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Taxing the Digital Economy Post-BEPS…Seriously

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TAXING THE DIGITAL ECONOMY POST BEPS . . . SERIOUSLY

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ABSTRACT

For years the advent of the digital economy has left countries stumped in their attempt to tax income earned by foreign firms without physical presence within their jurisdiction. International organizations and their member countries have failed in their attempts to tweak the rules of the international tax regime and address these challenges presented by the digital economy. This article argues that such conservative approach could not work, and fundamental reform is inevitable. The article proposes a withholding tax solution, explaining its merits and demonstrating its superiority over alternative reforms proposed to date.

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INTRODUCTION: THE PROBLEM

Adaptability is key to survival.[1] This famous Darwinist insight is apt, albeit metaphorically, for a contemporary analysis of the international tax

1. Insightful, even though often wrongfully attributed to Charles Darwin. *See* Darwin Correspondence Project, University of Cambridge, https://www.darwinproject.ac.uk/people/about-darwin/six-things-darwin-never-said#quote1(last visited Jan. 19, 2019).

regime.[2] Legal norms are constantly challenged by developments in the human societies which they serve, and constantly face the choice between certainty and fitness, between stability and adaptability, and between tweaking and fundamental reforms. One could hardly think of a more dramatic change than the digital revolution we all face at the present,[3] changing our culture, our thinking, and our markets, naturally applying pressure on legal regimes to respond.[4]

The international tax regime has struggled in face of this pressure. From radio waves to satellite-remitted content, from distant catalogue sales to electronic commerce, and cloud computing, the fundamental physical presence requirement for tax jurisdiction has become increasingly anachronistic.[5] The current tax rules were designed for a long gone, pure bricks-and-mortar economy, one that has begun to change almost from the very beginning of the regime itself.[6] As intangibles increasingly dominate cross-border trade, the traditional rules begin to struggle.[7] This struggle is evolving into a crisis with the more recent advent of true digital transactions, in which "Signals, in effect, are selling signals."[8] Charles Kingson wrote one of the first, and still one of the most thoughtful and well-articulated scholarly articles on the taxation of digital transactions.[9] Kingson identified the difficulties involved with international tax law reform and concluded that such reform would be inevitable due to the incompatibility between the international tax regime and the digital economy.[10]

The path to reform has, however, been treacherous. Beyond the

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2. Or, generally, to the contemporary business environment, see, e.g., Martin Reeves & Mike Deimler, *Adaptability: The New Competitive Advantage*, 89 HARV. BUS. REV. 134 (2011).

3. *See, e.g.*, MARSHALL MCLUHAN & BRUCE R. POWERS, THE GLOBAL VILLAGE: TRANSFORMATIONS IN WORLD LIFE AND MEDIA IN THE 21ST CENTURY (1989); DIRK HELBING, THINKING AHEAD—ESSAYS ON BIG DATA, DIGITAL REVOLUTION, AND PARTICIPATORY MARKET SOCIETY (2015).

4. *See, e.g.*, REINER SCHULZE & DIRK STAUDENMAYER, DIGITAL REVOLUTION: CHALLENGES FOR CONTRACT LAW IN PRACTICE (2016); Stanford Technology Law Review's 2012 Symposium: *First Amendment Challenges in the Digital Age*, *available at* https://law.stanford.edu/stanford-technology-law-review-stlr/stlr-past-symposia/#slsnav-2013 (last visited Jan. 19, 2019).

5. Charles I. Kingson, *The David Tillinghast Lecture: Taxing the Future*, 51 TAX L. REV. 641 (1996) [hereinafter Kingson, *Taxing the Future*].

6. *Id.*

7. *See, e.g.*, Lily Kahng, *The Taxation of Intellectual Capital*, 66 FLA. L. REV. 2229 (2014).

8. Kingson, *Taxing the Future*, *supra* note 5, at 649.

9. *Id.*

10. *Id. See also* Chang Hee Lee, *Impact of E-Commerce on Allocation of Tax Revenue Between Developed and Developing Countries*, 4 J. KOREAN L. 19, 21 (2004) ("[D]igital technology completely destroys the economic and legal basis for the existing rules of international taxation, implying the necessity of a complete overhaul").

natural resistance to reform, powerful stakeholders, led by the most developed world economies, understood that reform would entail loss of their controlling dominance of the international tax regime,[11] dominance that allowed them to stack the odds in their favor in revenue terms.[12] Geopolitical changes, most notably the decline of the superpowers and the ascent of emerging economies, led by the BRICS countries,[13] brought with them demand for reform of the international tax rules in favor of what they viewed as a fairer division of tax revenues. This change would increase the taxing rights of source (or market) economies where consumers or users reside,[14] inevitably at the expense of the traditional powerful economies, in which most of the world capital and multinational enterprises (MNE) reside.[15]

The demand for reform went beyond the digital economy, yet it coincided with its ascent and has been most clearly demonstrated in its context.[16] The digital economy permits MNE (usually resident in a developed country) to fully operate in developing countries, taking advantage of their markets without physical presence and hence without sufficient taxable presence,[17] giving a favorable (tax) outcome that would be much more difficult and costly to devise in most old economy contexts. Therefore, the digital economy presented taxpayers with

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11. *See, e.g.*, Reuven S. Avi-Yonah, *Commentary*, 53 TAX L. REV. 167, 169 (1999) (explaining that the regime is constructed around the network of bilateral tax treaties, essentially all of which are modeled after the OECD Model Tax Convention). The original acknowledgment of the existence of such a regime was in Avi-Yonah's "The Structure of International Taxation: A Proposal for Simplification." Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301 (1996).

12. *See, e.g.*, Pasquale Pistone & Yariv Brauner, *Introduction*, *in* THE BRICS AND THE EMERGENCE OF INTERNATIONAL TAX COORDINATION (Pasquale Pistone & Yariv Brauner, eds., 2015) [hereinafter Pistone & Brauner, THE BRICS AND THE EMERGENCE OF INTERNATIONAL TAX COORDINATION].

13. *Id.*

14. *See, e.g.*, BEPS Monitoring Group, Corporate Tax and the Digital Economy (Feb. 2018), *available at* https://bepsmonitoringgroup.wordpress.com/tag/bmg/ (last visited Jan. 19, 2019).

15. *See, e.g.*, Fortune, Visualize the Global 500, *available at* http://fortune.com/global500/visualizations/?iid=recirc_g500landing-zone1 (last visited Jan. 19, 2019).

16. *See, e.g.*, OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING (2013), http://www.oecd.org/tax/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm. In this first BEPS document the OECD identified the "[a]pplication of treaty concepts to profits derived from the delivery of digital goods and services" as a key pressure area that must be addressed by the BEPS project, later reflected in action item 1. *Id.* at 47.

17. *See, e.g.*, Peter Hongler & Pasquale Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy* (WU Int'l Taxation Res. Paper Series No. 2015-15, 2015), https://ssrn.com/abstract=2591829 (last visited Jan. 19, 2019) [hereinafter Hongler & Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*].

opportunities to make their taxation largely elective.[18]

Such tax planning flexibility affects not only developing countries but also developed countries that have been starving for revenue and struggling to protect their tax base, even prior to the global financial crisis of the early 2000s.[19] The outcome of the crisis was a sufficient similarity of interests among most nations, whose politicians demanded change and reform in what evolved into the Base Erosion and Profit Shifting (BEPS) project, of which, its primary goal was a solution to the tax challenges presented by the digital economy.[20] The inherent complexity of the issue was exacerbated by the BEPS's duality of purposes: to maximize collection of taxes from MNE, likely favoring the more developed countries; and a reform to the fundamental tax base division rules, likely in favor of the less developed countries.[21]

Therefore, despite the demand of politicians for reform, the BEPS representatives of countries with diverse and often conflicting interests found it difficult to agree on the content of the reform, strengthening the conservative voices whose energy was devoted to the discrediting of any reform proposals and building on the necessary imperfection of any proposal, which seemed par for the course in any complex and novel matter. Even at the present, more than two decades after Kingson's article, serious scholars still question the wisdom of reform, advocating alternatively a more traditional avenue of tweaking the existing rules and applying them by analogy to the new economy and digital transactions.[22] This conservative approach cannot prevail. It has been aggressively tried and failed in recent decades.[23] This Article demonstrates this conclusion,

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18. *See* OECD, BEPS website, http://www.oecd.org/ctp/beps/ (last visited Jan. 19, 2019) (describing the BEPS Project).

19. A process that started even earlier as a result of globalization as explained by Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000).

20. An important initial discussion of these matters took place within the G8 organization. *See, e.g.*, Prime Minister's Office & Cabinet Office, G8 factsheet: tax, GOV.UK (June 7, 2013), https://www.gov.uk/government/publications/g8-factsheet-tax/g8-factsheet-tax. It eventually led to the G20 organization's charge of the OECD with what became the BEPS project. *See* G20, G20 Leaders Declaration, at T48, G20 at Los Cabos, Mexico (June 18-19, 2012), https://www.g20.org/sites/default/files/g2Oresources/library/G20_LeadersDeclarationFinalLosCabos.pdf. *See also* OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING, *supra* note 16 (the original OECD BEPS document).

21. *See, e.g.*, Yariv Brauner, *What the BEPS*, 16 FLA. TAX REV. 55 (2014) [hereinafter Brauner, *What the BEPS*].

22. Most notably, Wolfgang Schön, *Ten Questions about Why and How to Tax the Digitalized Economy*, 72 BULL. INT'L TAX. 278 (2018) [hereinafter Schön, *Ten Questions about Why and How to Tax the Digitalized Economy*].

23. *See* OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013) [hereinafter OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING] (discussing the BEPS project and the positioning of this issue as the project's first action item). For the project's final, not yet

making, as its first contribution, the case for reform and explaining why reform is both desirable and inevitable.

The second contribution of this Article is an analysis of the various reform proposals considered in recent years and the assessment of the circumstances required for their success. Many prescriptions for international tax reform have been presented in recent years, yet at their core they belong to two groups:[24] (1) collaborative solutions, featuring a new rule that would permit taxation of digital profits by the market economies even when the taxpayers earning such profits lack physical presence within their jurisdictions (a "virtual PE" solution, often referred to as the nexus-based approach),[25] and (2) solutions based on actions by said market economies to tax digital presence within their jurisdiction in a "rough justice" manner, reducing the benefits of unacceptable tax planning by using BEPS through withholding taxes and equalization levies.[26]

This Article advocates in favor of a withholding tax solution, arguing that it is superior to all other alternatives in the current environment. Such analysis is the third and primary contribution of this Article. The specific proposed solution does not ring-fence the digital economy, but avoids controversial, difficult to devise definitions, providing more taxing opportunities for source jurisdictions (and therefore a fairer allocation of global taxing rights). It would directly target base erosion and focus on

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conclusive report, see OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *available at* http://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm [hereinafter OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT]. For information on the OECD's continuous effort on the matter, see OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *available at* http://www.oecd.org/ctp/tax-challenges-arising-from-digitalisation-interim-report-9789264293083-en.htm.

24. This Article assumes that whatever reform is adopted, the general framework of taxation will be kept as-is (*i.e*., taxation will remain at the exclusive power of nation-states and such states will continue to use multiple types of taxes in an uncoordinated manner), particularly preserving stand-alone income (and corporate income) taxes.

25. *See, e.g*., Hongler & Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, *supra* note 17 (giving a concrete proposal for reform of the current PE rules, expanding them to include virtual presence); OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 107-13; OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 135-39.

26. *See, e.g*., Andrés Báez Moreno & Yariv Brauner, WHT in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy, (IBFD, White Paper Series 33, 2015) [hereinafter Báez Moreno & Brauner, WHT in the Service of BEPS Action 1, White Paper]; OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 113-15 (withholding solution) & 115-17 (equalization levy); OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 139-40 (withholding taxes) & 139-44 (turnover taxes, including equalization levies).

the biggest ticket items involving the largest amount of taxes, doing so without fundamental violations of the current bases of the international tax regime. This Article demonstrates that the withholding tax solution is superior to the virtual PE solution, which relies on difficult-to-envision agreements of many countries on the factors that establish the virtual presence and on controversial definitions of the digital economy to which it applies, which in effect ring-fences the digital economy against the agreement of BEPS stakeholders.[27] Furthermore, a nexus-based approach requires difficult attribution of profits to a non-physical PE, a very complex exercise within the current framework of the international tax regime. In this regard, this Article adds that the withholding solution may also be developed as a remedial tool to adequately implement the nexus-based approach if adopted. This Article rejects equalization levies and similar solutions presented as interim measures, because such solutions undermine the existing international tax regime and its nontrivial achievements to date, portraying an unrealistic picture of temporariness, and ring-fencing the digital economy or parts of it while not addressing the key issues of BEPS.

The rest of this Article is organized as follows: Part I presents the withholding solution advocated by this Article, its advantages, and key design issues it presents. Part II demonstrates that fundamental reform of the tax rules applicable to cross-border digital transactions is necessary, rejecting the alternative of further tweaking of the current rules. Once the necessity of reform is established, Part III discusses alternatives to the proposal made by this article and actual country responses based on these alternatives, evaluating them and explaining why they are less desirable than the proposal advocated by this Article.

