growth of digital or digitalization of EU companies.

Likewise, even with the proposals, the tax systems of the Member States will continue to be vulnerable to BEPS from payments for services and royalties to non-resident entities.[89] It is, therefore, curious that the initiatives of the EU claim to be seeking 'fair taxation', yet they leave outside of their scope the major loophole in the post-BEPS era that permits base erosion, which gives them a certain flavour of populism or a need to present quick results, which in turn could be perceived by EU citizens as 'action' even if they are inaccurately designed and not targeted to their main goal ('fair taxation').[90] If fair taxation is indeed the goal, a better alternative would have been, as asserted above, to relax the PE threshold in the form proposed above (a less formalistic approach to companies of the same group and a reduction of the relevance of the fixed place/space and commercial element in favour of a business presence or carrying on business test) that could be linked to a more widespread use of withholding taxes, especially for services and royalties.

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88 Becker & English, *supra* n. 81.

89 The Interest and Royalties Directive does not permit the Member States to tax royalty payments to associated companies within its (limited) scope of application. EU Interest & Royalties Directive (2003): Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of Different Member States, OJ L157/49 (26 June 2003).

90 For a similar conclusion although they limit it to the interim measure, *see* Becker & English, *supra* n. 81.

6. Conclusion

No doubt the current international tax system has flaws and it is legitimate to contemplate a better one, although big-bang or revolutionary solutions that are applied by, and require the consensus of, all countries at the same time will be difficult to attain. In this context, evolution within the system already in place seems a more realistic and pragmatic solution.

The BEPS project represented such an evolution from within which was designed to fix some of the most pressing issues or defects of the international tax system. With the BEPS project outputs of 2015, there was some sort of agreement as to the principles that should be followed (with the exception of BEPS Action 1). However, the BEPS project also left wide open loopholes, which permitted BEPS by means of, especially, royalties and services, and even with the new transfer pricing standards (overvaluation of hard intangibles, and assigning too much importance to control over risks), above all if they are interpreted narrowly.

It is surprising that the post-BEPS debate and tax policy initiatives are focused on the digital economy and not on those (general) loopholes that affect digital and non-digital companies and, ultimately, are the ones that will impact most seriously the tax bases of different countries (developed and developing). It is no less remarkable that (i) the debate connected with BEPS Action 1 is attempting to define new nexus rules for taxation that do not take into account the parameters, principles or work agreed in the context of, mainly, BEPS Actions 8-10, and (ii) a more holistic approach to BEPS actions and their potential is not taken by the countries that more staunchly defend the need to adopt new standards (evolution of the PE threshold with regard to companies of the same MNE group or reinterpretation of the fixed place threshold, further development of profit splits). Even if the debate and actions on the digitalized economy that followed Action 1 BEPS can be seen as a sign of discontent with the BEPS project outputs (without fully developing them), it is also striking that those in favour of more source/market taxation do not more actively promote traditional standards for the taxation of business profits that are defined, mainly, in the context of the UN Model (2017) (traditional withholding taxes on royalties and services or traditional withholding taxes), linked with a less formalistic reading of Article 5 of the OECD Model as a means to enforce and tax relevant business presence, digital or otherwise, in a country.

Instead, a third way, a focus on digitalization, seems to pervade all the international tax debate at the risk of denaturalizing BEPS project outcomes and even the consistency and integrity of the international tax system. This form of acting could oversimplify the problems of the international tax order by singling out specific targets for more taxation while overlooking others. It might also seem that the measures on the taxation of the digitalized economy, at a political level, are (inadvertently or not) seeking the easy target of some MNEs that are concentrated and based in other countries, mainly the United States, and, because of that, the patches do not affect domestic companies too much, in a modern version of the saying 'don't tax you, don't tax me, tax that fellow behind the tree'. A more sophisticated (but not incompatible) reading could also be that some countries would like to tax what (for whatever reason) other countries do not, with a sort of peculiar 'single-tax principle' version. However, if this is the case, again, why should this principle be applied only to the digitalized economy and only some companies or MNE groups?

All of these movements reveal the frailty of the international tax system, and more precisely (i) of consensus around BEPS project outputs (on even crucial BEPS Actions, like Actions 8-10) and (ii) even traditional income tax treaties, which are being bypassed, too, with the new forms of taxes created to deal with the (alleged) problems of the digital economy. The OECD has already, in a commendable effort, attempted to fix the latter problem in the recent interim report on the digitalized economy (2018).[91] Mending the former problem – attempting to have a more

[91] OECD, *Tax Challenges Arising from Digitalisation: Interim Report 2018*, para. 415 ff.

holistic, meaningful and powerful deployment of BEPS project outcomes that could reduce BEPS permitted behaviours after the BEPS project and/or using the thresholds for business taxation of the UN Model and relaxing the standard of Article 5 of the OECD Model—seems to be a more daunting task in view of the factors (political, economic, technical and, to a certain extent, populist) that affect the discussions that should end in 2020.

The outcomes so far (e.g. proposals to abandon consensus when the ink has not even dried yet on the deals, unilateral regional or national flawed standards that sometimes take into account tax treaties but oftentimes try to override them), despite the efforts of organizations like the OECD and the UN, are not very promising on what will happen in the years to come, where uncertainty, controversy and heterogeneity seem to be the only sure and true conclusions. If this is the case, rather than closer, more uniform and robust standards, the international tax order seems to be marching towards more diverse and fragmented ones. In between, for individual countries, withholding taxation of payments for services and royalties at source seems to offer both a quick fix and a more principled, less complex solution to the post-BEPS project problems than those advanced in the debate on the digitalized economy.