[2] Source Taxation

The principle of source taxation, by contrast, relies on the source (country) where the income is generated.[42] There are more and more individuals and companies whose 'residence' is in one country but whose business is carried out and whose income is generated in another country. In such cases, the principle of residence-based taxation does not seem appropriate.

§2.03 THE GENUINE LINK REQUIREMENT FOR SOURCE TAXATION

Source taxation, as opposed to residence taxation, thus relies on the idea of taxation by the state within whose territory the *value is created*. Such taxation is traditionally based on business done or property located in the territory of a particular state, or transactions that occur, originate, or terminate in the territory of that state or have some other substantial connection to that state. Insofar as taxation is source-based, the nationality, domicile, residence, and presence of the parties to such transactions are irrelevant.[43]

[A] Lack of Adequate Rules

But, as EU Commissioner Moscovici has pointed out, our tax framework does not fit anymore with the development of the digital economy or with new business models,[44] unless it is understood differently. First, in the digital economy – e.g., in the advertising business – it is possible for values to be created all over the world by people from different nations, who might, in addition, move across borders. Second, as value in the digital economy can be created anywhere, companies are free to choose low-tax countries, such as Ireland, for their headquarters. That practice cannot always be said to be 'abusive', as those companies do not necessarily evade taxes in a particular country where they should be paid.[45] In principle, the lack of adequate rules cannot be attributed to – let alone be a basis for reproach of – the taxpayer in all of the cases. Therefore, it is not clear whether just applying all base erosion and profit shifting (BEPS) Action Plan[46] and EU anti-tax avoidance measures could solve the problem, as it is sometimes maintained.[47] And third, nowadays, users also contribute to the value

42. *See* 2017 Fair & Efficient Tax System Communication, *supra* note 1, at 3.
43. Restatement (Third), *supra* note 27, §§ 411 Abs. 2, 412 Abs. 1(b)–(c), Abs. 2, 3 & 4; Restatement (Fourth), *supra* note 11, regrettably, does not contain special parts on tax jurisdiction.
44. *See* Roxana Mironescu, *EU to Present 'Electroshock' Digital Tax Plan by March*, Luxembourg Times, 13 February 2018; 2017 Fair & Efficient Tax System Communication, *supra* note 1, at 6 ('has worked well for "brick and mortar" companies but …'); European Commission, *Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services*, 21 March 2018, COM(2018) 148 final, 2018/0073 (CNS) 2 (hereinafter '2018 DST Directive Proposal').
45. *See also* Georg Kofler et al., *Digitalisierung und Betriebsstättenkonzept*, 5b RdW 369, 376–382 (2017).
46. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing 2013).
47. Relying heavily on BEPS and anti-avoidance measures, *see* CFE, *supra* note 3, at 3 et seq.

of a digital enterprise.[48] Nevertheless, even Internet giants like Amazon generally rely on a functioning state structure including courts, energy, transportation, and waste disposal, just as other tax-paying businesses do.[49] Therefore, they should also be taxed similarly to other businesses. However, many digitalized businesses can be heavily involved in the economic life of different jurisdictions without any (significant) physical presence (scale without mass).[50] Therefore, the traditional nexus rules do no longer work.

Failure to adapt international nexus rules has led to unilateral measures in many countries, including EU Member States.[51] Especially within the EU, unilateral measures tend to cause problems with regard to the functioning of the internal market, the basic freedoms, and the general prohibition of discrimination. A new perspective with regard to nexus rules is, therefore, badly needed.[52]

[B] Virtual Establishments, Place of Consumption, and the Destination Principle

This, of course, leads to the discussions about 'virtual establishments', 'significant economic presence', and 'intangible presence' and how those terms could be defined. The starting point is that tax jurisdiction relies on the idea that there should be a fair relation between state-provided services, benefits, and opportunities[53] on the one hand, and taxation on the other.

[1] Redefining Territoriality

In some types of businesses, the only reliably determinable link to the territory of a state and, thus, to the internationally recognized principle of territoriality, is consumption. But, whereas a citizen, resident or person doing business in a state can be presumed to profit from the services, benefits, and infrastructure of that state, the same does not hold true as easily when it comes to selling or providing intangible services in a country via the Internet. Sales and consumption are recognized nexus for sales taxes and value-added tax (VAT) but not, traditionally, for income taxes. Factors like sales

48. 2018 OECD Interim Report, *supra* note 1, at 171 et seq.
49. *See* Kofler, *supra* note 45, at 382.
50. *See* 2018 OECD Interim Report, *supra* note 1, at 51.
51. For example, in France, India, Israel, Italy, Taiwan, Thailand, Turkey, and the US; *see* OECD, *Digitalization Tax Interim Report: Comments Received on the Request for Input – Part II*, 1, 17–18, 25 (OECD Publishing 2017); *see also* Julia Sinnig, *Besteuerung der digitalen Wirtschaft in Großbritannien, Italien und Ungarn – ein europäischer Rechtsvergleich*, 6 Internationale Steuer-Rundschau 408 (2017).
52. 2017 Fair & Efficient Tax System Communication, *supra* note 1; EU Commission, *Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence* of 21 March 2018, COM(2018) 147 final, 2018/0072 (CNS), Recital 8 (hereinafter '2018 SDP Directive Proposal').
53. *Wisconsin* v *Penney*, 311 U.S. 435, 61 (1940); *General Motors Corp.* v *Washington et al.*, 377 U.S. 436 (1964); *Goldberg* v *Sweet*, 488 U.S. 262 (1989).

and consumption can be used to apportion income among several states but, traditionally, only under the condition that the taxable person has some, even intangible, presence there. These factors alone have not been considered sufficient to establish the necessary link for income taxation.[54] However, national courts of EU Member States have occasionally recognized that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. According to that view, any corporation that regularly exploits the markets of a state should be subject to that state's jurisdiction to impose an income tax, even if not physically present there.[55]

Under Article 5 of the Commission's new proposal on taxing digital services, taxable revenues obtained by an entity are to be treated as obtained in a Member State if the users of that taxable service are located in that state.[56] Similarly, the OECD, in its 2015 OECD BEPS Action 1 Report, stated that: '[f]or consumption purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption'.[57] Numerous tax jurisdictions are already taking their lead from the OECD's recommended approach to taxing the digital economy.[58] This indicates that these states agree on the destination principle. The destination principle has the additional advantage that it might decrease the role of tax competition, given the immobility of the consumer base as opposed to the increasing mobility of production factors. It might, thus, allow taxpayers to allocate their resources wherever they find the best business environment, instead of engaging in tax-driven allocation of production factors or in mere profit shifting between jurisdictions. At the same time, problems regarding the control of transfer pricing (e.g., on the basis of the implementation of the EU state aid prohibition) might become redundant.[59] Against this background, a few states are also introducing 'significant economic presence' tests, based on online contract conclusion, the use of digital products and services and the generation of significant revenue that is closely related to the volume of online activities performed, not by a non-resident taxable corporation, but by users located in the taxing state.[60] Collecting data in the relevant state might be another factor, even

54. *But see* 2018 SDP Directive Proposal, *supra* note 52, Art. 2 ([t]his Directive applies to entities irrespective of where they are resident for corporate tax purposes, whether in a Member State or in a third country).
55. *See also* Peter Hongler & Pasquale Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy* 23 (IBFD, Working Paper 20 January 2015).
56. *See* 2018 DST Directive Proposal, *supra* note 44, Art. 5.
57. OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, Annex D, Guideline 3.1, 222 (OECD Publishing 2015) (hereinafter '2015 OECD BEPS Action 1 Report').
58. 2018 OECD Interim Report, *supra* note 1, Annex 3.B.1. *Implementation of the Measures on VAT/GST covered by the 2015 OECD BEPS Action 1 Report*, at 118 (e.g., Argentina, Bangladesh, Brazil, Canada, Colombia, Gulf, Israel, Malaysia, Philippines, Singapore, Thailand, and Vietnam).
59. *See* Wolfgang Schön, *Destination-Based Income Taxation and WTO-Law: A Note, in Essays in Honour of Manfred Mössner* 429 (Heike Jochum et al. eds., IBFD 2016).
60. For example, Israel and India; *see* 2018 OECD Interim Report, *supra* note 1, 137 et seq., Boxes 4.1 & 4.2; *see also*, for India, s. 9(1)(i) Expl'n 2A of the Income Tax Act, 1 April 2018, according to which 'significant economic presence' can be based on any:

though its contribution to value creation is controversial.[61] For advertisement taxes, the requisite nexus might be established by the destination of the advertisement and the location of the targeted public.[62] According to the Commission's 2018 SDP Directive Proposal, a robust definition of nexus must be based on the revenues from the supply of digital services, the number of users[63] or the number of business contracts for digital services.[64]

Also, intangible property has previously been recognized as a possible way to establish nexus. Thus, a taxpayer licensing intangible Intellectual property (IP) rights[65] for use in another state and deriving income from that use has been recognized by a US court as having a 'substantial nexus' with that state.[66] According to the Commission, the destination principle appears to reflect the current legal situation in copyright law. Accordingly, 'the act of communication to the public of a copyright protected work takes place not only in the country of origin (emission-State) but also in all the States where the signals can be received (reception-States)'.[67]

[2] A Broader Understanding of Nexus

Generally, state practice is becoming more lenient with regard to the nexus requirement.[68] There is a trend to expand the tax base in the country where the customers or users are located, generally based on a broader understanding of the enterprise's engagement in that country. Also, elements linked to a market are more and more included in the tax base, notably sales, revenue, place of use, or consumption.[69] This

1) transaction in respect of any goods, services or property carried out by a non-resident in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or
2) Systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as maybe prescribed, in India through digital means.

See also 2018 OECD Interim Report, *supra* note 1, 146, Box 4.6 (France's tax on online and physical distribution of audiovisual content focusing on the destination of the related supply, the place of performance of the sale or supply, or on whether the 'audience' of online-on-demand services is located in France (i.e., an Internet user established, domiciled, or usually resident therein)).

61. 2018 OECD Interim Report, *supra* note 1, at 25 et seq.
62. *Ibid.* at 145, Box 4.5 (Hungary's advertising tax).
63. 2018 DST Directive Proposal, *supra* note 44, at 11.
64. 2018 SDP Directive Proposal, *supra* note 52, Recital 6 & Art. 4, para. 3.
65. On intangibles as drivers of business value, 2018 OECD Interim Report, *supra* note 1, 52 et seq.
66. *See* Supreme Court of South Carolina, *Geoffrey, Inc.* v *SC Tax Comm'n*, 47 S.E.2d 13 (1993).
67. Commission Decision of 8 October 2002, Case No. COMP/C2/38.014 – IFPI 'Simulcasting', notified under doc. Number C(2002) 3639, 2003/300/EG, No. 21. *See also Society of Composers*, *supra* note 31, No. 68 (national practice confirms that either the country of transmission or the country of reception may take jurisdiction over a 'communication' linked to its territory, although whether it chooses to do so is a matter of legislative or judicial policy), and No. 76.
68. *See also* the recent US Supreme Court decision in *South Dakota* v *Wayfair, Inc.* 138 S. Ct. 2080 (2018) (concerning state sales taxes).
69. 2018 OECD Interim Report, *supra* note 1, at 159; Peter Hongler & Pasquale Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*; IBFD Working Paper

approach was first elaborated in competition law with its well-known effects doctrine[70] and can now also be found with regard to intellectual property[71] and in the law of data protection.[72] In view of the mobility of data, there seems to be no alternative to extraterritorial jurisdiction in data protection law.[73] In tax law, we are rather confronted with redefining nexus, territoriality and extraterritoriality.

However, tax enforcement may prove difficult without the physical presence of the taxpayer in the taxing country.[74]

20 January 2015 (IBFD 2015); *see* Schön, *supra* note 59, at 430 et seq. (apodictically '[f]rom the perspective of international customary law, this move towards a destination basis does not pose a problem: selling goods and services to a local customer base forges a "genuine link". between the taxpayer and the destination country, which is a legitimate basis for taxation.'); *see also* Kolja van Lück, *Besteuerung der 'Digital Economy' – Neue Vorstöße der EU und der OECD/G20-Staaten zur steuerlichen Erfassung digitalisierter Geschäftstätigkeiten*, 5 ISR 158 et seq., 168 et seq. (2018).

70. *See Geigy AG* v *Comm'n*, 52/69, Judgment, EU:C:1972:73, paras 41 et seq.; *Ahlström Osakeyhtiö & Others* v *Comm'n*, Joined Cases 89/85, 104/85, 114/85, 116/85, 117/85, 125/85, 126/85, 127/85, 128/85, 129/85, Judgment, EU:C:1993:120, paras 3 et seq., paras 15 et seq.; *Intel* v *Comm'n*, C-413/14, Judgment, EU:C:2017:632, paras 40, 45, 49 (the effects test).
71. *See* Alexander Peukert, *Territoriality and Extra-territoriality in Intellectual Property Law*, *in* 11 *Beyond Territoriality: Transnational Legal Authority in an Age of Globalization* 189, 196. (Gunther Handl et al. eds., Queen Mary Stud. in Int'l Law, Brill/Nijhoff 2012):

> In a globalized, Internet-connected world, however, in which innovations are often the result of cross-border collaboration and the use of inventions, works, signs, etc., occurs everywhere, these basic principles have become the subject of fundamental criticism. According to most observers, the territoriality principle in IP Law is based on an outdated focus on isolated national-sovereigns that are less and less able – as a matter of fact and of law – to regulate exclusively the conduct of their citizens.

72. *See Google Spain and Google*, C-131/12, Judgment, EU:C:2014:317, para. 55:

> The processing of personal data for the purpose of the service of a search engine such as Google Search, which is operated by an undertaking that has its seat in a third State but has an establishment in a Member State, is carried out 'in the context of the activities' of that establishment if the latter is intended to promote and sell, in that Member State, advertising space offered by the search engine which serves to make the service offered by that engine profitable.

Wirtschaftsakademie Schleswig-Holstein, C-210/16, Opinion of AG Bot, EU:C:2017:796, para. 92 ('"context of activities" – and not the location of the data – is a determining factor in identifying the … applicable law'). A broad definition of territoriality can be found in Art. 3(1) of Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) (Text with EEA relevance) (2016) OJ L 119/1 (the 'Regulation applies to the processing of personal data in the context of the activities of an establishment of a controller or a processor in the Union, regardless of whether the processing takes place in the Union or not'). Björn Steinrötter, *Feuertaufe für die EU-Datenschutz-Grundverordnung – und das Kartellrecht steht Pate*, 9 EWS 61, 62 et seq. (2018).

73. *See* Philip Uecker, *Extraterritoriale Regelungshoheit im Datenschutzrecht* 250, IX (Nomos 2017).
74. EU plans on a withholding of tax or a levy on revenues generated from the provision of digital services take this into account.

§2.04 THE FUTURE: APPORTIONMENT OR MOVE TOWARDS INDIRECT TAXATION?

Two problems, thus, remain: First, as mentioned above, sales and turnover may provide an important factor for apportioning the tax load of a *taxable* person in a particular state. Yet, those factors are not generally recognized as a sufficient link for income taxation in the first place, even though state practice seems to be in the process of changing. Second, as turnover does not equal profits, a destination- or consumption-based nexus leaves us with the problem of determining the profits of the corporation.