I. THE PROPOSED SOLUTION: WITHHOLDING ON DIGITAL TRANSACTIONS

A. *The Proposal*

This Article argues that in the current circumstances the international tax regime should optimally adopt the withholding solution proposed in this Part.[28] The core proposal is to design a standard low rated final withholding tax on all base-eroding payments to non-residents,[29] with

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27. *See, e.g.*, OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 11.

28. An early version of the proposal was advocated during the BEPS project by Báez Moreno & Brauner, WHT in the Service of BEPS Action 1, White Paper, *supra* note 26.

29. The White Paper, suggested a rate of 10%, yet for the purposes of the proposal the exact rate is immaterial, so long as it is sufficiently low (perhaps in the 3%-10% range), widely

specific standard exemptions from such withholding tax for payments made to payees registered to be domestically taxed under the normal net taxation scheme.[30] Withholding or other tax arrangements that are already in place,[31] (provided by domestic law[32] or by treaties[33]) should prevail over the new tax and consequently left intact. Most of the common international tax rules, such as those applicable to wages, dividends, rents, and interest paid to non-residents, will continue to apply as prescribed by the domestic law of the source country as amended by an applicable tax treaty if any.

All other payments (*i.e.*, business related, perhaps some falling-through-the-cracks payments, and base-eroding payments) will be subject to the proposed, low withholding tax. The implementation (and enforcement) of the tax will be done primarily with the help of a corresponding rule that will require all business expenses to be matched with a specific withholding tax (applicable, but not necessarily collected at a rate above zero) or a specific exemption to be deductible. Each deduction will require therefore an identified destination (payee ID and residence)[34] and an identified payment. Payments to unidentified payees or to resident payees resident in non-cooperating jurisdictions should incur a higher than standard withholding tax.[35]

Non base-eroding payments are a secondary concern of this Article, because the primary challenge that they present to the current tax regime is administrative. This Article, nevertheless, proposes to apply the same taxing rules to these payments. Yet, because the primary administrative challenge that they present is the ineffectiveness of customers, usually individual, non-business customers who make the bulk of these payments (think withholding agents like *Amazon* or *Ebay*) this Article argues that the most plausible withholding agents in such cases must be the facilitators of these payments (*i.e.*, credit card and similar financial

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accepted and neutral in the sense that it is not extrapolated from actual, currently imposed net taxation rates.

30. The intellectual origins of this paper are in Richard Doernberg, *Electronic Commerce and International Tax Sharing*, 16 TAX NOTES INT'L 1013 (1998).

31. Such as the taxation of income attributable to PE in the source/payment state.

32. Such as the withholding on wages. *See, e.g*., 26 U.S.C. 1441 & 3401-06 (the U.S. rules that resemble most countries' rules).

33. *See*, *e.g*., 2017 OECD Model art. 10(2) (capping domestic withholding on dividend payments at 5% or 15%).

34. Beneficial ownership rules may need to be adapted to the new tax, yet their operation should be no different than it is under the current rules.

35. The White Paper suggested a rate of 15%, yet again, the exact rate is immaterial, so long as it is sufficiently higher than the withholding tax rate applicable to payments made to participating jurisdictions. *See* Báez Moreno & Brauner, WHT in the Service of BEPS Action 1, White Paper, *supra* note 26.

institutions).[36] The burden that such rule will add to these regulated institutions does not seem to be excessive as they already possess essentially all relevant information.[37] Note that because these payments are not base-eroding, countries will more easily be able to negotiate different deals among themselves, reducing or even eliminating the withholding tax, effectively converting the role of the financial institutions in such cases to information gathering agents, a role that they already regularly perform.

The rest of this Article will focus on the first part of the proposal that applies to base-eroding payments, which is the primary contribution of this Article. This proposal addresses the key concerns raised by the advent of the digital economy and the BEPS project: insufficient or difficult to collect source taxation, base erosion, and the lack of consensus (and perhaps will) among nations to more tightly coordinate their taxation of MNE. The focus on base-eroding payments is the core of the proposal, stemming from the centrality of these payments to tax planning of the kind targeted by the BEPS project (and generally by all productive, non-haven countries), yet also realizing that such payments, mainly made in Business-to-Business (B2B) transactions, are the most significant in terms of revenue and impact.[38] Next, this Part begins to make the case for the proposal with an explanation of the importance of its focus on B2B payments.

B. *Key Advantages of the Withholding Solution*

1. Focus on B2B

Meeting the challenges presented by the digital economy is vital for the stability of the international tax regime, few could ignore that, yet the exact focus of the desired reform is more controversial. The current discourse has been enveloped in the BEPS project, enjoying the benefits of political support but at the same time being handcuffed by the rhetoric that comes hand in hand with such support. It was easy to focus on the

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36. Intermediation services, such as Uber or Booking may equally serve this purpose, would require a rule that would easily identify them and coordinate their obligations with those of the financial institutions.

37. The U.S. Internal Revenue Service, for example, already requires credit card companies and similar third parties to report various types of transactions that they facilitate. *See, e.g.*, IRS website, https://www.irs.gov/tax-professionals/third-party-reporting-information-center-information-documents (last visited Feb. 27, 2019).

38. Consumer-to-Business (C2B) and Consumer-to-Consumer (C2C) payments do not erode the tax base of the source countries since they are not typically deductible. They are also dwarfed by cross-border B2B transactions. *See, e.g.*, OECD, OECD GUIDE TO MEASURING THE INFORMATION SOCIETY 204 (2011); OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 55.

most famous, largest MNE, household names in every house. For the media, which very much made BEPS a reality, it was particularly easy to highlight a lack of source taxation that almost everybody in the world could identify with, because almost everybody had been knowingly guilty of not paying taxes on personal online purchases. Much of the discourse, therefore used the *Amazon* or *eBay* purchases narrative, directly or indirectly in the discussion and consequently in the design of reform proposals.[39] Policymakers followed to this discourse, refraining from making a critical distinction between B2B and Business-to-Consumer (B2C) (or Customer-to-Customer (C2C))[40] digital transactions, despite the important differences in the type of transactions. The lack of concern about base erosion where the latter are concerned being one very relevant difference. This Article argues that this confusion between media worthiness and salience led some of the discourse astray, alternatively proposing to discuss the two business forms separately, and primarily target B2B transactions that dominate the digital economy and present the most severe BEPS challenges.

The B2B model dominates the digital economy and is expected to continue to do so despite the projected growth in both B2C and C2C.[41] B2B payments present therefore the biggest challenge to the international tax regime, beyond their base-eroding properties, being the largest in terms of both nominal magnitude and revenue potential, and at the same time the most complex, and hence difficult to track and analyze, because they are often among related parties or part of complex corporate business relationship, and not merely an individual purchasing a book on amazon.com with a credit card. The good news is that experience with early ecommerce demonstrates that self-reporting and withholding obligations were much more effective in the B2B context, especially when the payer benefits from a tax deduction for the payment (a more common than not reality in B2B), than in the B2C context. We all know the ineffectiveness of similar measures when imposed on final individual consumers. The withholding solution is the only existing alternative that discerns between these easily distinguishable sectors of the digital economy and provides solutions tailor-made to each, focusing on salience rather than on the media worthiness of the challenges.

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39. *See, e.g.*, OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, annex B (Typical Tax Planning Structures in Integrated Business Models).

40. As explained below, this Article argues that for its purposes the differences between B2C and C2C are substantively unimportant and administratively minor and therefore it discusses them together.

41. *See supra* text accompanying note 38.

2. Focus on Base-Eroding Payments

The precise focus of the proposed solution is on base-eroding payments. This focus goes hand in hand with its enforcement mechanism and the unique legitimacy and efficacy benefits of the proposal. The BEPS project made base erosion its primary target. Although profit shifting is also a key target of the project it comes in different varieties, not all of which benefit from the same support. Shifting from residence countries to "havens" is "in," yet shifting away from source countries is much less so. Base erosion is presented by the BEPS project as inappropriate and worthy of fighting because of the arbitrage opportunity it presents: reducing usually high tax in a productive jurisdiction without actual taxation anywhere; this result annihilates the reason for the deduction (generation of "more," typically taxable income) and violates the matching principle—between deductions and income. The idea is that successful productive activity cannot end up not taxed anywhere, *a fortiori* not reducing the overall effective taxation. The Withholding solution is the only alternative directly targeting the harm (base erosion) that BEPS alleges to prevent.

3. The Proposed Solution Avoids the Addition of Problematic Definitions

The BEPS work on Action 1 struggled to define the digital economy. Reading most of the work on this topic, one gets the impression that the preferred approach is to use a mechanism of the "smell test" sort to identify digital economy issues. This may be useful, especially in a preliminary investigative stage such as the one in which the BEPS Project is currently engaged. However, it would be problematic if one were to impose an actual tax on digital transactions. This is particularly important for withholding taxes, which to be successful depends on a reasonably clearly defined target or payment. A reasonably clearly defined target or payment is required because otherwise withholding agents, upon whom compliance with the rules is critical to their efficacy, are unlikely to act optimally. They may overwithhold simply to relieve themselves of any potential liability. Such behavior would result in undue hardship for investors and thereby hinder the digital economy, which is clearly something the Organization for Economic Cooperation and Development (OECD) is careful not to do. Withholding agents might also underwithhold, succumbing to pressure applied by the taxpayer based on the vagueness of the definition, naturally defeating the purpose of the rule. Therefore, for a definition to be useful, it needs to be reasonably clear.

The definition must also be standard. The core of the current difficulties faced by the international tax regime, leading to the BEPS Project, was the variety of different, uncoordinated domestic law responses to the same international tax issues. Furthermore, the definition must correspond to the purpose of the rule using the definition—the imposition of a withholding tax mechanism. It would therefore be futile, for example, to rely on a generally accurate, dictionary-style definition if it cannot be appropriately used to identify when one should or should not withhold. These three conditions seem obvious, yet a quick review of the literature on the taxation of the digital economy reveals that little attention was paid to them in recent years.

The term "digital economy" is often traced to a 1997 book titled *The Digital Economy: Promise and Peril in the Age of Networked Intelligence*.[42] As of yet, a useful, universal legal definition has yet to be produced (by that book or elsewhere). In an often-cited work, Australia defined the digital economy as "the global network of economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks."[43] This is an example of a rather useful dictionary definition that cannot be used for our purposes. One could imagine a paraphrase of such definition such as "all payments in connection with economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks." The problem with this definition is that it is probably both over- and under-inclusive.

A lot of payments, perhaps even most business payments, relate in some way or other to digital economy networks and it may be difficult to determine when this relation is sufficient to mandate withholding. Moreover, payments are often made with remote connection to digital products but with immediate connection to non-digital products in circumstances where the payor (and definitely the payee) are unaware of the connection. Such circumstances may indicate an appropriate circumstance for nonwithholding, yet it would be difficult to draw the line here and to distinguish true and merely declared ignorance in these cases. The definition may be underinclusive since it mentions particular platforms that may not be exhaustive even at present and are unlikely to be so in future. The use of nonexclusive language ("such as") provides little remedy because it is too general and likely to end up being too vague

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42. DON TAPSCOTT, THE DIGITAL ECONOMY: PROMISE AND PERIL IN THE AGE OF NETWORKED INTELLIGENCE (1997).

43. Australian Government, Department of Broadband, Communications and the Digital Economy, What is the digital economy?, *available at* http://www.dbcde.gov.au/digital_economy/what_is_the_digital_economy (accessed July 9, 2012), *cited in* Jinyan Li, *Protecting the Tax Base in the Digital Economy*, *Papers on Selected Topics in Protecting the Tax Base of Developing Countries*, Draft Paper No. 9, June 2014: http://www.un.org/esa/ffd/tax/2014TBP/Paper9_Li.pdf (accessed Nov. 1, 2014).

and useless again. Other proposals do not fare better.[44]

Unable to satisfactorily define the digital economy, one may limit the definition to its most important applications. Indeed, to date, most of the work in this context had been done on electronic commerce.[45] Alas, that work focused on the redefinition of the PE notion to include digital presence. Such redefinition is not helpful for the purposes of this Part if we wish to use it to impose a withholding tax that does not require a PE to be established. In 2011, the OECD came up with: "An electronic transaction is the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders."[46] This definition is too limited since it does not adequately address digital goods and services.

This Article does not argue that a pragmatic approach could not reach a workable definition. An instrumental definition that would emphasize precision, even at the expense of limiting the scope, could work, perhaps through the use of specific platforms, yet with the understanding that the evolution of the digital economy may quickly make these platforms obsolete. A mechanism to update and improve the definition would have to be put in place to make it workable and address this issue in the future.[47] Nonetheless, this Article argues that the withholding solution presents a unique opportunity as the only alternative that does not necessitate reliance on imperfect definitions. The withholding solution proposed by this Article is to simply tax all that is currently not regulated, all base-eroding payments that are not already covered by existing rules, and therefore, it directly targets base erosion and profit shifting in the digital economy.

4. No Ring-Fencing

A direct consequence of the unique approach of the proposed withholding solution is that it does not ring-fence the digital economy, equally targeting non-digital base-eroding payments that are not currently taxed or explicitly exempted at source. The BEPS work, following essentially all of the experts in the field, has consistently made the non-ring-fencing a condition for a workable solution to the challenges presented by the digital economy.[48] At the moment, the withholding

44. *See, e.g.*, OECD definition from 2012: "The digital economy is comprised of markets based on digital technologies that facilitate the trade of goods and services through e-commerce," http://www.oecd.org/daf/competition/The-Digital-Economy-2012.pdf, at 5.

45. Most notably OECD Model Commentary on Art. 5, ¶¶ 122-131.

46. *See* OECD, GUIDE TO MEASURING THE INFORMATION SOCIETY, *supra* note 38, at 72.

47. *See* discussion in Báez Moreno & Brauner, WHT in the Service of BEPS Action 1, White Paper, *supra* note 26.

48. *See supra* text accompanying note 27.

solution proposed by this Article is the only alternative meeting this condition.[49]

5. More Taxation at Source

Perhaps the most controversial aspect of the withholding solution is that it also meets head-on the goal of increasing taxation at the source. This is an acknowledged goal of the BEPS project, yet one that remains challenged and only partially attained by the project.[50] There should be little doubt that BEPS was originally driven *inter alia* by the demand of source jurisdictions, and most importantly by the demands of China and India for expanded taxing rights at the source for so-called market economies.[51]

To date these demands have achieved little, resulting in a renewed push in the context of the digital economy framed in different ways, most importantly based on "user participation" as a justification for more taxation at the source.[52] The discussion of this justification has been complex and fraught with competing arguments that are difficult to balance, a task that is beyond the scope of this Article. Because the withholding solution does not require a particular justification for taxing transactions at the source, it directly meets the goal of more taxation at the source, providing the balance between source and residence taxation through the recommended low rate of withholding tax.

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49. The only other proposal potentially compliant with this condition may be the U.S. marketing intangible based proposal, yet this proposal has not yet been made public and the assessment of whether it will or not ring fence the digital economy depends on the details of the proposals.

50. *See, e.g.*, OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING, *supra* note 16, at 35-36; Brauner, *What the BEPS*, *supra* note 21, at 111-12.

51. *See, e.g.*, Pistone & Brauner, THE BRICS AND THE EMERGENCE OF INTERNATIONAL TAX COORDINATION, *supra* note 12, at 4-5; Manoj Kumar Singh, *Taxation of the Digital Economy: An Indian Perspective*, 45 INTERTAX 467 (2017); Diheng Xu, *The Convergence and Divergence Between China's Implementation and OECD/G20 BEPS Minimum Standards*, 3 WORLD TAX J. 471, 482-84 (2018) (examining the conflict over so-called "location-specific" advantages).

52. *See, e.g.*, OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23; Stephanie Soong Johnston, *India's Tax Chief: Digital Taxation Needs Fair Allocation Rules*, 92 TAX NOTES INT'L 435 (2018); Johannes Becker & Joachim Englisch, *Taxing Where Value is Created: What's 'User Involvement' Got to Do with It*?, 47 INTERTAX 161 (2019) [hereinafter Becker & Englisch, *Taxing Where Value is Created*]; HM Treasury, Corporate Tax and the Digital Economy: Position Paper Update (Mar. 2018), *available at* https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf (last visited Feb. 11, 2019).

6. Playing within the Rules of the Game

International taxation is a conservative field and reforms of the international tax regime are particularly cautious in nature and therefore gradual reforms that are easily reconcilable with the current rules of the game are more likely to gain consideration, support, and eventually legitimacy. This Article further seeks to accept the basic conditions provided by the BEPS project in the design of its recommendations, the most important of which is the preservation to the extent possible of the corporate tax and the fundamental bases of the regime itself to preserve the stability and achievements of the regime to date. It is impossible to completely avoid innovation if one genuinely wishes to face the challenges that the digital economy presents to the international tax regime,[53] a conclusion supported by the original BEPS documents.[54]

However, it is possible to do so with minimal incoherence as demonstrated by the withholding solution. All the elements of the withholding solution are familiar components of the current international tax regime: withholding tax obligations, denial of deduction on base-eroding payments, registration in source jurisdictions, and information reporting. Moreover, to the extent possible (and desired by the countries involved) the withholding solution preserves all the current regime's taxing rules by exempting them from the proposed withholding tax, leaving it applicable only to untaxed (or unreported) base-eroding payments. The law and treaty changes required should be minimal and focused, further demonstrating its compatibility with the current regime. Finally, the proposal operates within the current regime, unlike certain proposals, such as equalization levies that purport to operate outside the regime by adding a tax (the levy in this case) to the mix, claiming disingenuously, that it is external to the current international tax regime and hence not in conflict with its rules.[55]

7. The Proposed Solution is Feasible: Unilaterally or Multilateral Adoption

BEPS action 1 and the following OECD/inclusive framework output related to the taxation of the digital economy make it difficult to predict which course stakeholders may take, since their actions to date included inconsistent leaps from one idea to another without follow up research on any single proposal.[56] A realistic proposal feasibility should be tested

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53. *See infra* Part II.

54. *See, e.g.*, OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING, *supra* note 23, at 20.

55. *See infra* Part III.B.

56. *See also* Yariv Brauner, *Editorial: Developments on the Digital Economy Front –*

under different scenarios to see if the withholding solution withstands such a test. It could be adopted both unilaterally and multilaterally (under various possible options) with little impact on its desirability to the adopter.

Unilateral adoption of the solution is straightforward, because it merely requires the enactment of the proposed solution, and, if relevant, adaptation of treaties to accommodate the solution.[57] Unilateral actions in response to the use of the digital economy to undermine domestic tax bases is already prevalent, through the use of multiple measures, typically inferior to the withholding solution.[58] The main disadvantage of a unilateral solution would be the reduced incentive for other countries to cooperate in the provision of information required for effective implementation of the proposal. This may result in relatively high rates of tax (although in the unilateral scenario the implementing country fully controls the rate) and a concern about foreign investment. Another equally plausible scenario may be positive registration of foreign investors with the implementing country to avoid higher taxation. A concern may arise about the ease of tax treaty negotiation and even about relief of double taxation for the withholding tax, but unilateral adoption is likely to occur in a world (not much different than the one we currently live in) fraught with uncoordinated unilateral responses of productive states to BEPS by digital MNE, aligning the interests of most countries, and reducing the risks mentioned. Nonetheless, a coordinated, multilateral adoption of the withholding solution more directly relieves these concerns, because all of the involved parties would have an obvious interest in standardization, coordinated relief of double taxation, and the presentation of a single front against non-cooperating countries and their residents.

Finally, one may doubt the possibility of collective action in this context, especially in light of the unproductive BEPS process regarding the digital economy, yet the withholding solution presents an opportunity for a smaller number of countries to cooperate, achieving many of the advantages of multilateral adoption, and, in addition, the advantage of the first adopter with a voice, the power to determine the future course of the solution. One can draw an analogy to the process that led to the adoption of the Multilateral Instrument (MLI) to demonstrate how a comprehensive, flexible solution could quickly attract the attention of many countries, despite potential conflict with perceived maximization of interests of such countries. Technically the multilateral solution is quite similar to the unilateral solution, the sole difference is in the

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Progress or Regression?, INTERTAX (forthcoming, 2019).

57. *See infra* Part I.D. Indeed, countries following UN Model article 12A have already amended treaties with such a provision.

58. *See infra* Part III.

standardization of the mechanism for the adoption of such legislation (a multilateral rather than bilateral, or no treaty). Naturally, multilateral adoption may follow initial unilateral adoption by multiple countries; again, the process should have no effect on the operation of the solution.

8. Interim Conclusion

In conclusion, the withholding solution proposed by this Article meets all the requirements from a solution to the challenges presented by the digital economy to the international tax regime made by the BEPS project and general policy considerations. This Article argues and further demonstrates that in the case of some of these requirements the withholding solution is the only alternative that meets them, leading to the conclusion that it is superior to all other alternatives.

C. *Design Issues*

The digital economy presents not only new business models that conceptually challenge current tax rules, but also severe practical challenges to the ability of governments to collect revenue. In many cases, governments simply have not been collecting revenue from the digital economy,[59] and in others the collection fell short, triggering *inter alia* the BEPS Project.[60] Administration of measures to tax the digital economy is therefore paramount, requiring special care with the design of such measures.

1. Rates

Unlike normal tax rates that reflect the political choices of nation states, the rate of tax imposed by the withholding solution should preferably be internationally standard and set. This is because the purpose of the tax is to set a fair and legitimate standard for division of revenue among residence and source states. The digital economy discourse raised several more complex mechanisms, yet it is important to understand that the choice of a withholding tax to tackle the challenges presented by the digital economy means a preference for a simple and somewhat crude solution, and a view of reality where international collaboration is minimal (in comparison to the digital PE approach, for example).

It is likely that in the large majority of cases the tax would simply

59. See, e.g., the moratorium on taxation of the Internet. This is the U.S. "Internet Tax Freedom Act" that was first passed by Congress in 1998 and has since been extended several times.

60. *See, e.g.*, OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING, *supra* note 23, 20.

mean that the source state collects and keeps it, no more, no less, and therefore the rate should reflect an appropriate share of the tax base allocated to the source state. It should be sufficiently high, viewed as a final tax shadowing the corporate tax. Another reason to keep it sufficiently high would be to satisfy its base erosion role.

The rate should also be kept sufficiently low, to satisfy the residence countries that control the international tax regime at the present and hence may perceive the withholding tax as a concession they make in favor of source jurisdictions. This argument is quite weak since the residence jurisdictions have not been collecting on this tax base much in the first place, yet politically it may be viewed as powerful. A more significant reason not to set the rate too high would be to reduce the incentives to evade it. Note, however, that the latter is not an optimization argument, since it is likely that taxpayers will continue to have incentives to attempt avoidance or evasion of the tax at any acceptable level (one could study this point in more depth, but it is beyond the scope of this Article). It is rather an argument based on the aspiration to design the tax according to its purpose and keep it at a level that would be generally perceived as fair and legitimate by the largest number of countries possible. Furthermore, the tax should be kept at a level that would not significantly hamper cross-border business.

Taking all this into account, the rate should be anywhere between 5% (that may be viewed as insignificant by source jurisdictions as this is a rate often charged by accommodating conduit jurisdictions for treaty shopping accommodation) and 15% (a level close to the actual net corporate tax rate in some jurisdictions). Therefore, 10% comes to mind to make calculations simple, but of course this is not a magic number and it could be negotiated up or down without qualitatively changing the proposal.

Additionally, another rate should be used to address payments to noncompliant jurisdictions. It is well known that it is difficult to define tax havens, yet for the purposes of this proposal that inherently embodies a choice for a simple, perhaps imperfect solution, it is clear that a simple line should be drawn. The same 15% corporate tax rate comes to mind, but, again, the threshold rate could be a little higher or lower with little effect on this proposal. The elevated withholding tax rate should match. The proposal should therefore impose an elevated (perhaps 15%) withholding tax on payments to non-registered payees, including payees resident in jurisdictions with a corporate tax rate below 15%. Note that a PE of a resident of a sub-15% jurisdiction in a non-sub 15% jurisdiction should be eligible to register as such and enjoy the lower rate. Also note that the tax rate does not address effective tax rate reductions. This is partly to keep the solution simple and easily workable, and partly because harmful tax competition issues are beyond the scope of this Article.

2. Exemptions

A full description of exemptions from the withholding solution is beyond the scope of this Article. The basic idea is to capture all payments not subject to a taxing rule at the present (with a strong preference for capturing base-eroding payments) with as little disruption as possible to the current rules of the international tax regime (reflecting the conservative evolutionary approach), and without resort to definitions of digital payments.

Therefore, low-risk payments to identifiable taxpayers already taxed on a net basis should be exempt. The most obvious examples would be wages and deductible payments made to PE (in the same country). These payments do not present a classification difficulty because they are easily and clearly distinguished from other payments, and they are already subject to unique tax regimes (typically employer withholding in the case of wages and regular net corporate taxation in the case of PE) with little concern about abuse by manipulation of classifications.

Interest and dividend payments (but not royalties) should similarly be exempt. Dividends are not generally base-eroding payments and are usually controlled by Article 10 of bilateral tax treaties. As such, they present no unique problem from the perspective of the digital economy.[61] Interest payments are base-eroding payments, yet, they do not present any unique challenges in the context of payments related to the digital economy.[62]

All other business payments, including royalties,[63] will be subject to the withholding tax unless countries believe that they are clearly beyond the scope of the digital economy. For example, payment for the rental of equipment, land or buildings, or for their purchase, payment for material and payments for services entailing individuals present on-site. The construction of a list of standard payments should not be complex.

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61. Hybrid arrangements may present challenges for dividend payments, yet these are not unique to the digital economy and are dealt with, to the extent possible, by BEPS Action 2, and hence are beyond the scope of this Article.