[A] Apportionment

If those two problems can be overcome – that is, if there is some (potentially intangible) presence and if a corporate taxpayer's business income or 'apportionable income' can be determined – apportionment could mitigate the problem of 'unfair' distribution of tax revenues between the Member States of the EU.[75] Member States would have to use an apportionment formula to calculate the percentage of any income that is subject to their income tax. Apportionment, which has been practiced in the US, Canada, and Switzerland[76] for decades, was already suggested to the European Commission at the beginning of this century[77] and underlies the Commission's 2018 DST Directive Proposal.[78] However, it presupposes the adoption of the Common Consolidated Tax Base.[79]

Though the US Supreme Court upheld California's proportionate taxation of the *worldwide* income of unitary businesses,[80] California soon repealed its unitary business tax and such apportionment is rather used in interstate relations, but not when one of the taxing entities is a foreign sovereign.[81] In any case, unitary taxation with apportionment but without a common consolidated tax base creates a risk of double taxation.

But, if generally applied within the EU on the basis of a common consolidated tax base, taxing only the relevant percentage could avoid double taxation without any need to conclude double taxation agreements. EU Member States would then have to agree on an apportionment formula. In the US, there has been a development over the past

75. *Similarly*, Maarten de Wilde, *'Sharing the Pie': Taxing Multinationals in a Global Market*, 43 Intertax 438 et seq. (2015).
76. *See* Katerina Krchniva, *Comparison of European, Canadian and U.S. Formula Apportionment on Real Data*, 12 Procedia Econ. & Fin. 309 et seq. (2014).
77. Joann Martens Weiner, *Formulary Apportionment and Group Taxation in the European Union: Insights From the United States and Canada* (European Commission Taxation Papers, Working Paper No. 8/2005, 2005), *available at* https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/economic_analysis/tax_papers/2004_2073_en_web_final_version.pdf. (last accessed 26 February 2019).
78. 2018 DST Directive Proposal, *supra* note 44, Art. 7.
79. European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM(2016) 683 final, 2016/0336 (CNS), Recital (10) & Arts 28 & 32 et seq. (hereinafter 'CCCTB Proposal').
80. *Barclays Bank Plc.* v *Franchise Board of California*, 512 U.S. 298 (1994).
81. *Ibid.* at 332, 337–338, O'Connor J., dissenting (referring to the opposition of all EU Member States of the European Union to California's approach).

twenty years, from a formula with three equally weighted factors – (1) sales, (2) payroll, and (3) property[82] – to an enhanced or single sales factor. This mirrors the development of the modern, digitalized economy where sometimes only sales or consumption can be linked with certainty to a specific state territory.[83] The sales factor is the ratio of the taxpayer's sales within the territory of the taxing state to the taxpayer's total sales.

Even though apportionment is conceptually simple, it may prove difficult in practice to calculate with precision the amount of income that is properly taxable in a particular state. Nevertheless, the apportionment rules developed in the US do provide a 'reasonable approximation' of a corporation's in-state level of activity and therefore sufficiently calculate the 'fair share' of multistate income that a state may tax.[84] They also seem to comply with the public international law requirement of a genuine link.[85] Admittedly, American trading partners have opposed US apportionment schemes as based on worldwide income[86] and, so far, apportionment has not met with success within the OECD.[87] But apportionment might still be a reasonable solution within the EU.[88]

[B] Move Towards Indirect Taxation

As consumption typically relates to indirect taxes, an alternative would be to globally enhance VAT and to work on its effective collection worldwide.[89] Both source and residence taxation have become more and more difficult to handle for a growing category of cross-border economic activities. VAT, on the contrary, is successfully

82. For example, *Container Corp.* v *Franchise Tax Bd.*, 463 U.S. 159, 182 et seq. (1983); *see also CCCTB Proposal, supra* note 79.
83. Early cases concern interstate railway building, *see, e.g., Western Union Telegraph Co.* v *Taggart*, 163 U.S. 1 (1896); more recent cases relate to telecommunications, *see, e.g., Goldberg* v *Sweet*, 488 U.S. 252 (1989).
84. *See CCH White Paper: State Apportionment of Business Income, September 2014*, 784 (Wolters Kluwer 2014).
85. The US Supreme Court upheld the use of the worldwide unitary tax method, which uses the worldwide income of a 'unitary business' as the basis for tax assessment. It also upheld California's apportionment scheme as fair and as taking into account the undesirability of double taxation. *Container Corp.*, 463 U.S. 159, 193 (1983); *but see Japan Line* v *County of L.A.*, 441 U.S. 453 (1979) (A California *ad valorem* property tax law, even though apportioned, was found unconstitutional as applied to foreign-owned instrumentalities of foreign commerce due to the potentially immitigable risk of multiple taxation and its frustration of the federal government's ability to address foreign commerce with a unitary voice under the Commerce Clause). Due to the rather limited nature of the *Japan Line* ruling, it does not appear that, to date, the US Supreme Court has specifically ruled on the constitutionality of international apportionment. *See also* Restatement (Third), *supra* note 27, § 412 (Reporter's Note 7).
86. *See, e.g.*, Franklin Latcham, *Worldwide Combination and the Container Case: A Perspective on Unitary Taxation*, 2 Berkeley J. Int'l L. 89 et seq. (1984).
87. For example, OECD, *Review of Comparability and of Profit Methods, Revision of Chapters I-III of the Transfer Pricing Guidelines* 9 et seq. (OECD Publishing 2010).
88. *See also* 2018 DST Directive Proposal, *supra* note 44, Arts 5 & 6, particularly the rules concerning apportionment in Art. 5 No. 3.
89. Wolfgang Schön, *Der digitale Steuer-Irrweg*, FAZ (6 April 2018), *available at* http://www.faz.net/aktuell/wirtschaft/unternehmen/der-digitale-steuer-irrweg-15527941.html, at 16 (accessed 20 September 2018).

being introduced in more and more countries and is constantly becoming more important.[90] With respect to the present issue, businesses whose value creation cannot be localized reliably could be obliged to collect a potentially higher VAT on their goods and services.[91] That approach, combined with the destination principle, would also affect the allocation of tax revenues between the state of the corporation and the state of consumption; tax revenue in the countries of the shareholders might decrease whereas tax revenues in the countries of consumption might increase. Such a result would meet some of the concerns underlying the quest for an adaptation of the nexus requirement by recognizing the concept of a significant economic presence while posing a significantly lower risk of double taxation. However, the trend from direct towards indirect taxation may hit the wrong persons, namely consumers instead of big business.

§2.05 CONCLUSIONS

The foregoing leads to the following two conclusions:

(1) *Income* taxation presupposes a genuine link to the taxing state. Just providing or selling services via the Internet has not generally been considered sufficient. However, state practice is becoming more lenient. The notion of user- or consumption-based value creation is gaining ground.
(2) Insofar as some link to the taxing state can be established through at least an *intangible* presence, apportionment can contribute to a fairer distribution of tax revenues between EU Member States. However, it presupposes a common consolidated tax base and at least similar apportionment formulas.

90. *See, e.g.*, Alan Schenk, Victor Thuronyi & Wei Cui eds., *The Proliferation of VATs, in Value Added Tax: A Comparative Approach* 12 et seq. (Cambridge Univ. Press 2d ed. 2015).
91. *See also*, Marc Wolf, *La TVA pour surmonter la crise de la territorialité fiscal*, 3 Revue européenne et internationale de droit fiscal 94, 96 (2017).

comprehensive than the preceding theory, because it includes what there is of value in the benefit theory'.[39]

The abandoning, or the overcoming, of the benefit principle was not based on heuristic arguments, but to its final incorporation into the ability-to-pay principle, since the latter, in the understanding of the 1923 DT Report, comprehends the utility provided by the state or government services. In other words, addressing a syncretic concept of ability to pay, the 1923 DT Report fostered a theory of fair taxation based on the sacrifice of the subject, who surrenders a portion of his/her possessions, and on the economic utility received from the state or government. The role of the state or government could, therefore, be appreciated by the increase in the subjects' economic means.

It is worthwhile noting that, at the international level, fair taxation has also been analysed as a matter of economic justice among states (i.e., as the distribution of the authority to tax and, ultimately, tax revenue among states).[40]

The conceptual distinction between the interindividual and internation equity was first introduced by P. Musgrave over forty years ago. This perspective is based on the commonly accepted distinction between source and residence taxation. In particular, foreign and domestic income should be considered as income of the residence jurisdiction whereas the taxation of the source jurisdiction should require some kind of justification.[41]

A different solution to the issue of the distribution of the authority to tax among different jurisdictions was advanced by the 1923 DT Report, which considered economic allegiance to be the foundation of the state's competence in taxation:

> [a] part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual's whole faculty should be taxed, but that it should be taxed only once, and that liability should be divided among tax districts according to his relative interests in each (Part II, Section I).[42]

39. League of Nations Economic and Financial Commission, *Report on Double Taxation Submitted to the Financial Committee* Doc. E.F.S. 73.F.19, 1, 20 (1923) (hereinafter the '1923 DT Report'). It stated that:

> [s]o far as the benefits connected with the acquisition of wealth increase individual faculty, they constitute an element not to be neglected. The same is true of the benefits connected with the consumption side of faculty, where there is room even for a consideration of the cost to the government in providing a proper environment which renders the consumption of wealth possible or agreeable. The faculty theory is the more comprehensive theory.

40. The two dimensions of fairness in the international scenario are acknowledged also by Filip Debelva, *Fairness and International Taxation: Star-Crossed Lovers?* 10 World Tax J. 1, para. 3 (2018).
41. Peggy Musgrave, *Taxation of Foreign Investment Income. An Economic Analysis* 1, 16, 22, & 104 (John Hopkins Press 1963); Richard Musgrave & Peggy Musgrave, *Inter-Nation Equity, in Modern Fiscal Issues: Essays in Honour of Carl S. Shoup* 63, 68–78 (Richard Bird & John Head eds., Univ. of Toronto Press 1972).
42. 1923 DT Report, *supra* note 39, at 20.

The 1923 DT Report took the position that the authority to tax should be exercised according to the place of origin and the place of residence of the owner of the wealth. The origin of income corresponds to the place (or places) where it is created.[43] In this sense, the Experts suggested that income should be taxed only once where it was created, i.e., according to the economic allegiance.

In conclusion, leaving aside any issue concerning the internation equity, the benefit and ability-to-pay principles can be addressed as the guidelines in assessing the fairness of the international tax system or, in other words, the exercise of extraterritorial state authority to tax. These principles, as seen in §4.02[A][2] and [A][3], *supra*, justify the exercise of the authority to tax according to a social justice theory.

§4.03 TAX FAIRNESS AND THE PROPOSALS FOR THE TAXATION OF THE DIGITAL ECONOMY

[A] The Meaning of Tax Fairness Raised by the OECD and EU Documents on Digital Economy Taxation

Comparing the different official documents published by the OECD and the European Union (EU), the more elaborated attempt to define tax fairness and its implications in the digital economy context is contained in the 2017 EU FETS Communication.[44] After putting forward the modern tax mantra that profits should be taxed where the value is created, the Commission explicitly introduces the two main policy challenges raised by the changing paradigms of the international economy:

- **Where to tax? (nexus)** – how to establish and protect taxing rights in a country where businesses can provide services digitally with little or no physical presence despite having a commercial presence; and
- **What to tax? (value creation)** – how to attribute profit in new digitalised business models driven by intangible assets, data and knowledge.

These challenges need to be looked at together to find a meaningful solution for determining where economic activities are carried out and value is created for tax purposes.[45]

A fair tax system, according to this approach, would, therefore, require the determination of the economic contribution given by the digitalized business models, and, in particular, by data and knowledge, and, *if any*, the alignment between the profits (or the value) generated and the jurisdiction where they arise (and should be taxed). As clearly summarized by the dichotomy 'nexus' and 'value creation', the concept of fairness does not impose only a change, either in the sense of a revision or complete overhaul, of the current international rules on the allocation of the taxing rights, but, *first and foremost*, an economic analysis of the digitalized models to figure

43. *Ibid.* at 19–20, 24.
44. 2017 EU FETS Communication, *supra* note 3.
45. *Ibid.* at 7.

out the new items of taxable income (or, according to the international mantra, to the new taxable value).[46]

A similar meaning can be drawn from the 2015 OECD BEPS Action 1 Report, where the fact that the 'growing reliance in certain new business models on data may raise challenges both in terms of characterisation of and attribution of value from data, and in terms of the changing ways in which users and customers interact with businesses' has been stressed.[47] And again, the issues are summarized according to the categories of 'nexus', 'data' and 'characterization'.

On these latter issues, the 2018 OECD Interim Report[48] offers some further descriptive elements for the analysis of the income (or value) dimension of the issue:

> Finally, data and user participation, and, more generally, the ongoing and interactive relationships between digitalized businesses and their customers, may represent additional tax challenges, in and to the extent that they can be considered a source of a firm's value creation. This could be the case, for instance, if a large base of active online users producing substantial amounts of content and data is considered a material contribution to the value creation of a business, distinct from the algorithms and other intangible assets used for analyzing and processing this content and data.[49]

According to this brief selection of the hundred pages published by the OECD and the Commission, it can be concluded that the concept of tax fairness addressed is no more than the simple enforcement of the principle of tax equality. The purpose of the aforementioned documents is, therefore, to foster an equal tax treatment of the new business (digital) models and the traditional (or 'brick and mortar') ones, by means of:

(a) the updating of traditional concepts that are no longer in line with the economic reality;
(b) the measurement of new forms of wealth, arising from the new economic reality.[50]

46. This dichotomy is further developed by the 2018 EU DST Directive Proposal, *supra* note 3, in which the Commission states that fairness is heavily undermined by the fact that:

> the input obtained by a business from users, which actually constitutes the creation of value for the company, could be located in a tax jurisdiction where the company carrying out a digital activity is not physically established (and thus not established for tax purposes according to the current rules) and where therefore the profits generated from such activities cannot be taxed. Secondly, even where a company has a permanent establishment in the jurisdiction where the users are located, the value created by user participation is not taken into account when deciding how much tax should be paid in each country.

47. 2015 OECD BEPS Action 1 Report, *supra* note 1, at 98–99 § 247.
48. OECD, *Tax Challenges Arising from Digitalization – Interim Report 2018* 170, § 386 (OECD Publishing 2018) (hereinafter '2018 OECD Interim Report').
49. *Ibid.*
50. This distinction is also highlighted by Hey, *supra* note 37, at 204 (the concept of value creation is not limited to the attribution of profits for the application of the existing corporate income tax, but is also a fundamental reason for the invention of new taxable items).

The reference to tax fairness contained in the official documents of the international organizations is, therefore, an exercise of rhetoric (or, in other words, rather pleonastic) since it purports the need to re-establish the tax equality in a changed (and changing) economic world. However, the same documents do not contain any attempt or show any effort to assess the fundamental criteria according to which the tax burden should be (equally) distributed among the taxpayers. Any reference to the 'value' created through the digital businesses is, in fact, a reference to an empty concept that is not defined either by the international documents or by the OECD Member States tax jurisdictions.