62. Limitation on interest deductions are handled by BEPS Action 4, and many countries' implementation of its recommendation. *See, e.g.*, 26 U.S.C. § 163(j) (replacing the former earning stripping rule with the standard set by BEPS Action 4).

63. One could argue that so-called "literary" royalties should remain within the scope of tax treaties' Art. 12, yet we do not see the theoretical support for the distinction between royalties and business profits, especially in the context of the digital economy. In any event, if countries insist on that, Art. 12 may simply be left intact or amended to whatever scope countries wish. This action may create an area of uncertainty and open an opportunity for taxpayers to more aggressively include as many payments as possible within the scope of Art. 12. In the authors' view, this is inappropriate, yet it does not interfere with the analysis of the withholding solution and its superiority to alternative solutions for taxing the digital economy; a fundamental axiom of the international tax regime is that it never obligates a country to tax where it does not wish to do so.

There may be some controversial payments, but if their treatment follows the principles set out above, the method should be fairly non-controversial. These miscellaneous payments, clearly not digital economy payments, may be more susceptible to manipulation than the other exemptions. Taxpayers would have a clear incentive to inflate these payments, perhaps at the expense of other (closer to the digital economy) payments. However, the scale of abuse should be lower than any definition-based mechanism that would not be based on a widely scoped withholding tax.

First, because such payments are already subject to other tax safeguards, such as the transfer pricing rules. Second, the country of the payor would have the strongest incentive to ensure that exempt payments are not inflated. As a market country, it is also in the best position to monitor the application of the rules: the payment is likely made within its jurisdiction, it is its tax base that is eroded and the payor (who is the withholding agent, not the taxpayer) is under its control.

The most difficult cases are likely to be base-eroding payments for mixed equipment bundled with software, such as computerized machinery. The difficulty would be to allocate the appropriate price to each component, yet, every country already faces similar issues, typically requiring delineation of payments to the appropriate categories and treating truly bundled products or products where a certain piece (*e.g.*, the software) is *deminimis* as a single property belonging to the dominant category (typically equipment in this context) or the category that more easily fits into the standard tax analysis, and unlikely to be subject to the proposed withholding tax.[64]

3. Finality

Every withholding tax presents the question of finality, being a practical, inaccurate gross tax mechanism in a system dominated by net taxation. It is always simpler to use a final withholding tax, yet this often means sacrificing accuracy or neutrality. Unilateral adoption of the withholding solution should probably employ a final tax. The mere choice of a withholding tax reflects preference for simplicity and certainty, and a final tax would serve this preference better. Moreover, the price such country is likely to pay in terms of accuracy and neutrality are not completely sacrificed, since the tax would be final only from the perspective of the payment state in the case that the residence state would provide a credit for the tax. The relative low rate of the tax should make such credit mechanism meaningful and meet the purpose of the tax: a fairer division of revenue between the source and the residence states.

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64. *See*, *e.g*., Treas. Reg. § 1.861-18(b)(2).

Fairness may require that the elevated rate for payments to non-registered payees not be final, especially if a period of transition into the tax should be permitted. A country may provide an option to payees subject to this rate to file a tax return, claiming a refund of the excess rate paid to the country of source. The return should be filed with both jurisdictions consistently. Such mechanisms benefit both the source country that preserves its tax base and the residence country or the regime as a whole, because it secures its integrity, obtaining complete information about transactions, and fully taxing them.

The choice of a withholding tax necessarily entails a significant burden on struggling enterprises. These may include start-up companies, companies in transition, loss-making companies, and low-margin companies. For these companies, the tax would mean a pure cost (and a cash strap) that further encumbers them and makes it difficult for them to succeed. These companies also differ from each other in their loss of support by the system. We may wish to support start-up companies, but not necessarily help lengthen the winding-down period for failed enterprises. It is difficult, however, to fairly distinguish between these types of companies, and past experience demonstrates that such attempts have not necessarily been successful.[65] It is perhaps possible to add special rules for start-up companies that would work better, perhaps via special registration, but this Article prefers the option each enterprise gets—to register and be taxed on a net basis, which sufficiently balances the impact of this tax. Lastly, if countries are seriously concerned about the impact of this tax, they may further balance it in other ways, such as ensuring carry-forward of foreign tax credits, special exemptions, or even refund schemes.

4. Transition

Transition rules are sensitive to the specific rules adopted, so it may be too early to attempt to prescribe them in this Article, yet one observation is appropriate for a more complete analysis of the proposal, and to demonstrate that transition is not a weakness of the proposal. The withholding solution introduces a new mechanism and a broad, default withholding obligation. This would require legislation and regulation in all participating countries, a process that may take time and is open to manipulation in the interim. Nevertheless, a major shift of real business is unlikely to happen in response to the tax, because the focus of compliance and enforcement is on the market and the destination, which could not easily be abused, rather than the more mobile residence or origin.

65. The U.S. exceptions from the PFIC regime are an example. *See* I.R.C. § 1298(b).

5. Incentives

Countries should consider the use of incentives to promote proper withholding. There is ample experience in the employment tax and VAT areas that could help here. One example demonstrates this thought: countries could agree on a very small administrative award to the withholding agents.[66] This award could be facilitated similarly to a tax refund. The critical stage in the imposition of a withholding tax such as that proposed in this Article is its launch. In order to encourage compliance that would ensure its success, incentives should prove useful. These incentives may be tested over time and reviewed and amended as needed.

6. Versatility

The withholding solution is the optimal solution for the current state of affairs, as demonstrated throughout this Article. One cannot reliably predict the political responses to such reform. A major advantage of the withholding solution however is its versatility, its capability of functioning as a single, overall solution as suggested by this Article, or as a solution to the most acute challenge that the digital economy presents: the taxation of cross-border services,[67] or even as an implementation mechanism for profit allocation to virtual PE if the nexus approach were adopted.[68]

7. An "Alternative" Design: Withholding on Services

An alternative design of the withholding solution could limit the withholding obligation to cross-border services without loosing the advantages of the original proposal.[69] Reasons for this restriction may include: first, As regards sales of goods in general (both B2B and B2C) the problem of online retailers has nominally already been addressed under OECD BEPS Action 7,[70] and Article 13 of MLI. Indeed, despite

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66. The monitoring system for VAT purposes in Sao Paulo, Brazil that also requires registration and electronic monitoring of invoices. Ordinance CAT No. 128/2013, published in the official Gazette of the State of São Paulo on 10/25/2013.

67. *See* Andrés Báez Moreno & Yariv Brauner, *Reforming "Nexus": Fitting the Existing International Tax Framework Around the Digital Economy Tax Policy Options Regarding Tax Challenges of the Digitalised Economy Under the Benjamin Franklin's Rule for Decision Making* [hereinafter Báez Moreno & Brauner, *Reforming "Nexus"*], *in* TAX AND THE DIGITAL ECONOMY: CHALLENGES AND PROPOSALS FOR REFORM (Werner Haslehner ed., forthcoming 2019).

68. *See* Báez Moreno & Brauner, WHT in the Service of BEPS Action 1, White Paper, *supra* note 26.

69. *See* Báez Moreno & Brauner, *Reforming "Nexus*,*" supra* note 67.

70. OECD, Preventing the Artificial Avoidance of Permanent Establishment Status, Action

the limited (quantitative) success of article 13 of the MLI and the doubt surrounding attribution rules to the newly created PEs,[71] the significant reduction of PE exceptions in Art. 5(4) of the OECD Model will theoretically allow the Source State—that is, the state in which the 'logistic PE' is located—to tax many 'digital sales of goods' that had been untaxed before its implementation.[72] To the extent any new withholding also covers digital sales of goods, its interaction with the extended 'logistic PE' should be resolved. One possible solution might be a rule similar to the PE provision in Articles 10(4), 11(4) and 12(3) of the OECD Model that would place income derived from digital sales of goods back in the category of PE taxation. However, to achieve that result it might be simpler to exclude all goods from the new withholding tax. Without a special rule addressing such potential conflict, the coexistence of 'logistic PEs' and a withholding tax covering sales of goods will inevitably raise characterization issues. Second, any future reform involving the expansion of source taxing rights on business income would require changes to current bilateral tax treaties. However, a withholding tax (just) on services would require fewer fundamental changes to tax treaties and even be in accordance with the current literal language of a significant number of existing ones.[73] Third, limiting a withholding just to services might also avoid problems of compatibility with WTO Law, if any.[74]

Beyond the technical advantages this option realizes that the digitalized economy is, by and large, an economy of services.[75] Indeed

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7 – 2015 Final 285 (2015).

71. *See* Lisa Spinosa & Vikram Chand, *A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should the Focus Be on a Shared Taxing Rights Mechanism*?, 46 INTERTAX 476, 481-90 (2018).

72. Of course, the problem remains for suppliers without logistic centers in the market jurisdictions. *See* Georg Kofler, Gunter Mayr, & Christoph Schlager, *Taxation of the Digital Economy: 'Quick Fixes' or Long-Term Solution*?, 57 EUR. TAX'N 527 (2017) [hereinafter Kofler et al., *Taxation of the Digital Economy: 'Quick Fixes' or Long-Term Solution*?]; Georg Kofler, Gunter Mayr, & Christoph Schlager, *Taxation of the Digital Economy: A Pragmatic Approach to Short-Term Measures*, 58 EUR. TAX'N 123, 124 s. 2.2 (2018).

73. *See infra* Part I.D.

74. *See infra* Part I.E.

75. *See also* Jinyan Li, *Protecting the Tax Base in a Digital Economy* [hereinafter Li, *Protecting the Tax Base in a Digital Economy*], *in* UNITED NATIONS HANDBOOK ON SELECTED ISSUES IN PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES 407, 424 (Alexander Trepelkov et al. eds., 2015) [hereinafter UNITED NATIONS HANDBOOK ON SELECTED ISSUES IN PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES]; BEPS MONITORING GROUP, COMMENT, IN OECD, TAX CHALLENGES OF DIGITALISATION: COMMENTS RECEIVED ON THE REQUEST FOR INPUT PART I, at 20, 27 (2017); David Orzechowski, The Taxation of Fees for Technical, Managerial and Consultancy Services in the Digital Economy with Respect to Art. 12A of the 2017 UN Model, in Committee of Experts on International Cooperation in Tax Matters Fifteenth Session, E/C.18/2017/CRP.23 1, 29 (UN 2017).

the new business models of the digitalized economy have enlarged the very space of services (*servitization*) while expanding their overall quantitative importance. The advent of 'cloud computing,' which has actually turned software into service, is a classic example of servitization. Despite the doubts expressed by the 2015 OECD BEPS Action 1 Report on characterization,[76] it is clear that cloud-computing arrangements should qualify for tax purposes as service contracts. As for expanding the quantitative importance of certain new business models, online advertising is just one case in point; the advantages of Internet advertising in comparison to traditional channels—by means of 'user-generated content' provided for 'free' by customers in two-sided platforms and subsequent tailored advertising—has provoked a dramatic increase in these services, with an expected growth rate of 12.1% per year over the period from 2014 to 2019.[77] Similarly, digitalization has increased the importance of intermediation services, both between businesses and consumers[78] and among consumers themselves.[79]

D. *Tax Treaty Implications*

If the withholding solution were to be implemented, amendments to the OECD Model and tax treaties would be required. With the view to minimize changes to the Model language, this article proposes the following amendments.

1. A New Article 7(4)

The new article should provide:

> Payments made by an enterprise of a Contracting State or borne by a permanent establishment situated in a Contracting State may be taxed in that State. The tax so charged shall not exceed:

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76. OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 104-06. Some authors have correctly pointed out that both the 2014 OECD BEPS Deliverable and the 2015 OECD BEPS Action 1 Report overstate the alleged lack of guidance regarding cloud computing, probably reflecting an invigorated revenue interest of the source state (Matthias Valta, Article 12 (Income from Royalties), *in* KLAUS VOGEL ON DOUBLE TAXATION CONVENTIONS 1000 (m.note 107) (Ekkehart Reimer & Alexander Rust, eds., 4th ed. 2015).

77. OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 113-14. Additionally, figures show that online advertising may only be in its infancy. *See, e.g.*, Assaf Prussak, *The Income of the 21st Century: Online Advertising as a Case Study for the Implications of Technology for Source-Based Taxation*, 16 TUL. J. TECH. & INTELL. PROP. 39, 53 (2013).

78. A good example would be digital travel agencies, such as Booking.com.

79. This is the model of platforms within the collaborative economy such as Airbnb & Uber.

> (a) (10) per cent of the gross amount of the payments if the payee is an enterprise of the other Contracting State or a permanent establishment situated therein duly registered with the first-mentioned Contracting State for the purposes of this paragraph; and
>
> (b) (15) per cent of the gross amount of the payments in all other cases.
>
> A contracting state may not tax a payment borne by a permanent establishment of an enterprise of the same contracting state situated elsewhere.
>
> The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this tax, including specified exemptions for non-base-eroding and other similar payments.

2. The Commentary

This Article further proposes additions to the commentary for the sake of standardization of the exemptions to the withholding solution.

3. Other Adjustments

The old article 7(4) should become article 7(5). Article 7(1) Should be amended to begin with the phrase: "Subject to the provision of paragraph 4. Finally, although seemingly more than a minor adjustment, the article recommends that article 12 be considered for elimination. Article 12 primarily taxes income that is, in essence, business income, and therefore should be folded into article 7. The new withholding tax will capture payments not subject to article 7(1) and would not hurt any source taxation. There is no need to amend articles 10, 11, and 15.

All the above depends on a standard registration and qualifications scheme that could be developed in the Commentary or externally to the Model. In any event, it should not affect the text of the Model itself for the sake of effectiveness and flexibility. If countries chose to more strictly standardize a withholding tax solution, specific amendments may be made to articles 26 and 27 of the OECD Model to adapt the mutual assistance and information exchange mechanisms to the withholding solution. Of course, the registration scheme should improve the efficacy of treaty information exchange.

4. An "Alternative" Treaty Provision for a Withholding Tax on Services

If the limited option of restricting the withholding solution to services is elected, current article 12A of the UN Model Tax Convention could be followed. In 2017, the UN Model was revised to include a new provision attributing taxing rights to Source States with respect to fees for technical services in the absence of a PE. UN Art. 12A followed a growing trend in tax treaties 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.'[80] Apart from minor technical details, this new distributive rule would preserve the taxing rights of source states that choose to limit the withholding solution to services of the type described in this Article.[81]

E. *Potential Discrimination Issues: WTO, EU & Treaty Law*

A withholding tax proposal such as the withholding solution implies different treatment of domestic and cross-border transactions that in some circumstances may entail a breach of non-discrimination obligations under WTO, EU, and tax treaty Law. Withholding on cross-border transactions on the basis of gross payments as opposed to taxation on a net basis (the norm in domestic income taxation) has been routinely accused of infringing EU law, particularly with respect to EU fundamental freedoms.[82] Similar argument were made[83] based on potential violations of international economic laws (*i.e.*, the General Agreement on Tariffs (GATT),[84] and the General Agreement on Trade in Services (GATS).[85] Furthermore, since the withholding solution is based

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80. *See* Wim Wijnen, Jan de Goede, & Andrea Alessi, *The Treatment of Services in Tax Treaties*, 66 BULL. INT'L TAX'N, 27, 27-33 (2012) (documenting survey conducted); Angharad Miller, TAXING CROSS-BORDER SERVICES: CURRENT WORLDWIDE PRACTICES AND THE NEED FOR CHANGE, 147 (2016).

81. Báez Moreno & Brauner, *Reforming "Nexus*," *supra* note 67 (analyzing those details).

82. *See* OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 115; Kofler et al., *Taxation of the Digital Economy: 'Quick Fixes' or Long-Term Solution*?, *supra* note 72, at 529; Schön, *Ten Questions about Why and How to Tax the Digitalized Economy*, *supra* note 22, at 286.

83. *See* OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 115; Kofler et al., *Taxation of the Digital Economy: 'Quick Fixes' or Long-Term Solution*?, *supra* note 72, at 529; Schön, *Ten Questions about Why and How to Tax the Digitalized Economy*, *supra* note 22, at 286.

84. 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).

85. 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).

on a self-enforcing mechanism according to which the deduction of payments to non-residents for covered transactions is made conditional on the effective withholding, it may constitute a violation of Article 24(4) of bilateral tax treaties fashioned after the 2017 OECD or UN Models if, in fact, the deduction of similar payments to residents are not subject to a similar condition.

The first option for resolving these problems would be to simply extend the withholding obligation to similar domestic transactions.[86] Some commentators have claimed that extending the scope of 'digital taxes,' be they withholding taxes or equalization levies, to cover purely domestic transactions would have a dramatic, anti-technology impact,[87] However, as regards withholding taxes[88] such effect is not expected as a result of the extension of a withholding obligation to domestic transactions. Indeed, in a treaty context (when the treaty provides for source taxation of the corresponding transactions)[89] the tax withheld at source would be credited in the Residence State.[90] In a non-treaty context, depending on domestic regulation, the tax withheld at source would be creditable, in principle, in the Residence State according to a corresponding unilateral foreign tax credit. A purely domestic scenario should be handled in the same manner. If the withholding is extended to also cover domestic situations, the tax withheld will be creditable against domestic (mainstream) corporate income tax. In any case, the material outcome of this extension would be irrelevant if one considers that companies performing domestic transactions would normally have to make advance tax payments, which may be equivalent to an eventual new withholding tax on domestic transactions.[91]

Should the extension of the withholding solution to domestic transactions not be accepted, different potential discriminations should be considered. First, WTO law obligations. Both GATT and GATS require their signatories to tax foreign suppliers of goods and services no less favorably than its own domestic suppliers. GATS, However, provides broad exceptions when the signatory applies direct tax measures.[92] More specifically, GATS Art. XIV(d) provides that nothing in the Agreement

86. *See* Báez Moreno & Brauner, *Reforming "Nexus*," *supra* note 67.

87. Schön, *Ten Questions about Why and How to Tax the Digitalized Economy*, *supra* note 22, at 285.

88. *See, e.g*., Báez Moreno & Brauner, *Reforming "Nexus*," *supra* note 67 (regarding Equalization Levies and how things might be different).

89. *See supra* Part I.D.

90. Model Art. 23.

91. Of course, financial differences might exist in those cases in which standard advance payments are calculated on the basis of net profits, taking into account that our withholding proposal calculates tax liability on gross payments.

92. *See* OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 115.

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 withholding taxes to non-residents.[93] Therefore, a gross withholding tax on services[94] would not violate the GATS.[95] A broader withholding tax covering also sales of goods might face more difficulties in this respect, yet income tax rules rarely meet the preliminary requirements for the application of the GATT national treatment (non-discrimination) rules, requirement such as application to imports in the relevant case, and the discriminatory treatment of "like" goods."[96] The withholding solution will rarely apply to payments for imported goods in the first place, so there is little reason to believe that a broad withholding tax would be considered discriminatory under GATT even prior to the application of the remedial justifications available in the GATT.[97]

Second, EU-Law. In light of recent decisions coming out of the Court of Justice of the European Union (CJEU) on withholding taxes, particularly its *Brisal* decision,[98] certain withholding tax critics have become more specific and more strident in their criticisms.[99] Indeed, *Brisal* and other contemporary decisions[100] have made it clear that the CJEU's *Truck Center* judgment[101] could not be understood as an excuse to apply different tax collection systems to residents and non-residents.[102]

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93. JENNIFER E. FARRELL, THE INTERFACE OF INTERNATIONAL TRADE LAW AND TAXATION 192 (2013).

94. *See supra* Part I.C.7.

95. In the same vein, with certain nuances on services rendered outside the source state, see Brian J. Arnold, *The Taxation of Income from Services* [Arnold, *The Taxation of Income from Services*], *in* UNITED NATIONS HANDBOOK ON SELECTED ISSUES IN PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES, *supra* note 75, at 117-18.

96. Georg Kofler & Yariv Brauner, *Interaction of tax treaties with international economic law*, ch. OM3, *in* GLOBAL TAX TREATY COMMENTARY, IBFD Online (Richard Vann ed., 2016, updated 2018).

97. Advanced payments on imports of goods were the closest measures to withholding taxes that were examined under the GATT, and that only in a few country trade policy reviews cases under the GATT when imposed on importations of goods, a hardly analogous situation to that of the withholding solution. *See, e.g.*, FARRELL, THE INTERFACE OF INTERNATIONAL TRADE LAW AND TAXATION, *supra* note 93, at 56-57.

98. Brisal & KBC Finance Ireland, Case C-18/15.

99. Italian Banking Association (ABI), in *OECD, Public Comments Received on the Tax Challenges of Digitalization,* http://www.oecd.org/tax/beps/public-comments-received-on-the-tax-challenges-of-digitalization.htm (accessed Aug. 22, 2018), at 5.

100. 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.

101. *Truck Center*, C-282/07, Judgment EU:C:2008:762.

102. CFE ECJ Task Force, *Opinion Statement ECJ-TF 2/2016 on the Decision of the Court*

In fact, with respect to the main issue at stake (*i.e*., creating different rules for taxable bases for domestic and cross-border transactions)[103] it is clear from the CJEU's *Brisal* and other decisions[104] that in principle it is an infringement of the freedom to provide services if non-resident taxpayers, in contrast to resident taxpayers, cannot deduct expenses directly connected to the activity that is being taxed, which difference could well be found to be an insurmountable obstacle to the application of a withholding tax.[105] Yet, that hasty conclusion would not reflect reality, as a significant number of EU Member States already allow deductions for expenses directly related to the respective income obtained by (certain) service providers resident anywhere within EU/EEA countries.[106] In fact, some of these EU/EEA service provider regimes are the result of the attempt by various Member States' to implement the CJEU's criteria for an EU law compatible withholding tax.

Third, tax treaties law of non-discrimination. If the withholding obligation is not extended to purely domestic transactions it would seem to violate Art. 24(4)[107] of tax treaties fashioned after the OECD or UN Models. However, prominent authors have expressed dissenting views

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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).

103. 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).

104. See an exhaustive list of this case law in Opinion of Advocate General Kokott delivered on 17 March 2016 in Brisal & KBC Finance Ireland, C-18/15, AG Opinion, EU:C:2016:182, para. 27.

105. Particularly if these conclusions can be expanded to other sources of income such as royalties or service fees. In the affirmative as regards royalties: Eric Kemmeren, *Gross WHT: Is the Court of Justice of the European Union Back on Track with Regard to Deductible Expenses*, 2017-1 EC TAX REV. 2, 7.

106. In particular Andreas Hable & Christian Wimpissinger, *Austria*, *in* 97A *Enterprise Services* 116 (IFA Cahiers 2012); Claudine Devillet & Xavier Van Vlem, *Belgium*, *in* 97A *Enterprise Services* 144 (IFA Cahiers 2012) (referred to entertainers for which a limited lump-sum cost deduction is allowed); Lenka Fialkova, *Czech Republic*, *in* 97A *Enterprise Services* 260 (IFA Cahiers 2012); Anders Norgaard & Philip Noes, *Denmark*, *in* 97A *Enterprise Services* 277 (IFA Cahiers 2012) (for entertainers); Borbála Kolozs & Annamária Köszegi, *Hungary*, *in* 97A *Enterprise Services* 344 (IFA Cahiers 2012) (for individual service providers); René Monfrooig & Linda Ten Broeke, *The Netherlands*, *in* 97A *Enterprise Services* 501–502 (IFA 2012); Rita Calcada Pires, *Portugal*, *in* 97A *Enterprise Services* 571–572 (IFA Cahiers 2012); José Manuel Calderón Carrero, *Spain*, *in* 97A *Enterprise Services* 629 (IFA 2012) (only for services carried out physically in Spain).

107. Even if articles 24(4) of both the OECD and the UN Models differ in detail, both provisions essentially prohibit the implementation of deduction barriers for cross-border interests, royalties, and fees for technical services more burdensome than those imposed for similar domestic transactions.

claiming that Art. 24 would not prevent a country from denying a deduction of amounts paid by a resident to a non-resident where the resident does not withhold tax properly in accordance with the law.[108] This view seems to be exclusively based upon the Commentaries of both the OECD and the UN Model Tax Conventions when stating that measures that are mandated or expressly authorized by provisions of the treaty different from Art. 24 cannot be considered to violate the provisions of the latter even if they only apply, for example, as regards payments to non-residents.[109] The difficulty in the case of the withholding obligation is that tax treaties do not specifically obligate countries to tax but rather limit their taxing rights leaving the actual taxing rules to domestic law. Nonetheless, in the post-BEPS era when emphasis is given to anti-abuse aspects of tax treaties and the multilateral aspects of the international tax regime are increasingly recognized, with the multilateral instrument symbolizing the peak of such trend, it is not inconceivable to view the withholding solution from a similar angle, not different than BEPS action 2 that provides for a denial of deduction and taxation of income not regularly taxed under domestic law in appropriate circumstances.

II. WHY NEW LAW FOR TAXING THE DIGITAL ECONOMY?

A reform proposal must first justify its necessity and superiority to current law. Taxing the digitalized economy is not really a new problem.[110] Yet, until recently reform proposals have not been able to overcome this first hurdle, where countries repeatedly choose to tweak the existing rules and rely on increasingly weaker analogies rather than directly face the inevitability of fundamental reform. Recent measures adopted by several countries in response to the challenges presented by the digital economy suggest that the wall protecting the traditional rules is beginning to crack,[111] demonstrating the implementing countries' belief that traditional norms could not ensure adequate taxation of MNE, consistently with the concern manifested in the choice of the BEPS project to make the challenge to tax the digital economy its first action

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108. Arnold, *The Taxation of Income from Services*, *supra* note 95, at 120.

109. Para. 4 of the Commentaries to article 24 of the 2017 OECD Model Tax Convention and Para. 4 of the Commentaries to article 24 of the UN Model Tax Convention 2017.