A pragmatic attempt to assign some content to that concept is provided by the proposals to tax the digital economy, which are considered in the following paragraphs.

§4.04 DO THE PROPOSED SOLUTIONS COMPLY WITH TRADITIONAL CONCEPTS OF TAX FAIRNESS?

[A] Introduction: A Brief Summary of the Proposed Solutions

In the 2015 OECD BEPS Action 1 Report, the OECD suggested three different hypotheses for coordinating the direct taxation of the digital economy.

The first concerns the updating of the criteria for the definition of the non-resident taxable presence in the source jurisdiction, able to 'evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools.'[51] In detail, the economic taxable presence considers both a number of digital factors and a series of quantitative thresholds, in order to capture only the most significant cases. Of the latter, only revenues generated with in-country customers through an enterprise's digital platform, a minimum amount of revenues generated from remote transactions concluded with customers in the country concerned and the introduction of a mandatory registration system for enterprises meeting the previous criteria are suggested.[52]

As far as the digital presence is concerned, a series of 'digital factors' and 'user-based factors' are considered, including the existence of a local domain name, a local digital platform, local payment options, monthly active users, online contract conclusion and data collected.[53]

The alternative approaches suggested by the 2015 OECD BEPS Action 1 Report include:

(a) a withholding tax on payments by residents (and local PEs) of a country for goods and services purchased online from non-resident providers;[54]

51. 2015 OECD BEPS Action 1 Report, *supra* note 1, at 107 § 277.
52. *Ibid.* at 107–108 § 278.
53. *Ibid.* at 109 §§ 279 et seq.
54. *Ibid.* at 113 §§ 292 et seq.

(b) an equalisation levy.[55]

The proposed withholding tax is, in the 2015 OECD BEPS Action 1 Report, rather generic and undefined. It would cover 'certain payments made to non-resident providers of goods and services ordered online … or to all sales operations concluded remotely with non-residents' and would be levied on the gross-basis payments made.

Finally, the 'equalization levy' is addressed to tax remote sales transactions concluded with in-country customers when the business maintains a significant economic presence (as mentioned above) in the market jurisdiction.

It is well known that the 2018 OECD Interim Report does not implement any specific proposal, due to the lack of necessary consensus among the OECD Members.

The most detailed proposals for the taxation of the digital economy arose from the Commission.

Following the strategy drawn up in the 2017 EU FETS Communication, on 21 March 2018, the Commission published a short-term proposal and a long-term (or systemic) proposal.

With the 2018 EU DST Directive Proposal,[56] the Commission intends to tax revenues stemming from the supply of certain digital services provided by non-resident suppliers. According to Article 3 of the Proposal, only those services for which the participation of a user constitutes an essential input for the business carrying out that activity are subject to taxation.[57] The taxable revenues are those resulting from the monetization of the user input (i.e., the revenues obtained by a taxable person by means of the inputs gathered or collected in the user's residence jurisdiction).

The long-term proposal, the 2018 EU SDP Directive Proposal,[58] conversely, aims at introducing into the EU tax system the concept of 'significant digital presence (SDP)', which is grounded on three different elements: (1) revenues from supplying digital services, (2) the number of users of digital services and (3) the number of contracts for a digital service.[59] If these requirements are fulfilled, a permanent establishment (PE) is deemed to exist.[60] Finally, the 2018 SDP Directive Proposal deals with the rules for allocating profits to a SDP confirming the extension of the current guidelines developed in the authorized OECD approach (AOA).[61]

55. *Ibid.* at 115 §§ 302 et seq.
56. 2018 EU DST Directive Proposal, *supra* note 3.
57. The explanatory notes to the 2018 EU DST Directive Proposal, *supra* note 3, at 7, state that:

> the business models captured by this Directive are those which would not be able to exist in their current form without user involvement. The role played by users of these digital services is unique and more complex than that traditionally adopted by a customer. These services can be provided remotely, without the provider of the services necessarily being physically established in the jurisdiction where the users are and value is created.

58. 2018 EU SDP Directive Proposal, *supra* note 3.
59. *Ibid.* Art. 4(3).
60. *Ibid.* Art. 4(1).
61. *Ibid.* Art. 5.

§4.05 ARE THE SOLUTIONS AND THE PROPOSALS FOR DIGITAL ECONOMY TAXATION FAIR? A PRELIMINARY CONCLUSION

Once the meanings of tax fairness or, at least, the fundamental meanings of tax fairness have been defined, the next step is the assessment of the compliance of the international Proposals on the taxation of the digital economy with these meanings.

In general terms, two different profiles should be considered. The traditional problem relates to the justification of the taxation of resident and non-resident, or domestic or foreign wealth (income). Restricting the analysis to the digital economy, the core question regarding tax fairness is the justification for the activities carried on by non-residents in the source jurisdiction without any physical presence.

On the other side, a complementary issue concerns the measurement of the income (or, in the modern understanding, of the value) generated in the source jurisdiction through digital business models.

These profiles must be treated separately.

As far as the 'SDP' is concerned, the taxation of the income generated in the source jurisdiction without any physical presence can be sufficiently justified according to the utility non-residents derive from the market where the economic activity is carried out. In other words, taxation of the non-residents can be understood as the utility stemming from the (legal and economic) protection granted by that jurisdiction. In these terms, the 'SDP' represents a sharp revaluation of the benefit principle, understood not as the price for the services received but as the utility derived from the legal and economic system where the business is carried on. The legal and economic system should, therefore, be understood as the essential requirement for the exercise of the digital business models.[62]

Considering the 2018 EU SDP Directive Proposal, the mentioned economic and legal utility can be primarily inferred from the business contracts concluded in the tax period requirement (Article 4(3)(c)).

Instead, it is hard to justify the taxation of non-residents according to the ability-to-pay principle since the absence of any physical link with the source jurisdiction excludes any tangible participation of the subject to the polity and, therefore, it impedes to assign any specific duty of solidarity to the non-resident economic operator.[63] It is difficult, in other words, to identify a qualified participation to the polity

62. According to these conclusions, Baez & Brauner's position cannot be shared ('[t]he profit as taxable base bears no relation to the use of public goods by non-resident taxpayers; in a nutshell, the benefit theory and profit taxation, under whatever PE design, embody a *contradictio in terminis*', *supra* note 10, at 9). The relation considered by the benefit principle, in the version accepted above, is between the economic and legal system and the economic activity carried on, not directly between 'the use of public goods' and profits. Taxation should be justified for the advantages and the privileges businesses receive from public expenditure; in these sense, public utility is deemed to be the proxy for the allocation of the tax burden among taxpayers. In the mentioned authors' view of the benefit principle, conversely, taxation should be characterized as the price for the services received.
63. Concurrently, Baez & Brauner, *supra* note 10, at 5: 'source taxation is not warranted in most cases of the digital economy since its principal participation in the source economy is supplying goods and services to local customers, and such participation is not sufficient to constitute

in the mere presence of the domain or the digital platform or, again, in the gathering of the users' data.

In conclusion, the 'SDP' can be considered as a sufficient proxy to justify the taxation in the user's jurisdiction and to apportion the income generated through the digital business models. If the pragmatic consequences of such a solution would be to lower the PE threshold,[64] from the fairness perspective the introduction of the 'SDP' would lead to a change of the theoretical paradigm of the justification for taxation, shifting from the ability-to-pay to the benefit principle.

As already stated,[65] the use of different PE thresholds may give rise to issues of compliance with the tax equality principle. This deemed discrimination, however, should be rejected due to the non-comparability of the 'brick-and-mortar' and the 'digital' economy business models.

The challenging issue of this concept lies in the determination of the income attributable to the SDP. Any attempt to deviate from the AOA,[66] in fact, may create a clash with the tax treatment of the traditional PE and, therefore, the violation of the tax equality principle.[67] Again, however, the issue can be overcome considering these situations not comparable.

The justification for the withholding tax (or, in the wording of the EU, of the 'Digital Services Tax') presents more difficulties. The only way this levy could be coherent with the benefit principle is the demonstration that the source jurisdiction concurs with the production of the income (or concurs with the generation of the *taxable* value). This demonstration would also prevent the withholding tax on digital services from violating the tax equality principle and, in particular, the discrimination between traditional and digital models.

Both the OECD and the Commission focus on the user's role in the creation of the value for the non-resident.[68] However, the information or the data gathered by non-residents are not sufficient to generate *profits* since they derive from the processing performed by the non-resident, normally by means of algorithms. In this sense,

source taxation jurisdiction'. However, *see* the 2015 OECD BEPS Action 1 Report, *supra* note 1, at 107 § 276, which states that the:

> elements of the three potential options could be combined into a new concept of nexus for net-basis taxation (a 'significant economic presence'), with the intent to reflect situations where an enterprise leverages digital technology to participate in the economic life of a country in a regular and sustained manner without having a physical presence in that country.

64. See, in this sense, the sophisticated analysis provided by Peter Hongler & Pasquale Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy* 23 et seq. (IBFD, Working paper, 20 January 2015), *available at* https://www.ibfd.org/sites/ibfd.org/files/content/pdf/Redefining_the_PE_concept-whitepaper.pdf.
65. Baez & Brauner, *supra* note 10, at 6.
66. As proposed by the 2015 OECD BEPS Action 1 Report, *supra* note 1, at 111 §§ 284 et seq.
67. Concurring, Georg Kofler et al., *Taxation of the Digital Economy: 'Quick Fixes' or Long-Term Solution?*, 58 Eur. Tax'n 523, 529 (2017).
68. *See* Baez & Brauner, *supra* note 10, at 15: '[t]he more serious challenge, however, is not technical, but conceptual, as it provides a dominant destination basis for the tax, determined by the user not the provider'.

information and data are a necessary part of the chain for the creation of the value, but not sufficient for the process of profit generation and, thus, they cannot be qualified as taxable income in the source jurisdiction. If this reasoning is right, the withholding tax on digital services, or the EU DST, cannot be justified either according to the ability-to-pay principle, due to the lack of participation of the non-resident to the polity, or to the benefit principles since the source jurisdiction does not provide a sufficient utility for the creation of the income attributable to the non-resident.

A related issue concerns the determination of the final taxation of the digital services provided. Any final withholding tax, which cannot be credited in the residence tax jurisdiction, violates the net-basis income principle that can be inferred from the tax equality principle.[69]

Finally, the equalization levy, in one form proposed as 'excise tax', is intended to impose a burden on non-resident enterprise's significant economic presence in a jurisdiction. The purposes of such a levy is to place domestic and foreign providers on the same level.[70]

Since the significant economic presence is a necessary requirement for the application of the equalization levy, the justification for such a taxation can be found in the benefit principle, in the terms stated *supra* in this paragraph. For the same reasons, it is hard to provide any good argument for justifying such a tax lacking the economic presence.

§4.06 CONCLUSIONS

The analysis developed in the previous paragraphs allows three main conclusions:

(1) the widespread use of the expression 'tax fairness' in the OECD and EU documents is not much useful in the justification of the rationale for the taxation of the digital economy. Such an expression is not defined and, where it is, is done in a rather rhetoric or pleonastic manner;
(2) the benefit principle – as norm of a tax fairness theory – permits to justify the taxation of the significant economic presence in the source tax jurisdiction, understood as the compensation for the economic and legal utility provided by such jurisdiction;
(3) a final withholding tax cannot find the justification either in the benefit principle, nor in the ability-to-pay principle, unless levied on the basis of a significant economic presence in the source jurisdiction.

69. In such terms, *see also* Kofler, *supra* note 67, at 529, who added that '[u]nder a withholding tax, … the assessment of a uniform, final gross withholding tax, all business models in the digital economy would ultimately be "lumped together". This would disregard the fact that value creation and margins under various business models are very different'.
70. *Ibid.* at 530.

disadvantage should be nuanced, particularly if we take the following into account: for example, even though developing the technology required to provide services online can require substantial initial investment, once it has been created, providing subsequent services frequently requires limited marginal costs.[171] Nevertheless, in many services business models, providing such subsequent (digital) services could require significant ongoing expenditures, for which a WHT on gross revenues could be inadequate.[172] If source (or residence!) countries are seriously concerned about the impact of gross-basis taxation, they could further counteract the perceived negative impact in other ways, such as: (a) creating special rules for start-up companies, companies in transition, loss-making companies and low-margin companies,[173] and/or (b) allowing carry-forward for foreign tax credits or special exemptions, or even adopt tax refund schemes.[174]

[e] Compliance and Enforcement

It is commonly assumed that VPEs pose major challenges with regard to compliance and enforcement.[175] Indeed, according to current proposals defining SDP, the state in which the PE is located should become aware and be able to control that a non-resident taxpayer effectively exceeds the threshold(s) upon which the very concept of PE is based and, once this has been done, to also control the income generated and attributable to that SDP.[176] In the context of a company with no physical presence in the Source state this might prove extraordinarily problematic.[177] Academic proposals to alleviate these concerns, such as the creation of (Mini) One-Stop Shop obligations,[178] would certainly temper excessive compliance but it is still questionable whether it would be useful to align substantive and enforcement jurisdiction.[179] In this context, it has to be borne in mind that the level of compliance of the Mini One-Stop Shop for VAT purposes in the EU has been extremely low due, precisely, to the lack of practical means to require the collection of the taxes from businesses located beyond the jurisdictional reach of the tax authorities.[180]

Compliance and enforcement issues are not connatural to equalization levies as their existence largely depends on the very design of the levy. In principle, an equalization levy, such as the Indian one, will not pose special enforcement issues; being a tax on advertisement services, and covering by nature just B2B transactions,

171. 2015 OECD BEPS Action 1 Report, *supra* note 5, at 114. Wei Cui, *The Digital Services Tax: A Conceptual Defense* 21–22 (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3273641).
172. 2015 OECD BEPS Action 1 Report, *supra* note 5, at 114.
173. Báez Moreno & Brauner, *supra* note 69, at 22.
174. *Ibid.*
175. Kofler, *supra* note 52, at 529.
176. Blum, *supra* note 39, at 323.
177. Walter Hellerstein, *Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments*, 68 Bull. Int'l Tax'n. 346, 348 (2014).
178. *Ibid.* at 350 (referred though to effective collection of VAT in the digital economy). Hongler, *supra* note 32, at 36–37.
179. Following the popularized by Hellerstein, *supra* note 177, at 346–351.
180. Lamensch, *supra* note 153, at 11.

the service recipient would deduct the equalization levy when paying the service provider for the rendered services. If the deduction of payments for domestic income tax purposes of the services recipient is made conditional on the effective deduction and remittance of the equalization levy,[181] the system would work in a reasonable manner. However, the existence of a threshold in this levy might significantly alter this simple functioning scheme. The proposed EU Digital Services Tax, by making the service provider liable for payment and fulfilment of obligations, presents all the difficulties previously described in relation to Virtual PEs and, maybe for this reason, it also incorporates a 'simplification' mechanism in the form of a One-Stop Shop. Everything we said before in relation to compliance and enforcement of the Virtual PE solution remains applicable to equalization levies designed as the proposed EU Digital Services Tax.