110. *See, e.g.*, RICHARD DOERNBERG & LUC HINNEKENS, ELECTRONIC COMMERCE AND INTERNATIONAL TAXATION (1999) [hereinafter DOERNBERG & HINNEKENS, ELECTRONIC COMMERCE AND INTERNATIONAL TAXATION]; RICHARD DOERNBERG, LUC HINNEKENS, WALTER HELLERSTEIN, & JINYAN LI, ELECTRONIC COMMERCE AND MULTIJURISDICTIONAL TAXATION (2001); JINYAN LI, INTERNATIONAL TAXATION IN THE AGE OF ELECTRONIC COMMERCE: A COMPARATIVE STUDY (2003).

111. *See infra* Part III.A.

item.[112] These developments demonstrate that the majority of the world's countries are of the view that the current international tax regime cannot adequately apply to the digital economy, and that past tactics of tweaking and creative interpretations of the current laws are not adequate substitutes for reform. Nonetheless the conservative view is often supported by the perception of powerful countries that they might benefit in the short term from the blocking of reform. This is primarily because a fundamental principle of the necessary reform would be to more fairly distribute tax bases among countries, which seems to deprive them of potential revenue. Yet, such a view is Pollyannish at best. This Part demonstrates the inadequacy of current norms, followed by an explanation why fundamental, technical reform is necessary, and why tweaking current law is not a viable option, because it will lead to the undesirable consequences of blocking reform. The rest of the Article expands on this analysis more concretely with analysis of the various options for reform.

A. *Current Law is (Really) Insufficient and Unsustainable*

The inadequacy of the current regime in taxing the digital economy was a primary trigger of the BEPS project. This Part begins with a review of the project's observations and conclusions about the necessity of reform, followed by additional support for this conclusion.

BEPS Action item 1 required a report discussing the challenges posed by the digital economy to the current international tax rules,[113] based on an understanding, long realized by scholars, that such rules were never designed for it.[114] The regime failed to adapt to technological progress and to the ascent of intangibles, as it merely tweaked the rules,[115] apparently in an unsatisfactorily manner to fit these developments.[116] The BEPS context was obvious because MNEs, whose use of tax planning schemes triggered the launch of the BEPS project, all have heavily relied on intangibles in exploiting the tax advantages of an imperfectly

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112. OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING, *supra* note 23.

113. *Id.* at 14-15.

114. *See, e.g.*, Lee, *Impact of E-Commerce on Allocation of Tax Revenue Between Developed and Developing Countries*, *supra* note 10, at 19, 21.

115. *See, e.g.*, OECD, E-COMMERCE: TRANSFER PRICING AND BUSINESS PROFITS TAXATION 113 (2005), http://www.oecd-ilibrary.org/taxation/e-commerce-transfer-pricing-and-business-profits-taxation_9789264007222-en. The most significant outcome of this work was the changes to Article 5 in the OECD Commentary on the Model Tax Convention, resulting in the addition of paragraphs 42.1-42.10. to the Model Commentary on Article 5.

116. This is evidenced by the OECD identifying the "[a]pplication of treaty concepts to profits derived from the delivery of digital goods and services" as a key pressure area that must be addressed by the BEPS project, later reflected in action item 1. *See* OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING, *supra* note 16, at 47.

regulated digital economy.[117]

The goal of action 1 was modest: the generation of a report, but the OECD quickly understood that more than that was required. Consequently, the OECD focused on a few reasonable solutions for the most important issues at stake. The final action 1 report acknowledges the need for post-BEPS monitoring and seems to state that the digital economy taskforce will continue to exist for implementation and monitoring purposes.[118] It is unclear first whether meaningful action will be taken on any of the issues discussed. But eventually, the Task Force on the Digital Economy (TFDE), initially a subsidiary of the OECD tax committee on fiscal affairs, transformed into a subsidiary of the post-BEPS inclusive framework, and in 2017 proceeded to work on the matter.[119] Action was taken regarding consumption taxes.[120] The road taken by the OECD and the BEPS project regarding the taxation of the digital economy has been winding, exposing both the complexity of the matter and the deep disagreement and conflict of interests among countries over the optimal solution. One feature of the work has not changed: the understanding that some form of substantive reform is necessary because the current rules are inadequate.[121]

The inadequacy of the current rules and the urgency of reform were further exposed by unilateral actions taken by a number of countries, all of which were concurrently participants in the efforts to reach consensus

117. *See, e.g.*, Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES, Apr. 28, 2012, at A1; Jesse Drucker, *Google Revenues Sheltered in No-Tax Bermuda Soar to $10 Billion*, BLOOMBERG (Dec. 10, 2012, 12:01 AM), https://www.bloomberg.com/news/articles/2012-12-10/google-revenues-sheltered-in-no-tax-bermuda-soar-to-10-billion (last visited Feb. 14, 2019); Richard Waters, *Microsoft's Foreign Tax Planning Under Scrutiny*, FIN. TIMES (June 7, 2011, 2:38 AM).

118. Yet, no final recommendations have been furnished and no practical action had initially been taken to actually establish a follow-up forum in the same manner already done regarding other items, such as the consumption tax aspects of action items 1, 14, and 15. *See* OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 13; OECD, MAKING DISPUTE RESOLUTION MECHANISMS MORE EFFECTIVE, ACTION 14 - 2015 FINAL REPORT, at 37-41; OECD, DEVELOPING A MULTILATERAL INSTRUMENT TO MODIFY BILATERAL TAX TREATIES, ACTION 15 - 2015 FINAL REPORT.

119. Generating a so-called interim report: OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, promising a final report in 2020, followed by another apparently interim report: OECD, PUBLIC CONSULTATION DOCUMENT: ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY (Feb. 12, 2019) [hereinafter OECD, PUBLIC CONSULTATION DOCUMENT], each document's significantly divergent from its predecessor.

120. The discussion of consumption taxes is beyond the scope of this article. For more on that, see, e.g., Walter Hellerstein, *A Hitchhiker's Guide to the OECD's International VAT/GST Guidelines*, 18 FLA. TAX. REV. 589 (2016).

121. *See, e.g.*, OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 18-20.

on the matter.[122]

Finally, various outfits, including policy think tanks,[123] international institutions,[124] European institutions,[125] groups of academic economists,[126] NGOs,[127] and the French government pioneering the quantitative study of the issue,[128] all recorded information and analyses on the ineffective taxation of the digital economy under the current norms of the international tax regime.

B. *Fundamental and Technical Reform*

The overwhelming data about the inability of countries to adequately tax the digital economy was predated by burgeoning scholarship both predicting such futility and explaining the legal problems causing it.[129] The BEPS project echoed much of the same analysis,[130] yet increasingly

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122. For a more detailed review and analysis of some of these actions, see *infra* Part III.A. This was acknowledged and partly reviewed also by the interim report, OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, ch. 4.

123. *See, e.g*., BEPS Monitoring Group, TAX CHALLENGES OF THE DIGITAL ECONOMY (Oct. 2017), *available at* https://bepsmonitoringgroup.files.wordpress.com/2017/10/digital-economy.pdf (last visited Feb. 15, 2019).

124. *See, e.g*., Alex Cobham & Petr Janský, *Global distribution of revenue loss from tax avoidance: Re-estimation and country results* (WIDER Working Paper 2017/55, 2017), *available at* https://www.wider.unu.edu/sites/default/files/wp2017-55.pdf (last viewed Feb. 15, 2019).

125. *See, e.g*., European Commission, Communication from the Commission to the European Parliament and the Council, COM (2018) 146, 4 ("companies with digital business models pay less than half the tax rate of businesses with traditional business models").

126. *See, e.g*., FRANCE STRATEGIE, TAXATION AND THE DIGITAL ECONOMY: A SURVEY OF THEORETICAL MODELS - FINAL REPORT (FEB. 26, 2015), *available at* https://www.strategie.gouv.fr/sites/strategie.gouv.fr/files/atoms/files/ficalite_du_numerique_10_mars_corrige_final.pdf (last viewed Feb. 15, 2019).

127. *See, e.g.*, *Why Sabmiller Should Stop Dodging Taxes in Africa*, ACTIONAID.ORG, https://www.actionaid.org.uk/sites/default/files/doc_lib/calling_time_on_tax_avoidance.pdf. (last viewed Feb. 15, 2019); Petr Jansky & Alex Prats, *Multinational Corporations and the Profit-Shifting Lure of Tax Havens* (Christian Aid Occasional Paper No. 9, 2013), https://www.christianaid.org.uk/sites/default/files/2017-08/multinational-corporations-profit-sha ring-lure-tax-havens-march-2013.pdf (last viewed Feb. 15, 2019).

128. Pierre Collin & Nicolas Colin: Report from the Task Force on Taxation of the Digital Economy, 2013. English translation, *available at* https://www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf (last viewed Feb. 15, 2019).

129. *See, e.g*., Kingson, *Taxing the Future*, *supra* note 5; DOERNBERG & HINNEKENS, ELECTRONIC COMMERCE AND INTERNATIONAL TAXATION, *supra* note 110; Diane M. Ring, *Exploring the Challenges of Electronic Commerce Taxation through the Experience of Financial Instruments*, 51 TAX L. REV. 663 (1996); Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507 (1997); Arthur J. Cockfield, *The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles*, 56 BULL. INT'L FISCAL DOCUMENTATION 606 (2002); LI, INTERNATIONAL TAXATION IN THE AGE OF ELECTRONIC COMMERCE: A COMPARATIVE STUDY, *supra* note 110; Lee, *Impact of E-Commerce on Allocation of Tax Revenue Between Developed and Developing Countries*, *supra* note 10.

130. *See, e.g*., OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY,

with a muted voice that is attributed to the politics of the issue rather than from the countries' coping with the challenges of taxing the digital economy using current rules. The inevitability of declaring some success of the BEPS measures, and more importantly, the consensus-based nature of the OECD that simply cannot innovate when its members genuinely disagree on the optimal solution to the challenges, are challenges that all governments face.[131]

It would be useful therefore to review the precise flaws of the current rules pertaining to their inability, not weakness, to effectively tax the digital economy, providing theoretical support to the empirical case mandating reform. Note again, that this Article, in line with the BEPS agenda, assumes that reform of the international tax regime must be gradual, based on preservation of corporate income taxation and the majority of the current principles of the regime. This means that a discussion about replacing the current regime with a consumption-based scheme is beyond the scope of this Article.[132]

The first and most obvious challenge is the dominance of physical presence in the rule for taxing business income. There is consensus that countries should not tax foreign firms (typically identified by residence) unless such firms (or individuals)[133] sufficiently participate in the domestic economy, with sufficiency measures in terms of physical presence in a country. The almost universal rule tracks the tax treaties norm embedded in Article 5 of the OECD Model, using the PE terminology. This is a threshold rule that, first, mandates physical presence for domestic taxation of business income of a foreign corporation, and, second, clarifies that minimal, trivial presence cannot justify such taxation—only sufficiently significant (permanent) presence will.

The implicit assumption for this norm has been that every significant business presence would require significant physical presence in the country where it earns income, which makes it fair for the local jurisdiction to tax the related income to such presence. The power of this rule is in the intuition that domestic presence justifies domestic taxation,

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ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 78-82.

131. See, e.g., OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 90, 108. *Compare, e.g.*, *id.* ¶ 245 ("This early evidence of the impact and implementation of some key BEPS measures holds much promise for the resolution of double non-taxation concerns exacerbated by digitalization") *with, e.g.*, *id.* ¶ 312 ("[T]here is a growing perception that the BEPS measures will not address the tax challenges that have a broader impact and relate primarily to the allocation of taxing rights among different jurisdictions").

132. Although there are many good reasons for considering such more fundamental reform. *See, e.g.*, David F. Bradford, *Commentary: Electronic Commerce and Fundamental Tax Reform*, 52 TAX L. REV. 561 (1997).

133. The rules for individuals are basically the same. This Article focuses on the firm narrative for clarity.

because such intuition forges the legitimacy of the norm that eventually became universal. The assumption at the basis of this norm does not apply to firms operating in the digital economy, since they do not have to have physical presence where they generate profits.

Consequently, the basic norm for taxing business income cannot be used to tax these firms. Preserving the basic norm requires a digital analogy to the physical presence test, which is exactly the goal of the nexus-based solutions analyzed below,[134] yet such analogy inherently lacks the intuitive legitimacy that the physical presence rule enjoys. It requires a new formulation of the nexus rule to fit the digital economy, a formulation that is beyond mere tweaking of the current rule, requiring first the establishment of basic understanding of the rationale for the consequential division of tax bases between countries, and, second, agreement on the details of the rule, agreement that could garner acceptance by a divergent group of countries with differing interests (some of which necessarily will find themselves losing revenue as a result of the new arrangement), in short a tall order that clearly amounts to a fundamental reform.

A second pillar of the international tax regime is its reliance on the source/residence paradigm, translated into the general tax bases division norm of taxing residents on their worldwide income and non-resident only on their domestic source income. This paradigm depends on a universal understanding of the residence and source concepts. The residence rules for individuals were effectively harmonized, yet the residence rules for corporations proved unworkable, even when countries agreed on a mutual articulation of a corporate residence test (such as the common "place of effective management").

They failed to reach sufficiently similar interpretation of such test, leading the BEPS project to recommend elimination of a tie-breaking test for corporate residence, and therefore, leaving the matter to treaty partners to resolve among themselves through mutual agreement.[135] The source of the problem was the analogy between humans and corporations, as if the corporate person, like the human person, conducts business primarily where it is located, and location is determined based on easily observed, primarily physical attributes, attributes that are easily manipulable in the case of corporations and, more importantly, meaningless, since corporate business may easily be conducted in locations unrelated to the technical legal residence of the fiction we call corporation. Corporations participating in the digital economy face fewer constraints in establishing their residence for tax purposes, because they rely much less on physical factors, such as people and equipment, and

134. *See infra* Part III.B.
135. *See* OECD Model Art. 4(3).

more on computers that could be located essentially anywhere, to perform their core business functions.

The source rules present a similarly problematic picture despite the essential universality of the rules themselves. The majority of source rules have little basis in economics or any other explanatory paradigm, since their role is to facilitate the division of tax bases among jurisdictions where such division is itself arbitrary in the sense that it is not based on any normative theory but rather on a political necessity. They solely require acceptance or legitimacy to perform their functions. The current source rules achieved the necessary legitimacy, at least for purposes other than the taxation of the digital economy. Most source rules depend on residence, physical location of assets, people or identifiable transactions such as sales. These bases for the traditional source rules failed to pass muster in the context of the digital economy: residence, as explained above, is particularly manipulable and difficult to determine in this context, physical presence is meaningless, and assets and transactions "take place" nowhere. Source taxation of the digital economy has been proven impossible pursuant to the current international tax regime.

A third pillar of the international tax regime is the profit allocation regime for related party (non-market) transactions. These include the rules for allocation of profits to PE (*i.e.*, between the corporation and its branch) and the transfer pricing rules for allocation of profits among related parties (each of which is a separate entity) engaged in non-market transactions. Here too an essentially universal norm arose, demanding non-market transactions to be priced by analogy to "comparable" market transactions, following the arm's length standard (ALS). The idea behind this standard is to prevent manipulation, resulting in inappropriate tax minimization by multinational firms who completely control the pricing of intra-firm transactions that absent the transfer pricing rules would result in shifting of profits from high to low tax jurisdiction, robbing the former of due revenue. The application of the ALS is difficult at the best of times, yet the digital economy presents unique challenges:

(1) the firms participating in the digital economy transact in intangibles significantly more than other MNE, and often generate most of their income from such transactions, and the current transfer pricing rules are not equipped to deal with sophisticated transactions in intangibles;[136]

(2) the ALS depends on residence determinations that are especially difficult and manipulable for digital economy corporations,[137] permitting

136. *See, e.g.*, Ilan Benshalom, *Rethinking the Source of the Arm's Length Transfer Pricing Problem*, 32 VA. TAX REV. 425 (2013); Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79 (2008).

137. *See, e.g.*, Richard J. Vann, *Taxing International Business Income: Hard-Boiled*

additional degrees of freedom in their transfer pricing analysis;[138]

(3) ALS analysis depends heavily on assessments of risk, which is difficult to quantify and truly impossible to evaluate in an exercise of tax base division among two jurisdictions when the subject of division is profits of a digital economy firm, because such firm could essentially at will shift manifestations of risk to any jurisdiction it wishes,[139] a problem identified yet not satisfactorily resolved by the BEPS project;[140]

(4) the ALS is poorly designed to deal with highly integrated firms of the kind that dominates the digital economy.

In conclusion, neither the factual reality nor the theoretical basis behind the current international tax regime could support the claim that such regime is capable of adequately taxing the digital economy without significant reform.

C. *The Consequences of Blocking Reform*

To complete the argument in favor of the necessity of reform, this Article argues that blocking such reform is risky and undesirable. The biggest risk of waiting is to the very international tax regime that such a conservative approach pretends to preserve. Multiple countries, all of which participated in the BEPS project and the work on BEPS action 1, have already enacted unilateral measures to tax the digital economy.[141] These measures vary, as is expected from decentralized actions that respond to particular needs, interests, and internal politics of each country separately. Once unilateral measures begin to dominate the regime, standardization and the coherence of the international tax regime suffer, threatening its stability, especially when the countries jumping the gun are all powerful nations, naturally hurting the trust of the less powerful nations in the post-BEPS cooperation effort (through the inclusive framework), which is precisely the reverse of the desired effect.

III. VIABLE REFORM ALTERNATIVES AND THEIR SHORTCOMINGS

Seven years after the launch of the BEPS project, the OECD, now in the format of the inclusive framework, is still working on possible solutions to meet the challenges presented by the digital economy with a

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Wonderland and the End of the World, 2 WORLD TAX J. 291 (2010).

138. *Id.*

139. *Id.*

140. *See* OECD, ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION, ACTIONS 8-10 - 2015 FINAL REPORTS.

141. *See infra* Part III.A.

view of building a consensus among stakeholders around a standard solution. The work has been slow, and the road bumpy, causing the work to shift focuses over the years, yet, at the present several proposals have been presented and evaluated by international organizations, individual countries, taxpayers (and business organizations), scholars and other tax experts. This Article contributes to this discourse with elaboration on the withholding solution and demonstration of its advantages over other proposals, a task taken by this Part. The Part begins however with a review of actual countries' responses, all taking action while participating in the BEPS effort to reach a universal consensus, controversially "jumping the gun," with a view to influencing the final consensus, out of frustration with the pace or direction of the BEPS work, or simply because "they could," taking advantage of political opportunities to advance their interests, at least until a global solution is adopted, if at all.

A. *Actual Countries' Responses to BEPS Action 1*

A review of countries' responses to the challenges of taxing the digital economy while the BEPS project is working on a globally standard solution is important to give context to the comparison of proposals that this Part makes. First, actual measures adopted and implemented by countries serve as natural experiments of sorts, contributing to the assessment of both technical and political feasibility of the various solutions. Second, although it is too early to assess the impact and effectiveness of these measures, one could learn from responses to and assessments of the measures on possible merits and disadvantages of the various proposals. Third, these measures expose the political aspects of the digital economy tax discourse, the fragility of the current international tax regime (inability to stop stakeholders from jumping the gun, the ineffectiveness of current rules), and the relative power positions in the regime, allowing some countries to go rogue and at the same time to lead the consensus building effort without concern about the impact of such actions on their standing in the future international tax regime, while other countries (most notably—India), realizing their newly acquired power to influence the process and make sure their interests, ignored until present times, are considered in the development of a consensus based solution, if any.

Perhaps most famously the United Kingdom[142] and Australia[143]

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142. UK: Finance Act (FA) (2015). *See also* HMRC, Diverted Profits Tax Guidance (updated Dec. 2018), *available at* https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/768204/Diverted_Profits_Tax_-_Guidance__December_2018_.pdf (last visited Feb. 21, 2019).

143. Australian Tax Office, Practical Compliance Guideline, PCG 2018/5, *available at* https://www.ato.gov.au/law/view/document?DocID=COG/PCG20185/NAT/ATO/00001 (last

adopted diverted profit taxes (DPT), colloquially known as Google taxes. The U.K. DPT was the first notable unilateral measure in the context of BEPS action 1. It imposes a 25% tax (higher than the normal U.K. corporate tax rate) on diverted profits, which encompass profits of foreign companies generated by provision of goods and services in the United Kingdom without a PE, and profits generated by certain intercompany transactions lacking economic substance and not fully taxed in the United Kingdom.[144] The Australian DPT, at a rate of 40% is applicable as of July 1, 2017, and was preceded by a related change to the Australian GAAR, in effect as of January 2016, named multinational anti-avoidance law (MAAL), giving power to the tax authorities to apply a penalty up to 120% of the additional tax imposed on large entities (generally consolidated groups with turnover exceeding AUD 1b) meeting certain tax avoidance tests. Both measures include multiple tests and exceptions and seem to be designed to compel MNE to effectively become taxpayers (and information providers). Both taxes may be exposed to legal[145] and political challenges.[146] Although not directly targeting the challenging features of the digital economy the DPT was clearly designed to combat particular structures used by U.S. MNE that dominated the digital economy, most specifically the Google "Double Irish/Dutch Sandwich" structure.[147] This solution is therefore very crude and rife with legal problems that it could not be, and has not been presented as a potential global solution; it is the prototypical unilateral solution that disregards impact on other countries, and a measure that could only be imposed, if at all, by the most powerful economies that believe they could unilaterally compel MNE to subject themselves to their scrutiny.

Several other countries adopted versions of the nexus solution, or virtual PE. Israel effectively adopted this solution through a circular interpreting domestic law in a manner that permits taxation of significant economic presence similarly to PE.[148] The circular establishes criteria for identification of significant economic presence, including: operation primarily through the Internet and performance of activities such as:

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visited Feb. 21, 2019).

144. *See* HMRC, Diverted Profits Tax Guidance, *supra* note 142.

145. Most importantly compatibility with tax treaties and EU law, see, e.g., Dan Neidle, *The Diverted Profits Tax: Flawed by Design*?, 2015 BRITISH TAX REV. 147 (2015) (raising concerns, especially regarding compatibility with EU law); and Philip Baker, *Diverted Profits Tax: a Partial Response*, 2015 BRITISH TAX REV. 167 (2015) (arguing that the DPT should be compatible with EU law).

146. Primarily due to the discouraging impact on direct investment, see, e.g., H. Khiem (Jonathan) Nguyen, *Australia's New Diverted Profits Tax: The Rationale, the Expectations and the Unknowns*, 71 BULL. INT'L TAX'N 513 (2017).

147. See examples in HMRC, Diverted Profits Tax Guidance, *supra* note 142.

148. Israeli Tax Authority, Circular 04/2016 (Apr. 11, 2016). The circular included further clarification that the same taxpayers are also subject to VAT in Israel.

identifying customers, collecting or analyzing Israeli market information, providing customer services in Israel, and developing or maintaining a Hebrew-language website.[149] Finally, the circular clarifies that the agency PE analysis should apply also for virtual PE, giving an example of a related-party agent in Israel that makes all of the key decisions regarding the conclusion of contracts (formal approval of the foreign taxpayer does not reverse the PE status). Enterprises resident in non-treaty countries should fare worse under these rules triggering PE treatment with even minimal volume of the above-mentioned activities. The circular has already been implemented with assessments issued to the largest MNE operating in Israel without physical presence, despite the obvious conflict between the Israeli position and that of the BEPS project, on which the Israeli Tax Authorities supposedly rely in its interpretation.[150] India is expected to adopt a similar approach in new rules expected to be in effect on April 1, 2019, after the failure to do so through interpretation of the current PE rules in a manner similar to Israel's.[151] The Slovak Republic adopted in 2017 a more limited expansion of "fixed place of business," to include online platforms (AirBNB, UBER).[152] Hungary adopted a tax on net income from advertising services, based on the destination of the advertisement and the location of the targeted public (*i.e*., without need for physical presence in Hungary).[153] Several other countries seriously considered adopting similar rules or interpretations, yet have not done so.[154] Finally, the European Commission proposed on March 21, 2018 a directive for a long term solution for taxing the digital economy based on the nexus approach and the significant economic presence idea.[155] Yet, in parallel, the Commission proposed a so-called interim solution in the form of a "digital services tax," which attracted most of the interest as explained below, leaving the nexus proposal undeveloped, at least in the present.[156] Italy adopted in 2017, effective Jan. 1, 2019, a withholding scheme that

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149. Note that these and other activities will not be considered preparatory or auxiliary. Similar indicators include substantial advertising, marketing, and customer relations activities in Israel, a substantial number of contracts with Israeli clients online, a large number of Israeli residents using the online services provided by the foreign taxpayer, and online services aimed at Israeli resident consumers, in Hebrew or using Israeli currency payment options. *Id.*

150. *See, e.g*., William Hoke, eBay Israel Hit With $43.5 Million Tax Assessment, 2018 WTD 82-7 (Apr. 27, 2018).

151. *See also* OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 138.

152. Slovak Republic, Income Tax Law, Sec. 16, para. 2. *See* OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 135-36.

153. *Id.* at 145.

154. *See, e.g*., *id.* at 160 n.5.

155. COM(2018) 147 Final.

156. *See* COM(2018) 148 Final, *infra* note 164.

seem to be a hybrid between a withholding solution and an equalization levy.[157]

India chose to adopt a different version of source-oriented solution with its version of the equalization levy, which it was the first to implement.[158] The 6% levy imposed in June 2016,[159] following court losses of the government of India attempting to tax MNE in India based on analogy to traditional PE rules.[160] It is imposed on the gross amount paid by business taxpayers in India to non-residents (unless they have a PE in India) for online advertisement and related services above a threshold amount.[161] This levy also is subject to various legal challenges, the most important of which is its incompatibility with tax treaties; proponents argue that treaties do not apply to the levy since it is not targeting net income, yet it will be difficult to distinguish the levy from withholding taxes that are universally accepted as taxes in lieu of income taxes.[162] Moreover, if the levy is not subject to tax treaties' rules it should not benefit from tax relief in the country of the taxpayer, resulting in double taxation. Discussions with Indian officials reveal that the levy was enacted out of frustration with the inability of India to expand the PE rules within BEPS to include digital presence: India will allow MNE to avoid the levy by declaring PE in India, applying the normal attribution rules, and India even seems to prefer a negotiated (hopefully treaty-based) solution that will allow it to impose sufficient source based taxation.[163] The European Commission, as already mentioned, made on March 21, 2018 a proposal for an interim digital services tax (DST) at a rate of 3% on income from the supply of certain services, including: advertising, transmission of data collected about users which has been generated from such users' activities on digital interfaces, and "intermediation services" or online platform, all based on meaningful user participation in the creation of value from the relevant services, which is the justification for the source/destination based tax.[164] The DST is intended to relieve the

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157. *See* OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 143.