A stand-alone gross-basis final WHT on services in B2B contexts is self-enforcing. If the deduction of payments to non-residents for services is made conditional on the effective withholding, it seems evident that the system will work on its own.[182] Of course, in a treaty context, this mechanism can pose compatibility problems with, in particular, Article 24(4) of both OECD- and UN Model-patterned DTCs. However an extension of the WHT to also embrace domestic services – and the corresponding limitation of deduction in case of no or improper withholding – would easily solve the problem.

[B] Legal Consistency Issues

Our proposal for a WHT on (cross-border) B2B services will be compared with the other two policy alternatives found in the 2015 OECD BEPS Action 1 Report (i.e., the new SEP concept of nexus and DEQLs) with regard to three key aspects of consistency with higher-ranking legal rules: (1) DTC law, (2) WTO law and (3) EU law.

[1] Double Taxation Conventions (DTCs)

Among DTC law specialists, there is almost universal consensus that the introduction of a new VPE nexus would require existing bilateral DTCs to be renegotiated.[183] A

181. And this seems to be the case, *see* Wagh, *supra* note 61, at 549.
182. This advantage has been reported both under the auspices of the UN Project on services and other more general proposals of WHT founded on the base erosion approach; this advantage is even reported by opponents of the new provision. In this respect, *see* Doernberg, *supra* note 102, at 1017; *see* Li, *supra* note 85, at 594; Dale Pinto, *E-Commerce and Source-Based Income Taxation* 6.4.4 (IBFD 2003); Pickering, *supra* note 166, at 35.
183. The recent proposal by Pistone and Brauner suggesting an intervention at the level of interpretation to extend the fixed place of business requirement under Art. 5(1) of the OECD/UN Model Tax Conventions to also embrace virtual presence (Pistone & Brauner, *supra* note 32, at 3) which is certainly beyond the limits of interpretation (Schön, *supra* note 17, at 10). In any case, an eventual adoption of the 2018 SDP Directive Proposal would automatically override PE provisions in bilateral tax treaties between Member States (*see* Kofler, *supra* note 52, at 528) & 2018 SDP Directive Proposal, Explanatory Memorandum.

similar concern has been expressed in relation to any WHT on (digital) services.[184] Conversely, the specialists appear to agree that DEQLs fall outside the scope of DTCs based on the OECD and UN Models.[185] Against this background, it may be (rashly) concluded that a DEQL would represent a better alternative than either the VPE or the WHT solutions.[186] However, this conclusion should, at the very least, be tempered by the following reflections: first, there has been a growing tendency in DTCs concluded between developing countries and, to a lesser extent, between developing and developed countries, to include separate provisions allowing source taxation of 'fees for technical services'.[187] In 2017, the UN Model was revised to include new provision attributing taxing rights to the Source state for fees for technical services, which will almost certainly lead to an increase in the bilateral DTCs that incorporate these kind of attribution rules.

Some commentators, particularly those commenting on India's DTCs, have signalled that, according to India's settled case law, standard or general services provided *en masse* to a company's clients are excluded from the objective scope of DTC provisions referring to *fees for technical services* because of the requirement that technical services involve specialized knowledge, skill or expertise on behalf of a particular client.[188] That interpretation would mean that the taxation imposed on a significant volume of digital services would not be covered by any particular DTC provisions, even on *fees for technical services*, which would speak in favour of alternative solutions such as DEQLs.[189]

However, others,[190] including the authors, cannot find, either in the precise wording of the DTC provisions referring to technical services or in its alleged ordinary meaning (i.e., applying specialized knowledge, skill or expertise on behalf of a client as reflected in the UN Model Commentary on its new provision on *fees for technical services*)[191] any clear and reasonable basis for excluding automated, standard, general,

184. Schön, *supra* note 17, at 27; *see* Kofler *supra* note 52, at 529.
185. *See* Kofler, *supra* note 52, at 531; Schön, *supra* note 17, at 14 (though hesitantly); Pistone & Brauner, *supra* note 32, at 2.
186. In fact, the *Indian Committee on Taxation of E-Commerce* did not recommend either a Virtual PE or a WHT because these would require changes in tax treaties. Instead, an equalization levy, so the Committee, provided a simpler option under domestic laws without needing amendment of a large number of tax treaties (Lahiri, *supra* note 61, at 15–16).
187. This growth is clearly visible by comparing the treaties containing these kind of provisions in the survey carried out by Wijnen, de Goede and Alessi in 2011 (Wim Wijnen et al., *The Treatment of Services in Tax Treaties*, 66 Bull. Int'l Tax'n. 27, 27–33 (2012) and the later work by Angharad Miller, *Taxing Cross-Border Services: Current Worldwide Practices and the Need for Change* 1, 147. 6.6 (IBFD 2016).
188. This is particularly the view taken by Falcão and Michel when stating that many of the services provided through an online interface are 'generic' in nature and not of the required technical and specialized nature to be caught by Art. 12[a] in the first place (Tatiana Falcão & Bob Michel, *Scope and Interpretation of Article 12 A: Assessing the Impact of the New Fees for Technical Services Article*, 4 Brit. Tax Rev., 422, 438 (2018)).
189. Lahiri, *supra* note 61, at 3–4.
190. The OECD seems to also share this view when stating that: *While this definition* (that of *fees for technical services*) *is not specifically targeted at digital products and services, it generally includes a broad range of cloud computing services* (2018 OECD Interim Report, *supra* note 4, at 140).
191. UN Model Commentary, para. 62, Art. 12 A.

routine or 'canned' services, whose performance requires the application of specialized knowledge, skill or expertise on behalf of a client, sometimes in an even more intense fashion than in tailored services, from new inclusion in the term. Things would be different if a reference were made to an immediate application of specialized knowledge, skill or expertise on behalf of a client; in that case, there would be a legal basis for a distinction between standard and tailored services. But again, this nuance is not found in the proposed Commentaries nor, more importantly, in the UN Model's text.[192]

Second, in view of the fact that the concept of 'taxes on income' under both the OECD and UN Models remains problematic, it might prove more daring to simply assert that, regardless of the specifics of any particular DEQL, as DEQLs are not a tax on income, the DEQL is outside the scope of DTCs. In fact, if the concept of income, as generally agreed, is centred on both the receipt and the recipient of payments,[193] some DEQLs, such as the one proposed in the 2018 DST Directive Proposal, still run the risk of being qualified as income taxes and, therefore, incompatible with DTC obligations.[194] Indeed, if the service provider is the person liable for the DEQL's payment and fulfilment obligations,[195] and, at least for these purposes, the fact that the tax is levied on gross revenue is not relevant, it seems difficult *not* to consider DEQLs as a tax on income.[196] Moreover, in relation to DEQLs that are less focused on the recipient of income, such as India's DEQL,[197] considering them income taxes is not inconceivable either,[198] as it could even be argued that a domestic DEQL law, without ever involving a DTC override, could still be labelled 'treaty dodging'.[199]

Therefore, on balance, although it is clear that any new VPE would require a systematic revision of all bilateral DTCs in force, the compatibility of WHTs and DEQLs

192. For more details on this issue, *see* Báez, *supra* note 103, at s. 3.2.1.2.2.
193. Roland Ismer & Alexander Blanck, *Article 2 Taxes Covered*, *in Klaus Vogel on Double Taxation Conventions*, *supra* note 81, at 143, 159 m.note 36; Marjaana Helminnen, *General Report*, *in The Notion of Tax and the Elimination of International Double Taxation or Double Non-Taxation*, 101 B IFA Cahiers 19, 36 (2016).
194. Of course, this would not be a problem among the Member States if the 2018 DST Directive Proposal is finally approved as written, inasmuch as bilateral DTCs among the Member States would automatically be overridden by the Directive. However, this might be a problem when the service provider is a resident in a third State, which will often be the case, particularly in relation to digital MNEs targeted by the new tax. It is likely that the EU Commission either ignored this problem or simply considered the 2018 DST Directive Proposal as outside the scope of DTCs if we recall that, unlike it did for the 2018 SDP Directive Proposal, it did not make a recommendation that Member States adapt their third-state DTCs to the DST.
195. 2018 DST Directive Proposal, *supra* note 14, at 9.
196. In the same vein: Martín Jiménez, *supra* note 122, at 636. Adolfo Martín Jiménez, *The Concept of Tax in Treaties in the Post-BEPS World*, *in Tax Treaties After the BEPS Project. A Tribute to Jacques Sasseville* 165, 189–190 (Brian J. Arnold ed., Canadian Tax Foundation 2018).
197. Under India's DEQL, the service recipient must withhold the levy when paying the non-resident service provider, but a failure to withhold does not allow India's tax authorities to send notices or otherwise penalize the non-resident service provider (Wagh, *supra* note 61, at 549). Therefore, the service provider (and recipient of the payments) seems relatively unaffected thereby.
198. Wagh, *supra* note 61, at 550; *see* Mehta, *supra* note 61, at 5.
199. Mehta, *supra* note 61, at 5.

with DTC obligations will depend largely upon the specific design of the measure in domestic law and the specific wording of the applicable DTC.

[2] WTO Law

Unlike the VPE solution, both the WHT[200] and DEQL solutions[201] have been accused of violating international commerce laws (i.e., the General Agreement on Tariffs (GATT)[202] and the General Agreement on Trade in Services (GATS)),[203] which, once again, gives the VPE solution the preferential air described, *supra*, with respect to DTC consistency issues. But, once again, that rushed conclusion must confront two significant realities. First, both GATT and GATS require their signatories to tax foreign suppliers of goods and services no less favourably than its own domestic suppliers. However, GATS provides broad exceptions when the signatory applies direct tax measures.[204] More specifically, GATS Article XIV(d) provides that nothing in the Agreement is to be construed to prevent the adoption or enforcement by any Member of measures inconsistent with Article XVII (i.e., the national treatment rule) provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members; Article XIV(d)'s footnote 6 expands on that concept, to cover measures that include, in particular, the application of WHTs to non-residents.[205] Therefore, a gross WHT, like the one we propose in this chapter, would not violate GATS.[206] (ii) As regards DEQLs on services (e.g., the 2018 DST Directive Proposal and India's DEQL), the application of GATS Article XIV(d)'s carve-out would very much depend on the DEQL's qualification as an income tax.[207] Be that as it may, the DEQL could always be imposed on both resident and non-resident service providers to avoid any such concerns.[208] However, as previously reported,[209] this expansion might cause serious inconsistencies, particularly in the field of 'compensatory' DEQLs.

200. 2015 OECD BEPS Action 1 Report, *supra* note 5, at 115 (making though an accurate distinction between GATT and GATS); *see* Kofler *supra* note 52, at 529; Schön, *supra* note 17, at 27.
201. 2015 OECD BEPS Action 1 Report, *supra* note 5, at 116–117; *see* Kofler *supra* note 52, at 531; Schön, *supra* note 17, at 15.
202. General Agreement on Tariffs and Trade 1994, 15 April 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1867 U.N.T.S. 187, 33 I.L.M. 1153 (1994).
203. General Agreement on Trade in Services, 15 April 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, 1869 U.N.T.S. 183, 33 I.L.M. 1167 (1994).
204. 2015 OECD BEPS Action 1 Report, *supra* note 5, at 115.
205. Jennifer E. Farrell, *The Interface of International Trade Law and Taxation: Defining the Role of the WTO* 1, 192 8.4.2.1 (IBFD 2013).
206. In the same vein, with certain nuances on services rendered outside the Source state, *see* Brian J. Arnold, *The Taxation of Income from Services*, in *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*, *supra* note 101 at 47 & 99–101.
207. *See supra* Chapter 3. However Professor Schön, very much in favour of considering these levies as coming on top of existing direct and indirect taxes, categorically concludes that the carve-out in Art. XIV paras d & e of the GATS would not protect such legislation (Schön, *supra* note 17, at 15–16).
208. This is the case for example of the *Proposal for a Common System of a Digital Services Tax*.
209. *See* §5.04[A][3][c].

[3] EU Law

That a VPE approach does not raise EU law concerns is, for the most part, taken for granted,[210] while both WHT[211] and DEQL[212] solutions are routinely accused of infringing EU law, particularly with respect to EU fundamental freedoms protected by the Treaties. Once again, certain realities counter that accusation. First, at the time of this writing, VPE proposals have yet to satisfactorily resolve the problem of how to attribute profits to a VPE. Hence, unless new attribution rules like those contained in Article 5, 2018 SDP Directive Proposal are further developed, there would be ample reason to claim unacceptable (i.e., unjustifiable) discrimination under EU fundamental freedoms, if only on the basis of the uncertainty surrounding the new 'rules'.[213]

Second, when analysing the compatibility of WHTs and DEQLs with EU law, particularly with regard to the available policy alternatives for taxing the digital economy, many scholars frequently refer to their potential for different treatment of domestic and cross-border (digital) services and, based solely upon that different treatment, deduce therefrom that the solutions will result in EU law violations. In light of recent decisions coming out of the Court of Justice of the European Union (CJEU) on WHT, particularly its *Brisal* decision,[214] certain WHT critics[215] have become more specific and more strident in their criticisms. Indeed, *Brisal* and other contemporary decisions[216] have made it clear that the CJEU's *Truck Center*[217] judgment could not be understood as an excuse to apply different tax collection systems to residents and non-residents.[218] In fact, with respect to the main issue at stake in the application of a WHT on services (i.e., creating different rules for the taxable bases for domestic and cross-border transactions[219]), it is clear from the CJEU's *Brisal* decision (as well as

210. *See* Kofler, *supra* note 52, at 529, these referring to (Joachim Englisch. *BEPS Action 1-EU Law Implications* 3 Brit. Tax Rev. 280, 285–286 (2015)). However this last author referred to 'crude' version of BEPS Action 1 merely analysing potential extensions of the PE concept under BEPS Action 7.
211. 2015 OECD BEPS Action 1 Report, *supra* note 5, at 115; *see* Kofler *supra* note 52, at 529; Schön, *supra* note 17, at 27.
212. 2015 OECD BEPS Action 1 Report, *supra* note 5, at 116; 2018 OECD Interim Report, *supra* note 4, at 183 (if not equally applied to residents and non-residents); *see* Kofler, *supra* note 52, at 531; Pistone & Brauner, *supra* note 32; Schön, *supra* note 17, at 15.
213. In this context, a reference to the decision of the CJEU *SIAT*, C-318/10, Judgment, EU:C:2012:415.
214. Case C-18/15.
215. Italian Banking Association (ABI), in *Tax Challenges of Digitalization: Comments Received on the Request for Input Part I*, *supra* note 11, at 5.
216. Such as *Hirvonen*, C-632/13, Judgment, EU:C:2015:765; *Miljoen*, Joined Cases C-10/14, C-14/14 & C-17/14, Judgment, EU:C:2015:608.
217. *Truck Center*, C-282/07, Judgment EU:C:2008:762.
218. CFE ECJ Task Force, *Opinion Statement ECJ-TF 2/2016 on the Decision of the Court of Justice of the European Union of 13 July 2016, in* Brisal & KBC Finance Ireland *(Case C-18/15), on the Admissibility of Gross WHT of Interest*, 57 Eur. Tax'n 30, 32–33 (2017).
219. As regards the existence of different techniques for charging tax on residents and non-residents, AG Kokott states correctly that the Court held on a number of occasions that the specific technique of deducting tax at source for non-resident service providers in principle does not infringe freedom to provide services (*Brisal & KBC Finance Ireland*, C-18/15, AG Opinion, EU:C:2016:182, para. 22).

however, is seen as being unprecedented.[63] Still, whether and to which extent users should be deemed participants in a firm's business operations is mentioned as one of the central dividing lines between the Members of the Inclusive Framework on BEPS[64] requiring further analysis.[65]

This divergence exposes a problem far more crucial than potential analogies to traditional (non-digitized) business models: 'Value creation' alone cannot satisfyingly justify any changes to generally accepted principles on the international distribution of taxation rights, as the term itself is not a fully fledged concept with a generally agreed-upon meaning.[66] One might even go further and argue that 'value creation' itself requires a definition first and thus yields no additional arguments for the issue of whether a taxable nexus should be assumed in a jurisdiction at all. The term rather just paraphrases the question of where to internationally locate the origin of business income for the purpose of taxation, so far simply referred to as 'source'. It seems highly doubtful whether 'value creation' is any distinct from the concept of 'source' as regards the rationale for the establishment of a taxable nexus.[67]

Whether labelled as 'source' or 'value creation', the terminology should not distract attention from the fundamental problem remaining unsolved. Business income generally results from combining multiple input factors, transforming them to an output and supplying this output to third parties for consideration, often multiple times in a row as long as the third party itself is not a final consumer. These 'value chain' processes are abstract economic concepts and thus per se immaterial. As was mentioned on the analogous example of the place of services before, locating the resulting income at distinct geographical points for taxation will thus always require some degree of simplifying fiction. It seems natural to derive such fictions from the locations of people and objects most closely related to each part of the process. Yet, which of these 'physical manifestations' is connected to specific portions of the income of an individual taxpayer and, in this regard, where the income sphere of one taxpayer ends and that of another one begins are mere conventions, having become principles through mutual recognition.

The currently recognized principles of income taxation in cross-border cases (as embodied in the PE definition in Article 5 OECD MC) are based on the general fiction that business profits arise where physical space at the disposal of a business is used for its operations with a certain degree of permanence.[68] Simply put, a business is assumed to generate all its income at the places, where its equipment or its personnel 'work' for the business, if such places somehow effectively 'belong' to the business and are not only used temporarily or coincidentally (i.e., are at the constant disposal of the

63. *See, e.g.*, 2015 OECD BEPS Action 1 Report, *supra* note 14, paras 166, 169, 259 & 262.
64. 2018 OECD Interim Report, *supra* note 7, para. 372.
65. *Ibid.* para. 397.
66. *See* Olbert & Spengel, *supra* note 16, at 12; Schön, *supra* note 16, at 5 & 21 et seq.
67. *See also* Johanna Hey, *'Taxation Where Value is Created' and the OECD/G20 Base Erosion and Profit Shifting Initiative*, 72 Bull. Int'l Tax'n 203, 204 (2018); Jonathan Schwarz, *Value Creation: Old Wine in New Bottles or New Wine in Old Bottles?*, http://kluwertaxblog.com/2018/05/21/value-creation-old-wine-new-bottles-new-wine-old-bottles (accessed 30 June 2018).
68. *See* OECD Tax Convention Commentaries, *supra* note 39, Art. 5 para. 6.

business[69]). This, however, does not necessarily require closeness to the market jurisdiction.[70] Deeming the criteria of 'physical presence' an assumption of such closeness seems like an over-interpretation (with demand-side orientation in mind).

The aforementioned dependent agent rule is an exemption to this principle, as the activity of a person alone (without 'space') is sufficient for the establishment of a PE. Yet, that person must be dependent on the business and thus quasi-'belong' to it as well. Ultimately, the whole process of 'value creation' is attributed to premises and contracting agents 'under the control' of a business by these principles (and even those are not always fully covered, as the still upheld exemptions for preparatory and auxiliary business functions with deemed minor importance in Article 5 paragraph 4 OECD MC prove). By design, they ignore any 'work' done or potentially 'valuable inputs' obtained outside that scope, even if they can clearly contribute to commercial success (e.g., distance selling, Television (TV) advertisement in a foreign country, occasional consultation at a client's location, inspiration coming to R&D personnel at a conference abroad).

Especially, all possibly beneficial inputs by persons or conditions not under control of the business are disregarded. A supplier's plant is not attributed to another business, even if all its production is bought by that business as the sole customer.[71] The place of origin of certain raw materials or intermediate products in general is not per se deemed part of a business, even if distinct qualities of these inputs clearly shape its own output and are crucial for its commercial success. Comparable examples can be mentioned for the other end of the 'value chain', as customers often play a vital part in enabling or facilitating a supplier's operations without being attributed to these. The delivery dock at a customer's warehouse may be used by a transportation company daily for multiple years without becoming assigned to the latter's business.[72] A consumer driving to a shop for getting a good implicitly aids the respective seller by saving her the need for delivery while still making the sale possible. Buyers of cars create the opportunity for follow-up sales of spare parts and workshop services. Viewers of commercial TV, cinemagoers or readers of newspapers enable media companies to sell valuable advertisement by providing their time and attention. Lottery participants raise the prize jackpot and thus the lottery's appeal to additional participants.

All these examples have in common that third parties somehow aid in the 'value creation' process in its entirety, however without being attributed to a business generating profit as only one step of that process under the prevalent taxation principles. Hence, value contributing factors beyond the control of the business itself are not seen as part of its own income-generating (and thus taxable) operations, even if they create the indispensable environment or prerequisites for these. Economically interpreted, profit embodies the portion of 'value created' a business can claim because it was added by factors committed to the process under its own risk and command (the

69. *Ibid.* Art. 5 paras 10 et seq.
70. *See* Schön, *supra* note 16, at 22.
71. OECD Tax Convention Commentaries, *supra* note 39, Art. 5 para. 12.
72. *Ibid.* Art. 5 para. 16.

extent of this claim of course being subject to market conditions). Against this background, these elements became natural proxies for locating the taxable income of that very business. Third parties and circumstances not at its disposal are, conversely, not attributed to its income-generating operations and thus do conceptually not attract any income of the business for the purpose of taxation.

Despite contrary assertions, 'brick and mortar' businesses are not fundamentally different from any providers of 'digital services' in this regard. The latter can also not operate in empty space, but need a minimum of physical input factors at their disposal (at least some computer equipment or working space for employees setting-up and maintaining the algorithms and systems). Even when the users of digital services are deemed to act like 'involuntary suppliers of value' to the business, they act in a generally non-coordinated manner and the 'net worth' of their contributions per se will often be almost negligible. Only when the business combines and uses these inputs to create a marketable product or service, which at one point has required 'traditional' work, will there be a remarkable appreciation in value from a traditional supply-side perspective.

Would, however, users truly be seen as 'suppliers' of an input that already has some worth, one has to raise the question why they would provide this value to the business without consideration. Generally, suppliers of raw materials are not attributed to the 'value creation' of a business not only because they do not act under its discretion but also because there is a market transaction, which delimits the supplier's business (and taxable income) from the sphere of the customers. If users are to be conceptually treated like suppliers, their motive for 'supporting' a digital service provider will not be sheer generosity. Their 'contribution' to the service is either mandatory for their own purposes (e.g., showing a photo to friends online requires its upload) or they even accept inconveniences as fair consideration (e.g., a website showing advertisements before providing access to videos free of monetary charges). No matter the exact reason, the users act in their own interest, generating 'value' primarily for themselves and not offering it 'for free'.

If user contribution is deemed to be a valuable 'raw material' to businesses in the 'digital economy', one has to justify why the users are attributed directly to the business and not taxed for their own 'profits' themselves. Taxation on such scale is obviously not viable. However, this thought leads back to the central issue. Justifying a 'digital PE' on grounds of existing profit taxation principles and traditional supply-side reasoning results in manifold inconsistencies. These are not deficiencies of the 'digital PE' notion itself, they result from treating it as something else than it actually is.

[D] The True Background: Tax Policy and the Sentiment of Revenue Lost by 'Importers' of Digital Services

Ultimately and notwithstanding all contrary assertions, the 'digital PE' concept is a fundamental move to demand-oriented income taxation. The arguments raised for its justification under feigned retention of existing principles in 'modern' form, especially

the notion of 'value creation', can only pertain when demand-side factors are considered more decisive than before in international tax law. On close consideration, this also is an implicit key point separating Action 1 from large parts of the rest of the BEPS Project.[73] Businesses in the 'digital economy' may have some features beneficial for their tax planning (e.g., the possibility of easy relocation, as they do not require extensive physical premises). These, however, are the result of the nature of their operations, not primarily a result of tax considerations. Such businesses often do not 'avoid' the establishments of PEs with elaborate schemes (which are tackled by other parts of the BEPS Project); they simply have no reason to be physically present in many jurisdictions. The BEPS Action Plan already recognized this and admitted that even low taxation per se is not an indicator for deficiencies in tax law against this background.[74]

The true essence of tax challenges arising from the 'digital economy' is thus less a problem of tax law but rather a question of tax policy. Considering the arguments for special treatment of the 'digital economy' in the BEPS reports (e.g., the 'scale without mass' aspect, the monopoly tendencies or the elusive role of intellectual property rights[75]) with this in mind shows a rather obvious political reality. The 'digital economy' affects large parts of the world, but its most thriving 'big players' are few and they are unevenly spread from a global perspective. The nature of their operations allows for maintaining huge commercial influence from relatively small, local hubs. Some states find themselves in the unfamiliar role of one-sided importers as regards the digital economy. This raised awareness of the perhaps unfavourable position such jurisdictions face in international income taxation. Less need for physical input factors and the resulting growing mobility and long reach of the 'digital economy' also naturally fuel tax competition. Local providers in high-tax jurisdictions might not only face the sheer market power of a foreign 'big player', their perception of tax burden grew as competition has entered a more global scale and local proximity alone does not necessarily compensate for disadvantages of higher taxation any longer.

For an 'importing' nation seeking to establish a level playing field in income taxation from the perspective of local competition, it seems natural to push for more demand-oriented taxation. This is understandable and it is definitely a justifiable policy goal,[76] but a question of policy nonetheless.[77] However, dangerous discrepancies and legal uncertainties arise when this objective is covered under pretensions of maintaining the traditional supply-focused position of international income taxation. Circumventing the true rationale behind motions for 'digital PEs' adds a sense of dishonesty to the debate.[78] It might not be far-fetched to suppose that an open call for demand-oriented income taxation is avoided, as the jurisdictions 'importing' digital services often are exporters in the 'traditional economy' and would thus most likely face

73. *See, e.g.*, Blum, *supra* note 16, at 316; Staringer, *supra* note 16, at 348.
74. OECD, *Action Plan on Base Erosion and Profit Shifting*, 10 (OECD Publishing 2013).
75. *See, e.g.*, 2018 OECD Interim Report, *supra* note 7, paras 130 et seq.; 2015 OECD BEPS Action 1 Report, *supra* note 14, paras 151 et seq.
76. *See* Schön, *supra* note 16, at 17.
77. *Cf.* OECD Tax Convention Commentaries, *supra* note 39, Art. 5 para. 136. *See also* Staringer, *supra* note 16, at 344.
78. *See also* Schwarz, *supra* note 67.

disadvantages from a general realignment of international profit distribution rules. The large consumer markets of the future will be found in populous nations. Pushing for a demand-oriented PE, even when currently focused on the 'digital economy' only, might turn out as short-sighted strategy for established industrialized nations.

§7.03 SDP: THE 'DIGITAL PE' AS CONCRETELY PROPOSED BY THE EUROPEAN COMMISSION

[A] Legal Framework

As mentioned in the introduction, the European Commission just recently revealed its vision of the SDP, a 'digital PE' for mandatory implementation between EU Member States, as recommendation for their relationships towards third states and even as model for a global solution beyond the EU. The term SDP is not an original creation but was already used in the BEPS Action Plan[79] and the following Action 1 Deliverable 2014.[80] Interestingly, the following works did not continue that terminology.[81]

In a first step, a Council Directive should force Member States to include the SDP as an addition to their PE definitions for corporate tax purposes. By explicitly demanding an insertion into the existing PE concepts, the SDP as a solution for the taxation of the 'digital economy' should fit in smoothly with existing tax systems[82] instead of creating a new tax (like the equally proposed interim DST). Moreover, this strategy can be seen as an example for policymaker's aforementioned efforts to deny fundamental realignments of international tax distribution and belittle the paradigm shift caused by the introduction of a 'digital PE' model. The Commission's Impact Assessment does not consider the SDP a 'fundamental reform' of corporate taxation, as opposed to a destination-based cash flow tax, unitary taxation or a residence tax base with destination tax rates.[83]

The Commission bases its proposal on Article 115 of the Treaty on the Functioning of the European Union (TFEU),[84] which allows for the enactment of directives for the approximation of laws affecting the establishment or functioning of the internal market. The justification in the proposal seems rather peculiar, as the Commission depicts Article 115 TFEU ambiguously as quasi-catch-all clause for EU tax legislation not already covered by Article 113 TFEU on turnover taxes.[85] While it is true that Article

79. 2018 OECD Interim Report, *supra* note 7, at 29 & 35.
80. OECD, *Base Erosion and Profit Shifting Project: Accessing the Tax Challenges of the Digital Economy – Action 1: 2014 Deliverable*, 143 et seq. (OECD Publishing 2014) (hereinafter '2014 OECD BEPS Action 1 Deliverable').
81. 2015 OECD BEPS Action 1 Report, *supra* note 14, para. 277 refers to 'significant economic presence'; 2018 OECD Interim Report, *supra* note 7, para. 397 even more generally to 'nexus rules that would consider the impacts of Digitalization on the economy' instead.
82. 2018 SDP Directive Proposal, *supra* note 2, at 2.
83. *Ibid.* at 6; Commission Staff Impact Assessment on Significant Digital Presence & Provision of Digital Services, *supra* note 43, at 29 et seq. and 34 et seq.
84. Consolidated version of the Treaty on the Functioning of the European Union, Art. 115 OJ C 326, 26 Oct. 2012, 47.
85. 2018 SDP Directive Proposal, *supra* note 2, at 4 et seq.

115 TFEU normally is the only basis for EU legislation in the field of direct taxation,[86] it is not a general provision, but requires an effect on the internal market. The measure in question has to prevent obstructions of the EU's fundamental freedoms arising from differences in national legislation while an ancillary effect of harmonizing market conditions alone is insufficient.[87] Nonetheless, the explanations on the necessity of the SDP for the functioning of the internal market, although fundamentally required for the legitimacy of EU action, remain fairly vague and abstract. They refer to a cross-border nature of digital activities, equal treatment of taxpayers in all Member States, legal certainty and, in case the EU should not act, a multitude of ineffective unilateral measures with potentially disrupting effects for the internal market.[88]

The specific distortions of the internal market feared by the Commission, however, do not become clear, especially as even the existing PE concepts are not yet fully harmonized. While a coordinated multilateral approach in questions of international taxation undoubtedly entails benefits, it is hard to see why measures in the tax systems of individual Member States should automatically be a hindrance for the internal market, as long as fair competition between and equal treatment of all EU businesses within a certain jurisdiction is guaranteed. The European Court of Justice (ECJ), particularly in its decisions on double taxation, has repeatedly held that disadvantages arising from the individual Member States' different and uncoordinated rules on taxation are not per se restricting the fundamental freedoms that constitute the internal market, as long as they are non-discriminatory in nature. Neither is the parallel exercise of tax competences by multiple Member States alone a violation of EU law nor are Member States in any way obliged to adapt their own tax system to the systems of other states, if not required by harmonizing acts of secondary law.[89] Within these limits, Member States are *inter alia* free to determine the connecting factors for the allocation of fiscal jurisdiction in their bilateral agreements on taxation.[90] In determining the chargeable events of a tax, the taxable amount and the tax rates applicable to profits coming within their jurisdiction they are only restricted by the obligation to treat non-resident companies not discriminatory in comparison with national establishments.[91]

This ECJ case law is hardly compatible with the Commission's current standpoint on corporate taxation, which basically comes down to differences in the national tax

86. *See Commission* v *Council*, C-338/01, Judgment, EU:C:2004:253.
87. *See Germany* v *Parliament and Council*, C-380/03, Judgment, EU:C:2006:772, paras 36 et seq.; *Arnold André*, C-434/02, Judgment, EU:C:2004:800, paras 29 et seq.; *Germany* v *Parliament and Council*, C-376/98, Judgment, EU:C:2006:772, paras 81 et seq.; *Parliament* v *Council*, C-187/93, Judgment, EU:C:1994:265, para. 25.
88. 2018 SDP Directive Proposal, *supra* note 2, at 5.
89. *See, e.g., NN(L)*, C-48/15, Judgment, EU:C:2016:356, para. 47; *X*, C-302/12, Judgment, EU:C:2013:756, paras 28 et seq.; *Banco Bilbao Vizcaya Argentaria*, C-366/10, Judgment, EU:C:2011:864, para. 31; *Block*, C-67/08, Judgment, EU:C:2009:92, paras 28 et seq.
90. *See, e.g., Beker*, C-168/11, Judgment, EU:C:2013:117, para. 32; *Renneberg*, C-527/06, Judgment, EU:C:2008:566, para. 48.
91. *See, e.g., X*, C-68/15, Judgment, EU:C:2017:379, para. 41; *Test Claimants in the FII Group Litigation*, C-446/04, Judgment, EU:C:2006:774, paras 123 et seq.; *Kerckhaert & Morres*, C-513/04, Judgment, EU:C:2006:713, paras 19 et seq.

systems themselves already being considered distortions to the internal market.[92] A likewise premise seems to be required for understanding why the SDP should have to be implemented uniformly in all Member States in order for the internal market to function. If different rules on taxation in different Member States and even double taxation are not per se seen as distortions to the internal market (in line with the ECJ's view), there seems to be no reason for prohibiting even partly different national strategies (or bilateral agreements) on the taxation of the 'digital economy'. It, e.g., would not distort the internal market if some Member States simply decided to generally not implement the SDP concept and retain their current PE definitions. Profits elsewise allocated to such countries by the SDP rules would simply remain taxable in the taxpayer's residence country. This would not even fuel tax competition between Member States beyond the existence of different tax rates, which explicitly remain permitted either way.[93]

The true reason for the necessity of EU legislation on the SDP might again be found in policy rather than sophisticated legal assessments. The SDP could hardly become the global model the Commission envisions it to be, if it was not even generally established throughout the EU. Moreover, an EU directive seems highly attractive from the perspective of those Member States pushing for the introduction of 'digital PEs' in their national tax laws. While unilateral moves are not prohibited by EU law, these states most likely face the problem of having entered into double taxation conventions preventing them from raising taxes for a purely 'digital PE'. The SDP directive saves these states the difficulties of having to renegotiate (or breach) their intra-EU tax treaties by acting as a general, yet lawful 'treaty override' for all cases between Member States.[94]

Joint and public action on the EU level might also raise pressure on Member States where companies affected by 'digital PE' provisions reside.[95] As these countries will potentially see parts of their tax base eroded, their willingness to change their tax treaties in bilateral negotiations might not be grand. However, Article 115 TFEU requires unanimity in the Council, so the pressure to accept the SDP proposal is again more political than legal in nature. At the same time, this prerequisite of unanimity practically relativizes the question whether Article 115 TFEU provides sufficient basis for EU legislation.

92. *See, e.g.*, European Commission, *Proposal for a Council Directive on a Common Corporate Tax Base*, 4 et seq. (25 October 2016), COM(2016) 685 final.
93. 2018 SDP Directive Proposal, *supra* note 2, at 5.
94. *Ibid.* at 3. This power of a directive results from the primacy of EU over national legislation in case of conflict as originally developed by the ECJ in *Costa* v *E.N.E.L.*, 6/64, Judgment, EU:C:1964:66. The resulting derogation of national provisions also applies to transnational treaties between EU Member States. For a comprehensive review, *see, e.g.*, Georg Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht*, 265 et seq. (Linde 2007).
95. The respective intra-EU disparities are, e.g., mentioned by Commission Staff Impact Assessment on Significant Digital Presence & Provision of Digital Services, *supra* note 43, at 41 et seq.

[B] Territorial Scope

In accordance with the legal framework just described, the SDP will primarily be applicable in relations between EU Member States. Article 2 of the proposed directive generally covers all entities, whether resident within the EU or in a third state for purposes of corporate taxation. This wide scope, however, is followed by an exemption for all entities resident in third countries that have entered into double taxation conventions vis-a-vis the Member State concerned, if these treaties do not (yet) contain provisions similar to the SDP.[96] This restriction was deemed necessary, as such double taxation conventions might overrule the national SDP provisions[97] and Member States should not be forced to breach their treaties.[98] The residence of a taxpayer for application of the SDP rules will thus have to be determined not under a Member State's national law, but after considering respective treaty provision (e.g., a 'tie-breaker provision' for dual-residents akin to Article 4 paragraph 3 OECD MC), even though these usually apply on the treaty level only.[99]

Actually, the restraint might less be driven by the *pacta sunt servanda* principle than the EU's severely limited authority over tax treaties between Member States and third states[100] (especially as the functioning of the internal market can hardly be invoked in these constellations). This is the likely reason why the Commission's plan is restricted to a mere non-binding recommendation[101] for SDP amendments to the bilateral tax treaties of EU members with third states.

As EU Member States usually maintain extensive networks of such conventions even with non-EU jurisdictions, the SDP will primarily result in shifts of taxable profits between Member States and not substantially enlarge the total 'EU tax base' by attracting large profits from businesses in third states. While there might also be intra-EU discrepancies between the locations of 'digital service' users and the tax residences of companies providing these services,[102] public attention usually revolves primarily around taxation of non-EU enterprises with presumed high profitability and low tax burden like Alphabet (the holding company of Google), Apple, Facebook or Amazon. The SDP Directive, however, will overwhelmingly not affect the majority of such cases. Only intra-EU tax competition or deemed unfair profit allocation might be fought. In the worst case, the SDP Directive could lead to companies relocating their residence to non-EU jurisdictions to avoid distribution of their taxable profits to multiple tax jurisdictions within the EU under the SDP provisions.

96. *See* 2018 SDP Directive Proposal, *supra* note 2, at 14 (proposed Art. 2).
97. *Ibid.* at 4.
98. *Ibid.* at 7.
99. *See* OECD Tax Convention Commentaries, *supra* note 39, Art. 4 para. 7.
100. *See* for a comprehensive analysis Kofler, *supra* note 94, at 288 et seq.
101. EU Comm'n, *supra* note 5.
102. *See* EU Comm'n, *supra* note 43, 41 et seq.

[C] Material Scope: 'Digital Services Through Digital Interfaces'

While most 'digital PE' concepts share similar objectives and general principles, the question which services and businesses are to be covered by such provisions in detail is essential and far from trivial. It implicitly requires policymakers to leave the realm of keywords behind and take a concrete stand on what they consider the 'digital economy', for which existing PE rules are deemed insufficient, and how to distinguish it from 'traditional' business models.

The OECD/G20's BEPS Action 1 Reports already elaborately demonstrate that it is relatively straightforward to describe the 'digital economy' by looking at specific and well-known examples and identifying similarities between them. These elaborations also show that the 'digital economy' can be thought of as having two facets, the digitization of existing 'offline' business models (e.g., online retailing or online payment services) and the emergence of radically new commercial concepts 'born' from digitization and impossible without widespread computer networks (e.g., social networks or cloud computing).[103] The line between these two sectors is, however, a blurred one.

There will hardly be any businesses with cross-border operations not making commercial use of the Internet in any way (at least as means of communication) even in the most 'traditional' industries. On the other end, some 'traditional' business models have so profoundly changed due to the possibilities offered by modern technology that they are barely still comparable to their 'offline equivalents' (e.g., online advertising personalized to individual consumer preferences using elaborate automatized analysis of user data). Thus, it might be more suitable to imagine the modern economy as a continuum of commercial activities ranging from less to more focus and dependency on digital technology. As the OECD/G20 accurately hold: 'The digital economy is increasingly becoming the economy itself.'[104]

The blurred borders of the 'digital economy' pose a fundamental problem to policymakers with the objective of designing a 'digital PE' only for specific business models they want to cover. They need to find a general definition embracing these businesses while keeping the existing PE concepts in place for the rest of the economy as to not risk complete realignments of taxation rights. The OECD/G20 expressed their concerns that such attempts of 'ring-fencing the digital economy' would be impossible or require arbitrary lines to be drawn.[105] Nonetheless, the fundamental issue from a legal perspective is not the creation of special provisions for taxpayers in a specific situation per se, as certain circumstances justifiably call for modifications of more

103. *See* 2014 OECD BEPS Action 1 Deliverable, *supra* note 80, at 69 et seq.; 2015 OECD BEPS Action 1 Report, *supra* note 14, paras 116 et seq.; 2018 OECD Interim Report, *supra* note 7, paras 100 et seq.
104. 2014 OECD BEPS Action 1 Deliverable, *supra* note 80, at 73; 2015 OECD BEPS Action 1 Report, *supra* note 14, para. 115.
105. 2014 OECD BEPS Action 1 Deliverable, *supra* note 80, at 73; 2015 OECD BEPS Action 1 Report, *supra* note 14, para. 115. *See also* 2018 OECD Interim Report, *supra* note 7, para. 375.

general rules. The challenge, however, is that these special provisions should still fall in line with the general principles and structures of international tax law.[106]

After all, even the OECD/G20's statements on the undesirability of 'ring-fencing' prove quite hollow. The BEPS Action 1 Reports themselves go great lengths to identify features distinguishing the 'digital economy' or 'more digitalized business models' from the rest of the economy,[107] which would hardly be necessary without any desire for legal separation. Furthermore, the reported concepts for a new and extended taxable nexus under the PE label contain elements perceptibly limiting the scope of such provisions to certain 'digital activities';[108] a necessity, when a general shift of the PE concept to demand-oriented factors is not intended.[109] The Members of the Inclusive Framework on BEPS, however, hold divergent views on whether such a set of specific rules tailored to the 'digital economy' is required.[110]

The European Commission's full plan for the 'taxation of the digital economy' interestingly follows two different alternatives for determining the scope of operations covered. The interim DST should apply to three exhaustively enumerated types of digital services only, namely personalized online advertising, multi-sided digital intermediary platforms (e.g., electronic market places), and sales of user data.[111] The SDP proposal follows the opposite approach and relies on a broad general definition of activities covered, followed by specific (non-exhaustive) examples and exemptions. A business can maintain a SDP, when it supplies 'digital services through a digital interface'.[112] A 'digital interface' is simply defined as any piece of software (including websites and mobile applications) directly accessible to end users, whether these are individuals or businesses.[113] 'Digital services' generally encompass all services which are delivered over computer networks, would be impossible to provide without information technology, and are designed to be rendered essentially automatically with minimal human intervention on the side of the supplier.[114]

This definition of 'digital services' is not a novel one. Its origins trace back to EU legislation on the common value added tax (VAT) system,[115] where it defines the term 'electronically supplied services'. This term and the 'digital services' under the SDP

106. *See* Schön, *supra* note 16, at 6 et seq.
107. *See, e.g.*, the conclusions in 2014 OECD BEPS Action 1 Deliverable, *supra* note 80, at 84 et seq.; 2015 OECD BEPS Action 1 Report, *supra* note 14, paras 151 et seq.; 2018 OECD Interim Report, *supra* note 7, paras 130 et seq.
108. 2014 OECD BEPS Action 1 Deliverable, *supra* note 80, at 143 et seq. proposes an *a priori* limitation to 'fully dematerialized digital activities'. 2015 OECD BEPS Action 1 Report, *supra* note 14, paras 281 et seq. recommends a combination of revenue factors with digital or user-based factors as a threshold for new PE concepts, thus making a seemingly neutral PE provision effectively applicable to certain forms of digital operations only.
109. *See* already §7.02[C] *supra*.
110. *See* 2018 OECD Interim Report, *supra* note 7, paras 388 et seq.
111. *See* with further details 2018 DST Directive Proposal, *supra* note 11, at 7 et seq. & 24 et seq. (proposed Art. 3).
112. 2018 SDP Directive Proposal, *supra* note 2, at 16 (proposed Art. 3).
113. *Ibid.* at 14 (proposed Art. 3 paras 2 and 4).
114. *Ibid.* at 7 & 14 et seq. (proposed Art. 3 para. 5).
115. Council Implementing Regulation (EU) No 282/2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax, Art. 7 [2011] OJ L 77.

Directive are intended to include the same kind of services.[116] Even the exemplary list of services particularly covered by the definition and the list of exemptions[117] (partly moved to annexes[118]) are copied word by word from that VAT provision. It has to be noted, though, that the VAT provision is used in its original form ignoring subsequent amendments.[119] The SDP definition of 'digital services' thus differs in detail from the VAT definition as currently in force.

One aspect the SDP proposal adds to the original VAT definition is an explicit exemption for sales of (regular) goods or services, which are merely 'facilitated' by using digital networks. Thus, the SDP Directive should cover the provision of access to a digital market place, but not the sales concluded there. The Commission considers this essential, as the SDP should not establish a taxable nexus based on the place of consumption only.[120] This clearly stated objective, however, makes the borrowing of the 'digital services' definition from VAT, a consumption tax, without any fundamental adaptions seem somewhat contradictory.

Indeed, the treatment of software and digital versions of media content (e.g., e-books, electronic versions of newspapers, music or movies) seems inconsistent, considering the Commission explicitly wants the SDP concept not to cover 'mere' sales of goods and services, even when conducted online. The supply of digitized products generally, however, is, deemed a 'digital service'.[121] Providing access to or downloads of software, the digitized content of books, photographs, music, films or games are *inter alia* listed as particular examples.[122] However, supplying the same content on physical media (e.g., a data disc) is exempt (even in cases of distance selling).[123] Therefore, not the material content provided by a seller but the way of delivery or transmission determines whether this sale is covered by the SDP rules. This becomes particularly notable in cases of online retailers offering the same product (e.g., a certain music album, book or video game) on one webpage in different formats as downloadable or 'physical' version (e.g., an audiobook as download or on compact disc).

One could argue that downloads of 'digital goods' can often be processed fully automatized and over far distances once the basic system is set up while the delivery of physical media with the same content usually still requires 'brick and mortar' business operations like storage and transport. Human contribution and physical proximity to a client's location may still be beneficial for such operations, thus making them more likely to establish a 'traditional PE' close to the market jurisdiction. Such justification of the SDP, however, revealed quite obviously a reorientation of tax policy

116. 2018 SDP Directive Proposal, *supra* note 2, at 7.
117. *Ibid.* at 14 et seq. (proposed Art. 3 para. 5).
118. EU Comm'n, Annexes to the Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, 2 et seq. COM(2018) 147 final (hereinafter '2018 SDP Directive Proposal Annexes').
119. Council Implementing Regulation (EU) No 1042/2013 amending Implementing Regulation (EU) No 282/2011 as regards the place of supply of services, Art. 1 [2013] OJ L 284.
120. 2018 SDP Directive Proposal, *supra* note 2, at 7.
121. *Ibid.* at 14 (proposed Art. 3 para. 5(a)).
122. 2018 SDP Directive Proposal Annexes Taxation, *supra* note 118, at 2 (Annex II, points (f), (l), (m), (t), (v), (w)).
123. *Ibid.* at 3 (Annex III, points (d)–(h)).

towards a more market-, demand- or destination-based income taxation. The current key argument for the introduction of 'digital PEs', namely user's contribution to 'value creation'[124] or the role of intellectual property,[125] can hardly be raised in defence of a different treatment of downloads vis-à-vis physical copies of the same content. For the users, downloading is just a way of transmission but does not fundamentally change their involvement in the service. The intellectual property embodied in the content provided and monetarized by the business is also the same in both cases (only the digital platform providing and processing the downloads might constitute an additional intellectual property element).

Except the (policy-driven) desire for the establishment of a PE at or close to the place of consumption, there barely seems to be any justification for specific provisions on downloads in income taxation. The profit arising from the (distance) sale of digital content does not change its nature and origin, whether that content is transferred by download or delivery of a storage medium. The proposed directive aims to avoid application of the SDP concept to mere sales of goods or services just because the transaction is 'facilitated by using the Internet'.[126] Using the Internet as a quasi-means of transportation in essence also facilitates the underlying transaction without fundamentally changing the 'product'. The content itself usually is at the parties' central interest and embodies the actual 'value' transferred. Singling out profits from downloads just because they can more easily be provided remotely would barely be different from distinguishing between profits from sales 'ex-works' and profits from distance selling.

Under the EU's common VAT system, which differs between the 'supply of goods' and the 'supply of services',[127] different treatment of downloads and delivery of the same content on physical media may, however, be reasonable. Nevertheless, even in the area of VAT, one of the Commission's proposals presently under debate pushes for the possibility of equal treatment of downloads and physical media: E-publications (e.g., e-books) as 'electronically provided services' currently fall under the standard VAT rates while Member States may apply a reduced rate to printed books, newspapers and periodicals. As both, cross-border sales of goods and electronic services have gradually been redesigned to be taxable at the same place (consumer's location) and tax competition for the lowest VAT rate is thus no longer a prime concern, the mandatory unequal treatment of e-publications and printed content is considered outdated. The Commission explicitly mentions that both formats offer the same content for users.[128] Yet again, given the statutory place of consumption is unaffected by the 'style of delivery', the Commission itself does not recognize any material difference in the content provided that would justify different tax treatment. As the designated aim of the SDP is not to focus on the place of consumption only, one might

124. *See* §7.02[C] *supra*.
125. *See, e.g.*, 2018 OECD Interim Report, *supra* note 7, paras 135 et seq.
126. 2018 SDP Directive Proposal, *supra* note 2, at 15 (proposed Art. 3 para. 5 final sentence).
127. Council Directive 2006/112/EC on the common system of value added tax, Art. 2 para. 1(a) and (c) and Arts 14 et seq. and 24 et seq. [2006] OJ L 347, 11.
128. *See* EU Comm'n, Proposal for a Council Directive amending Directive 2006/112/EC, as regards rates of value added tax applied to books, newspapers and periodicals, 2 COM(2016) 758 final.

The presumption does not apply (i.e., can be rebutted) when the initial service provider is explicitly indicated as the supplier by the taxable person taking part in the supply,[56] and this is reflected in the contractual arrangements with the customer, either because the initial supplier is identified on the invoice issued by each person taking part in the B2B supply or in the customer's bill or receipt in the case of a B2C supply.[57] When these (cumulative) conditions are met, the initial provider of the electronically supplied service will remain the one liable for assessing and collecting the tax.[58]

A taxable person taking part in the supply by authorising payment or delivery[59] or setting the terms and conditions of the supply will, however, have no possibility to escape from the application of the presumption, even if he/she fulfils these conditions (one of the three events is enough to exclude the rebuttal of the presumption).[60] In contrast, a taxable person only processing the payment will not be covered by the presumption.

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a portal such as a marketplace for applications, a taxable person taking part in that supply shall be presumed to be acting in his own name but on behalf of the provider of those services unless that provider is explicitly indicated as the supplier by that taxable person and that is reflected in the contractual arrangements between the parties. In order to regard the provider of electronically supplied services as being explicitly indicated as the supplier of those services by the taxable person, the following conditions shall be met:

(a) the invoice issued or made available by each taxable person taking part in the supply of the electronically supplied services must identify such services and the supplier thereof;

(b) the bill or receipt issued or made available to the customer must identify the electronically supplied services and the supplier thereof. For the purposes of this paragraph, a taxable person who, with regard to a supply of electronically supplied services, authorizes the charge to the customer or the delivery of the services, or sets the general terms and conditions of the supply, shall not be permitted to explicitly indicate another person as the supplier of those services.

(b) …

3. This Article shall not apply to a taxable person who only provides for processing of payments in respect of electronically supplied services or of telephone services provided through the internet, including voice over internet Protocol (VoIP), and who does not take part in the supply of those electronically supplied services or telephone services.

56. EC explanatory notes, 33, clarify that the identification of the supplier must be clear and unambiguous (i.e., can be made by a code provided it is clear enough for all the parties, does not need to include full coordinates). European Commission.
57. EC explanatory notes, 24.
58. *Ibid.* at 32–33.
59. *Ibid.* at 34. According to the EC explanatory notes, authorizing the payment means deciding that the customer's account, credit or debit card can be debited as payment for the electronically supplied service while authorizing the delivery refers to deciding whether, at what time or under which preconditions the delivery is made. In practice, a taxable person authorizes a delivery when he either sends approval to start the delivery of the service, delivers the service himself or instructs a third party to do so (in practice the person authorizing the delivery is likely to be the one who controls the technical platform over which the services are provided).
60. *Ibid.* at 34–35. According to the EC explanatory notes, this for example includes the terms and conditions set by marketplaces and similar platforms requiring users to agree to general terms and conditions for doing business with that website or platform (such as maintaining an account) as well as the general terms and conditions (including licence agreements) which the final consumer has to agree with before receiving access to the app or content. Illustrative charts of the scenario in which all the intermediaries rebutted the presumption and in which some intermediaries are caught and not others are offered on the following pages.

According to the EC explanatory notes, if at any stage an intermediary is covered by the presumption (either because one or two above conditions are not met or if he/she authorizes the payment or delivery or sets the terms conditions), it will not be possible for intermediaries further down the chain to indicate the original supplier as the supplier of the service. In that case, it will only be possible to go back up to the first intermediary covered by the presumption.

The EC explanatory notes also give several examples (with illustrative charts) of situations in which a taxable person is, in the EC's opinion, 'taking part' in the supply for the purpose of Article 9a of the Implementing Regulation. This includes the case in which the taxable person owns or manages the technical platform over which supplies are provided, controls or exerts influence on the pricing, issues a VAT invoice, receipts, or bills to the customer, provides customer support in relation to the service supplied, owns the customer data, or exerts influence over the presentation and format of the virtual market place 'so that the brand and identity of the taxable person are significantly more prominent than those of the other persons involved in the supply' (and here the explanatory notes explicitly refer to app stores).[61]

The EC explanatory notes also stress that the assessment of the chain supply should start at the level of the final consumer and move upstream in the chain.[62] In other words, in case several intermediaries could be covered by the presumption, it is the intermediary covered by the presumption under 9a of the Implementing Regulation that is the closest to the customer that will be the taxable person. The explanatory notes further hold that a taxable person should normally be deemed to be taking part in the supply if contractual or legal arrangements stipulate clearly that this person is acting in his own name but on behalf of the initial provider and this reflects reality, but that if the contractual or legal arrangements may be not sufficiently clear on that question, all the factual features of the transaction need be taken into account. The notes also clarify that it is not sufficient to insert a clause in the contract that would exclude a taxable person from the chain of transaction if this does not reflect economic reality.[63] Because a taxable person only processing the payment will not be covered by the presumption, the EC explanatory notes analyse more concrete situations where the Internet provider or mobile operator facilitates the flow of cash and/or content.[64] In short, the question in these cases is whether the participation of these intermediaries is sufficiently predominant.

Shifting the tax liability to the successive intermediaries taking part in such chain supplies seems a logical and desirable improvement that increases legal certainty. As a matter of fact, when a digital supplier relies on several intermediaries to market his products (including for example a marketplace for applications), he will in many cases not have any contact whatsoever with final customers. In these circumstances, he cannot reasonably be expected to correctly assess and collect VAT on final supplies. In contrast, intermediaries will in many cases have easier access to relevant and reliable

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61. *Ibid.* at 28–29.
62. *Ibid.* at 35.
63. *Ibid.* at 27.
64. *Ibid.* at 29.

information regarding customers, obtained in the context of more established relationships (e.g., if the intermediary covered by the presumption is a marketplace for applications to which all the devices of the customer are connected, e.g., Apple store).

This having been said, because of the complexity of some transaction chains, and the high number of intermediaries possibly involved in an online supply, implementing Article 9a of the Implementing Regulation 282/2011 may not always be so easy and the EC explanatory notes are in this case extremely useful, provided the interpretations given therein are fully endorsed by the Member States and would be confirmed by the CJEU. In the author's view, however, the EC explanatory notes offer a rather disputable interpretation of this provision. As a matter of fact, even though Article 9a of the Implementing Regulation provides that an intermediary, who authorizes the charge to the customer or the delivery of the services or sets the general terms and conditions of the supply, cannot indicate another person as the supplier of those services (and therefore is automatically to be considered as the taxable person in the supply), it does not say anything that, in the author's view, can be interpreted as including intermediaries who, for example, provide customer support in relation to the service supplied, exert influence over the presentation and format of a marketplace or own customers data.

Some cases will also remain more difficult to handle, for example when, at the end of the chain, two intermediaries 'taking part' in the supply can be considered as equally close to the final customer, or when the different intermediaries are not aware of the others' 'interventions', and therefore cannot assess how close they are to the final consumer. However, it can be assumed that in the great majority of the cases, intermediaries 'taking part' to a supply will know who else is involved in the supply and how 'close' they are to the customers. Moreover, even if Article 9a of the Implementing Regulation 282/2011 may be complex to implement, the complexity in fact mostly comes from the transactional scenario chosen by the taxable persons involved.

[4] Changes to Come with the Adoption of the E-Commerce Package?

[a] *An 'E-Commerce Package for All B2C E-Commerce Transactions'*

On 5 December 2017 the VAT 'e-commerce package' was adopted. The package is composed of one directive (Council Directive 2017/2455 amending Directive 2006/112/EC and Directive 2009/132/EC as regards certain VAT obligations for supplies of services and distance sales of goods) and two regulations (Implementing Regulation (EU) 2017/2459 amending Implementing Regulation (EU) No. 282/2011 laying down implementing measures for Directive 2006/112/EC on the common system of VAT and Council Regulation (EU) 2017/2454 amending Regulation (EU) No. 904/2010 on administrative cooperation and combating fraud in the field of VAT). The e-commerce package covers all B2C 'e-commerce transactions', including supplies of intra-EU and inbound B2C electronically supplied services, intra-EU B2C distance sales

of goods and B2C imports. The next subsections summarize the amendments that are made to the provisions that concern electronically supplied services only.

[b] *Availability of the Non-union Scheme for Non-EU Suppliers with an EU VAT Number*

At the moment, non-EU taxable persons who do have a VAT number in the EU (for occasional supplies) are allowed to use neither the non-EU scheme nor the EU scheme. As a consequence, they have to register in each jurisdiction of consumption. As of 2019, a taxable person not established in the EU but having an EU VAT number will be able to use the MOSS (non-Union scheme). A loophole of the current MOSS system will thus be fixed.

[c] *A First Threshold of EUR 10,000 (as of 2019)*

As of 2019, a threshold of EUR 10,000 will be applied below which the place of supply of B2C supplies of electronically supplied services will be in the Member State of the supplier. Only B2C supplies are taken into account for the application of the threshold.[65] We will thus have a comeback of the origin principle in the case of intra-EU B2C supplies when the supplier has a small cross-border turnover. This move goes at odds with the OECD VAT/GST guidelines that services and intangibles should be taxed at destination in order to ensure neutrality in cross-border trade.[66] As a result thereof, distortions of competition may again arise in favour of taxable persons located in low VAT Member States. In addition, this step backward reintroduces a discrimination towards non-EU businesses that will still be required to collect the tax at destination (with the related compliance burden) irrespective of the volume of sales to the EU.

From a government perspective the risk also exists that taxable persons with a low cross-border turnover under-declare VAT in order to remain under the threshold (which they might not be tempted to do if the consequences of exceeding the threshold were not as substantial as having to register to the MOSS and make periodical returns even in the absence of sales in a given period).

On the positive side, the threshold is likely to be a relief for EU taxable persons making a few sales cross-border. Origin taxation should moreover remain optional. In other words, small and medium-sized enterprises (SMEs) should be 'allowed to use the MOSS anyhow, e.g., if during a calendar year their turnover is exceptionally below the threshold'.

Another positive aspect is that it mitigates to a certain extent the non-applicability of the SME exemption scheme at a cross-border level (at least for what concerns digital suppliers). As confirmed by the CJEU in the *Schmelz* case,[67] Member States are indeed not obliged to grant the benefit of their domestic SME scheme to taxable person located

65. Paragraphs 2 to 5 to be added to VAT Directive, Art. 58. This means that a company with a large domestic turnover but a small cross-border turnover will also be able to benefit from the option.
66. OECD, *International VAT/GST Guidelines*, *supra* note 3.
67. *Schmelz*, C-97/09, Judgment, EU:C:2010:632.

in another Member State (according to the CJEU, this is an obstacle to the free movement of services that is justified by the effectiveness of tax controls).[68] While a simplified registration via the MOSS would already be easier than a traditional registration for small digital suppliers that are exempt at home, an origin-based taxation (exemption) is even easier.[69]

[d] *Home Country Rules for Invoicing and Record-Keeping*

Also as of 2019, the invoicing rules of the Member State of identification will apply.[70] In other words, while the Member States of consumption have the taxing rights, they should accept to audit taxable persons on the basis of invoices drawn up in accordance with other Member States rules. This is likely to be a major relief for businesses. On the downside, however, they will have to keep records of all transactions for a period of ten years, which largely exceeds the record-keeping requirements of most Member States.

From a government perspective, it remains to be seen how tax administrations will audit taxable persons on the basis of invoices of a very different format (and in different languages).

[e] *Relaxed Customer Identification Requirement below a Second Threshold of EUR 100,000*

The requirements regarding customer location in the case of electronically supplied services will also be relaxed as of 2019. From that date, a single piece of evidence will be sufficient (instead of two as mentioned above) where the total annual value of intra-EU B2C supplies, exclusive of VAT, does not exceed EUR 100,000.[71] This threshold does thus again only apply to intra-EU supplies (in the same way as the first threshold of EUR 10,000 discussed above). Accordingly, it again provides for a less favourable treatment of non-EU businesses. The question then arises how are small non-EU taxable persons supposed to comply with the two pieces of evidence requirement when it is clearly acknowledged that small EU taxable persons cannot?

In general, also, it seems that only requiring one piece of evidence means that it will be very easy for fraudulent customers to obtain VAT-free supplies (e.g., by changing their IP address or by providing a false billing address). For the sake of clarity, and as already written elsewhere, the author believes that the two pieces of evidence requirement were difficult to abide by SMEs.[72] However, the solution does, in the

68. For an analysis of this decision, see Marie Lamensch (2013) *Lenient Constitutional Control of the VAT Exemption for Small- and-Medium Sized Enterprises? – Commentary on the European Court Decision in the Schmelz case, in Tax Law in the Light of Judgments: Interaction Between European law and Domestic Courts – 2012; Tax Planning: What Is (Un)acceptable – 2013, in* 5 *Forum Reports on European Taxation* (Servaas van Thiel ed., CFE 2013).
69. As of 2021, the same threshold will apply for intra-EU distance supplies of goods.
70. VAT Directive, Art. 219(a).
71. Implementing Regulation 2011, Art. 24(b), paras 2 & 3.
72. Marie Lamensch, *The 2015 Rules for Electronically Supplied Services – Compliance Issues*, 26 Int'l VAT Monitor 11 (2015).

author's view, not lie in the relaxing of this requirement but rather in the design of an alternative method of assessing and collection VAT on electronically supplied services.[73]

[f] *Longer Deadlines to Submit MOSS Returns and Easier Procedure to Correct VAT Returns*

As of 2021, the deadline to submit MOSS returns will be extended, from twentieth to the last day of the month following the end of the tax period.[74]

Another positive change for business is that, from 2021 on, it will also be possible to correct previous VAT returns in a subsequent return (instead of in the returns of the tax periods to which the corrections relate).[75]

[g] *Final Comments on the E-commerce Package*

We already noted that the newly adopted e-commerce package does not address the flaws of the current rules applicable in the case of B2B supplies.

With respect to B2C supplies, although it does contain several amendments, it is regrettable that nothing is foreseen to address the key issue of the low level of compliance by non-EU taxable persons (as reflected in the very low number of MOSS registrations by non-EU suppliers). In this context, it is also regrettable that difficult and costly verification requirements are being maintained on non-EU taxable persons regarding customer location (while they are being softened for the smaller EU suppliers because the EC itself acknowledges that the current requirements are difficult to comply with). This will certainly not help increasing the level of compliance from non-EU taxable persons. Consequently, the EU Member States will continue to lose substantial VAT revenue.

§9.03 ELECTRONICALLY SUPPLIED SERVICES: EU VAT DIRECTIVE PROVISIONS ON REDUCED RATES AND RECENT EC PROPOSAL

[A] Current Rules

In accordance with Article 98(2) of the VAT Directive, electronically supplied services cannot be subject to reduced rates. In 2015, the CJEU had to confirm that both French and Luxembourg legislation providing for the application of reduced rates to e-books were infringing the VAT Directive and thereby causing distortions of competition with the twenty-six other Member States.[76] The Court further decided that Article 98(2) of

73. Lamensch, *supra* note 8.
74. VAT Directive Art. 369(f) for the EU scheme; *and* VAT Directive Art. 364 for the non-EU scheme.
75. VAT Directive Art. 365 for the non-EU scheme; *and* VAT Directive Art. 369(g)(4) for the EU scheme.
76. *Commission* v *France*, C-479/13, Judgment, EU:C:2015:141; *and Commission* v *Luxembourg*, C-502/13, Judgment, EU:C:2015:143. To be noted that the distortions of competition in question

the VAT Directive could not be challenged on the basis of the principle of fiscal neutrality because this principle 'cannot extend the scope of reduced rates of VAT to the supply of electronic books' and because 'Point 6 of Annex III to the VAT Directive is not a provision which, unequivocally, extends the scope of reduced rates of VAT to the supply of electronic books'.[77] The Court here referred to its decision in C-174/11 Zimmermann,[78] that:

> The principle of fiscal neutrality – a particular expression of the principle of equal treatment at the level of secondary EU law and in the specific area of taxation …[79] is not a rule of primary law against which it is possible to test the validity of an exemption provided for under Article 13 of the Sixth Directive. Nor does that principle make it possible for the scope of such an exemption to be extended in the absence of an unequivocal provision to that effect.

The Court thus decided that France and Luxembourg were not justified in applying reduced rates to e-books under the arguments, first, that the text of the VAT Directive as currently drafted does not allow for the application of reduced rates to e-books and, second, that the principle of fiscal neutrality cannot overrule the text of the VAT Directive. As written elsewhere, the author is of the opinion that the principle of neutrality is not breached in this case because books and e-books are not similar and therefore a different treatment cannot be found discriminatory.[80] In her opinion, the decision to apply different rate may be disputable from a tax policy perspective (why not also encouraging reading e-books?) but not on the ground of equal treatment.

The CJEU eventually adopted a different view in the C-390/15 *RPO* case. The referring Court was asking the CJEU whether Article 98(2) of the VAT Directive read in conjunction with point 6 of Annex III would not be invalid on the ground that, by ruling out any possibility for the Member States of applying a reduced rate of VAT to the

have naturally disappeared on 1 January 2015, when all intra-EU supplies of electronically supplied services to non-taxable persons became taxable at destination in accordance with VAT Directive, Art. 58(c), as amended by Council Directive 2008/8 amending Directive 2006/112/EC as regards the place of supply of services, Art. 5, [2008] OJ L 44/11.

77. *Commission* v *Luxembourg*, C-502/13, para. 51.
78. *Zimmermann*, C-174/11, Judgment, EU:C:2012:716; Same decision in *Deutsche Bank*, C-44/11, Judgment, EU:C:2012:484, in which the Court endorsed Advocate General Sharpston's (ad absurdum) reasoning (*Deutsche Bank*, C-44/11, AG Opinion, EU:C:2012:276, pt. 60) that:

> If all activities partly in competition with each other had to receive the same VAT treatment, the final result would be – since practically every activity overlaps to some extent with another – to eliminate all differences in VAT treatment entirely. That would (presumably) lead to the elimination of all exemptions, since the VAT system exists only to tax transactions.

79. Reference is made to *NCC Construction Danmark*, C-174/08, Judgment, EU:C:2009:669, para. 44.
80. Marie Lamensch, *Different VAT Rates for Digital and Paperback Publications in the EU, a Breach of 'Fiscal Neutrality'? A Tentative Answer and Broader Reflection on the Coherence of the EU Rules Prohibiting Indirect Tax Discrimination*, 4 World J. VAT/GST L. 1 (2015). *See also*, *K Oy*, C-219/13, Judgment, EU:C:2014:2207, that did not concern electronically supplied services but books supplied in a physical format other than a paper format (i.e., an electronic file on a physical support).

supply of e-books, that article would infringe the principle of equal treatment as set out in Article 20 of the EU Charter of Fundamental Rights. In a first step the CJEU found that, in the light of the objective pursued by Article 98(2) of the VAT Directive, read in conjunction with point 6 of Annex III, the supply of digital books on all physical means of support and the supply of digital books electronically amount to comparable situations.[81] The CJEU, however, still did not conclude to a breach of neutrality because it considered that the discrimination resulting from the non-applicability of reduced rates to the latter situation is justified.[82]

According to the CJEU, when the EU legislature adopts a tax measure:

> it is called upon to make political, economic and social choices, and to rank divergent interests or to undertake complex assessments. Consequently, it should, in that context, be accorded a broad discretion, so that judicial review of compliance with the conditions set out in the previous paragraph of this judgment must be limited to review as to manifest error.[83]

Based on the preparatory documents for Directive 2002/38 (which introduced the first provisions as regards electronically supplied services in the VAT Directive), the CJEU highlighted that the amendments then proposed were 'a first step in implementing a new policy on VAT, intended to simplify and strengthen the VAT system in order to encourage legitimate commercial transactions within the internal market'[84] and that it was considered necessary to make electronically supplied services subject to clear, simple and uniform rules in order that the VAT rate applicable to those services may be established with certainty and, thus, that the administration of VAT by taxable persons and national tax authorities is facilitated'.[85] It is therefore on the basis of the principle of legal certainty (in the sense that EU rules should enable those concerned to know unequivocally the extent of their rights and obligations so that they are in a position to order their affairs with the benefit of full information)[86] and simplicity (considering that it is a legitimate objective to lay down general rules which can be easily applied by economic operators and are easily verified by the competent national authorities)[87] that the non-applicability of reduced rates to electronically supplied services, which 'spares taxable persons and national tax authorities from an obligation to examine, for each type of electronic service that is supplied, whether it falls within one of the categories of services that qualify for such a rate under Annex III to the VAT' and the resulting discrimination would be justified. The CJEU further confirms that the measures are appropriate and proportionate to reach that objective.[88]

81. *RPO*, C-390/15, Judgment, EU:C:2017:174, para. 49.
82. *Ibid.* para. 52; with reference to *Arcelor Atlantique and Lorraine & Others*, C-127/07, Judgment, EU:C:2008:728, para. 46.
83. *RPO*, C-390/15, para. 54; with reference to (*see*, to that effect, judgments *British American Tobacco (Investments) and Imperial Tobacco*, C-491/01, Judgment, EU:C:2002:741, para. 123; *and Billerud Karlsborg and Billerud Skärblacka*, C-203/12, Judgment, EU:C:2013:664, para. 35).
84. *RPO*, C-390/15, para. 56.
85. *Ibid.* para. 57.
86. *Ibid.* para. 59.
87. *Ibid.* para. 60.
88. *Ibid.* paras 63–64.

While the general prohibition laid down under Article 98(2) of the VAT Directive still remains valid, on 6 November 2018, the Member States have adopted a Directive that allows them to apply reduced, super-reduced, or zero VAT rates to 'electronic publications', thereby allowing future alignment of VAT rules for electronic and 'physical' publications.[89] Although this Directive only concerns 'electronic publications', this might be actually be the first step towards a generalization of reduced rates on electronically supplied services as the EC subsequently issued a proposal which would allow Member States more flexibility as regards rates in general, in the context of the 'definitive' VAT system (the 6 November Directive will only apply until such a broader liberalization is achieved). The key features of this EC proposal will be sketched and briefly commented in the next section.

[B] EC Proposal: Possibility to Apply Reduced Rates in the Future?

On 18 January 2018, the EC tabled an ambitious Proposal regarding VAT rates.[90] The EC indeed proposes that more flexibility be offered to the Member States regarding the applicable rate structure in general – not only with respect to electronic publications. The reasons is that the historical ambition to set up a 'definitive VAT system' based on the principle of origin (which required a certain level of harmonization of rates in order to avoid distortions of competition) was abandoned, and the Commission is now proposing a 'definitive VAT system' based on the destination principle (under which different rates would not distort competition).

The main points of this proposal can be summarized as follows.

A first important point is that no amendment of Articles 96 and 97 of the VAT Directive is foreseen, which means that even in the new VAT rate system a standard rate of at least 15% will have to be applied to both supplies of goods and services.

A second point is that a new Article 98 of the VAT Directive, which combines the current Articles 98 and 99 of the VAT Directive, would allow Member States to not only maintain the two existent reduced rates (of a minimum of 5%) but to also add an additional reduced rate with no minimum requirement and a zero rate. However, these reduced rates should always benefit the final consumer and should be in the general interest. In practice, it means that reduced rates should not apply to supplies that are only used as intermediate input and will not eventually be sold to final consumers. Moreover, the new Article 99a would require from Member States that take into account that the weighted average VAT rate, which should in any case exceed 12%.

A third and most important point is that the method of listing supplies for which a reduced rate can be applied (current Annex III) would no longer apply. A reverse

89. Council Directive amending Directive 2006/112/EC, as regards rates of value added tax applied to books, newspapers, and periodicals, OJ L 286, 14.11.2018, pp. 20–21. The proposal for this Directive was adopted on the same day as the proposal for the e-commerce VAT package.
90. *Ibid.* (SWD(2018) 7 final) – (SWD(2018) 8 final COM(2018) 20 final).

method is proposed instead: a new Annex (Annex IIIa) would indeed list the supplies to which reduced rates could not apply (e.g., supply of excise goods, precious metals, jewellery, alcoholic beverages and tobacco products, to the supply of weapons, oil, computers, watches, furniture, musical instruments, works of art and surprisingly even financial and insurance services).[91]

An in-depth analysis of this proposal would go beyond the scope of this manuscript. A general comment may, however, be made that is relevant for electronically supplied services: although the initial idea that the EU VAT system would eventually become 'origin based' was abandoned, the author shares the opinion of other scholars[92] that it remains necessary to maintain a certain level of approximation with respect to rates for the sake of the achievement of the Internal Market, i.e., an area without internal borders where goods and services move freely. As a matter of fact, the possibility that VAT rates schemes would greatly vary among the Member States is a clear obstacle to cross-border trade within the EU. For what concerns electronically supplied services in particular, the arguments of legal certainty and simplicity raised by the CJEU in the RPO case are extremely relevant. In the case of a digital supplier serving customers in potentially all Member State, not being able to apply the standard rate would indeed be extremely complex. All the more so if different rates were adopted depending on the type of electronically supplied services (e.g., Music, videos, e-books, audiobooks).

§9.04 CONCLUSIONS AND FINAL COMMENTS

After setting the scene by summarizing the challenges to which the VAT system in general is confronted with the development of the Digital Economy and the apparition of 'digital supplies', this contribution sought to provide a detailed analysis of the place of supply and related collection rules that apply to 'electronically supplied services' under the EU VAT Directive and the Implementing Regulations. While pointing at the flaws of the current legislation, it also discussed the positive and less positive amendments that will enter into effect in 2019 and 2021. A main conclusion that can be drawn from this analysis is that enforcement, in particular on non-EU taxable persons making supplies to EU non-taxable consumers, remains a major weakness. In the author's view, only a complete change of approach – and the reliance on new technologies – would enable the Member States to effectively collect their VAT on such digital supplies.

91. EU Comm'n, Annex to the Proposal for a Council Directive amending Directive 2006/112/EC, *supra* note 91, COM(2018) 20. The European Commission justifies this list by stating that a standard rate in these domains prevents distortions of competition and serves as a counterbalance against the increased flexibility that is given to the Member States.
92. *See* Rita de la Feria & Max Schofield, *Towards an [Unlawful] Modernized EU VAT Rate Policy*, 26 EC Tax Rev. 89 (2017). The authors conclude that: 'Article 113 TFEU could not be used as a legal basis for a Directive aimed at disharmonizing VAT rates, and that any such Directive, would lack legal basis and, consequently, be unlawful under the EU constitutional principle of conferral of powers.'