158. The idea of the equalization levy was presented by the final action 1 report. *See* OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 115-17.

159. Chapter VIII of Finance Act, 2016. *See, e.g*., Sagar Wagh, *The Taxation of Digital Transactions in India: The New Equalization Levy*, 70 BULL. INT'L TAX. 538 (2016).

160. ITO v. Right Florist Pvt. Ltd., I.T.A. No. 1336/Kol./2011.

161. *See, e.g*., Wagh, *The Taxation of Digital Transactions in India: The New Equalization Levy*, *supra* note 159.

162. *See, e.g*., Amar Mehta, *Equalization Levy Proposal in Indian Finance Bill 2016: Is It Legitimate Tax Policy or an Attempt at Treaty Dodging*, 22 ASIA-PAC. TAX BULL. 2 (2016).

163. *See, e.g*., Marnix Schellekens, Report on Seminar H: Recent developments in international taxation in IFA's 70th Congress in Madrid (IBFD Online, Sept. 26, 2016).

164. COM(2018) 148 Final.

pressure on and from EU Member States to tax the digital economy while a global standard solution is being negotiated.[165] The DST is essentially equivalent to the Indian equalization tax, yet in the European context it suffered from ample criticism about its legality and political wisdom,[166] especially when presented as an interim measures, eventually voted down by the Member States, yet not disappeared as the European Parliament launched a new initiative to revive the proposal in an expanded form.[167] The United Kingdom, Spain, France, and Austria announced that they will adopt domestic versions of the DST.[168] One can observe the pressure on governments and international organizations "to do something" about taxing the digital economy, and the easiest thing to do is to impose a gross-based, roughly defined, new tax that has the optics of strong political response even when its legality is cast in doubt, a matter that would be resolved in the less pressing future. The typical tagging of these measures as interim measures fits such tactics, yet, it is disingenuous, since once interim measures are in place there will be less political will to push for implementation of the permanent, consensus based measures, and, more importantly, it is unclear how long will it take to reach such consensus, if possible at all, reminding us of the cliché about temporary measures being the most permanent of all. Turnover taxes, similar to the equalization levy in all relevant aspects were also enacted in a few countries, such as Argentina[169] and France.[170] Finally, other countries adopted different measures that involve the taxation of the digital economy, yet in forms other than the more comprehensive solutions on the international agenda.[171]

Although beyond the scope of this Article,[172] various countries adopted new rules for taxing the digital economy with their VAT,[173] some

165. *Id.*

166. *See, e.g.*, Georg Kofler & Julia Sinnig, *Equalization Taxes and the EU's 'Digital Services Tax*,' 47 INTERTAX 176 (2019).

167. *See, e.g.*, Teri Sprackland, European Parliament Votes for Strong Digital Services Tax, 2018 WTD 241-10 (Dec. 14, 2018).

168. As did Korea, outside the European Union, see, e.g., William Hoke, Austria to Introduce Digital Services Tax, 2019 WTD 1-2 (Jan. 2, 2019). *See also* Alvaro de Juan Ledesma, Spain: Digital services tax approved by government, IBFD Online (Jan. 24, 2019).

169. Imposed at the provincial level, see, e.g., Jimena Milessi, *Argentina's Journey to a Digital VAT*, 90 TAX NOTES INT'L 47 (2018).

170. Imposed on transfers of audio-visual content, see OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 146.

171. *See, e.g.*, Romero J.S. Tavares & Aline Dias, *What will a Post-BEPS Latin America Look Like*?, 83 TAX NOTES INT'L 551 (2016) (discussing Chile adopting extensive reporting requirement pertaining to the digital economy).

172. *See infra* Part III.E.

173. *See, e.g.*, Slim Gargouri, Argentina Enacts VAT Rules for Nonresidents' Digital Services, 2018 WTD 88-14 (May 7, 2018);

following the OECD work on similar measures.[174]

B. *The Nexus Approach*

The term "nexus" is somewhat imprecise,[175] yet in effect the use of the term became widespread in reliance on an implied nexus between an item of income and a territory to broaden the traditional PE concept contained in article 5 of both the OECD and the UN Model Tax Conventions. Article 5 already includes physical and personal extensions to the PE concept, contained in articles 5(1) to 5(3) and 5(5) of the Models, all of which could also be considered manifestations of the nexus approach,[176] yet in the context of the taxation of the digital economy the term "nexus approach" refers to the various initiatives to include (at both treaty and domestic law level) an extended concept of Virtual PE or Significant Economic (Digital) Presence and corresponding rules for attributing profits to such newly created PE.

1. The Virtual PE Solution

Despite the terminology, the Significant Economic Presence rule is really about modifying the PE concept for the digital age, suggesting that there can be a virtual PE, meaning a PE that is fully dissociated from the current physical and personal presence requirements that have traditionally characterized PE. The existence of a Virtual PE could hypothetically depend on:(1) a revenue factor identified, with a (preferably) high[177] threshold of gross revenues generated from remote transactions,[178] calculated on a group basis;[179] combined with either (2) digital factors either in the form of local domain names, local digital platforms or local payment options;[180] or (3) user-based factors, such as monthly active users, online contract conclusion or data collected.[181]

This new definition of a Virtual PE is actually not much different from that proposed in recent academic work,[182] in the '2018 EU Significant

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174. OECD, INTERNATIONAL VAT/GST GUIDELINES (Apr. 12, 2017).

175. And, to make things worse, is often used in the context of U.S. state and local taxation.

176. As well as the common "service PE" provisions, such as article 12A of the UN Model.

177. Intended to minimize administrative burdens for tax administrations, as well as compliance burdens for the taxpayer. *See* OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 108.

178. A reference to 'digital' transactions is avoided in order not to treat other 'remote' transactions (mail-order or telephone transactions) differently. *Id.*

179. A separate-entity basis should be avoided in order to prevent artificial fragmentation of distance selling activities. *Id.*

180. *Id.* at 109.

181. *Id.* at 110-11.

182. Hongler and Pistone refer to the provision of digital services used by more than one thousand monthly users if the total amount of revenue due to the aforementioned services in the

Digital Presence Directive Proposal'[183] and, to a lesser extent, by national regulation referring to Virtual PEs.[184]

The proposal has significant advantages and continues to be on the official agenda of the OECD,[185] yet a Virtual PE entails serious technical drawbacks as well. The breach of the continuity requirement (*i.e.*, the non-existence of a PE leads from full to zero taxation), that is present in traditional physical and personal PEs, would become even more dramatic in the new nexus, where the lack of a single threshold unit (day, dollar, user or consumer) could lead from full taxation of income attributable to the Virtual PE to no source taxation at all.[186] Additionally shaping the threshold(s) upon which the concept of Virtual PE is based is a difficult task;[187] as a result, the final rules would be complex and difficult to

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other Contracting State exceed a yet-to-be-determined minimum turnover. Hongler & Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of Digital Economy*, *supra* note 17). In fact, their proposal combines a revenue factor with a user-based factor. *See also* Yariv Brauner & Pasquale Pistone, *Adapting Current International Taxation to New Business Models: Two Proposals for the European Union*, 71 BULL. INT'L TAX'N 681, 683 (2017) [hereinafter Brauner & Pistone, *Adapting Current International Taxation to New Business Models*].

183. Article 4(3) of the '2018 EU Significant Digital Presence Directive Proposal' provides that 'significant digital presence' shall be considered to exist in a Member State if digital services are provided through a digital interface and one or more of the following conditions is met: (a) the proportion of total revenues obtained in that tax period and resulting from the supply of those digital services to users located in that Member State in that tax period exceeds EUR 7,000,000; (b) the number of users of one or more of those digital services who are located in that Member State in that tax period exceeds 100,000; (c) the number of business contracts for the supply of any such digital service that is concluded in that tax period by users located in that Member State exceeds 3,000.

184. On February 1, 2018 the Indian Finance Minister presented the country's then-latest budget containing a new sourcing rule that referred to SEP based upon two alternative factors: (1) the aggregate of payments arising from a transaction carried out by a non-resident during the financial year exceeding a yet-to-be-prescribed amount or (2) systematic and continuous soliciting of business activities or engaging in interactions with a yet-to-be-prescribed number of Indian users through digital means. For its part, the Indian budget proposal defined SEP by, alternatively: (a) a mere revenue factor (on a transaction by transactions basis) or (b) a combination of a user-based factor and a totally undefined concept of 'continuous soliciting of business.' The Indian Significant Economic Presence threshold has been rightly criticized for its vagueness and ambiguity. *See* Shilpa Goel, *Indian 2018 Budget: New Nexus to Tax Based on Virtual Presence*, KLUWER INT'L TAX BLOG (Feb. 5, 2018), *available at* http://kluwertaxblog.com/2018/02/05/indian-2018-budget-new-nexus-tax-based-virtual-presence/ (last visited Aug. 22, 2018). Israel effectively adopted a Virtual PE solution as well. *See supra* text accompanying notes 148-50.

185. PUBLIC CONSULTATION DOCUMENT, *supra* note 119.

186. For more on the continuity approach and the avoidance of the all-or-nothing rule, even if unrelated to a VPE, see Wolfgang Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 WORLD TAX J. 67, 99-101 (2009). For the same reasoning regarding service PE or virtual PE, see Báez Moreno & Brauner, WHT in the Service of BEPS Action 1, White Paper, *supra* note 26, at 18.

187. For a good description of these difficulties, see Daniel. W. Blum, *Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined*?,, 69 BULL. INT'L TAX'N 314, 322-23 (2015) [hereinafter Blum, *Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative*].

interpret. Rules defining thresholds in relation to existing proposals on Virtual PEs have been criticized for being vague and ambiguous,[188] and, at the same time, a nightmare of complexity and uncertainty.[189] In the same vein, thresholds, particularly revenue- or user-based factors, may be easy for a potential taxpayer to avoid, which will, inevitably, lead to such thresholds being designed on a related-group basis rather than on a separate-entity basis[190] and, for any domestic sales thresholds, to the application of anti-avoidance rules to address artificial (or resale) arrangements with non-group members.[191] Although theoretically effective for ensuring the integrity of the system, such rules would add complexity to already-cumbersome threshold rules. Due to all the above it is evident that Virtual PEs pose major challenges with regard to compliance and enforcement. Indeed, according to current proposals defining significant digital presence, 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 significant digital presence. In the context of a company with no physical presence in the source state this might prove extraordinarily problematic.

However, the above are just minor problems in comparison to what has been labelled as the Achilles' heel of all of the current proposals that favour a new Virtual PE:[192] the attribution of profits to whatever newly created Permanent Establishment. These problems merit separate

188. In relation to the new Indian nexus to be taxed on virtual presence, see Goel, *supra* note 184.

189. In relation to the 2018 EU DST Directive Proposal, see Johannes Becker & Joachim English, *EU Digital Services Tax: A Populist and Flawed Proposal*, KLUWER INT'L TAX BLOG (Mar. 16, 2018).

190. As recognized by OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 108, and by OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 188, for revenue-based factors. Both the 2018 EU Significant Digital Presence Directive Proposal, art. 4(3) and the 2018 EU Digital Service Tax Directive Proposal, art. 4(6), follow this recommendation. *See supra* notes 155 & 164.

191. Recognized by OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 188-89, for domestic sales thresholds.

192. *See, e.g.*, Li, *Protecting the Tax Base in a Digital Economy*, *supra* note 75, at 445; Blum, *Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative*, *supra* note 187, at 322-23; Kofler et al., *Taxation of the Digital Economy: 'Quick Fixes' or Long-Term Solution*?, *supra* note 72, at 529; DALE PINTO, E-COMMERCE AND SOURCE-BASED INCOME TAXATION 322 (2003); Schön, *Ten Questions about Why and How to Tax the Digitalized Economy*, *supra* note 22; Matteo Cataldi, *The Attribution of Income to a Digital Permanent Establishment*, *in* TAXATION IN A GLOBAL DIGITAL ECONOMY 143, 149 (Ina Kerschner & Maryte Somare eds., 2017); Adolfo Martín Jiménez, *BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties*, 46 INTERTAX 620, 624 (2018); OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23, at 111-12.

consideration.

2. Focus on Profit Attribution Rules

Proposals based on the nexus approach originally focused on the reframing of the traditional nexus (or PE) rules to accommodate taxable presence based not only on physical but also on virtual presence. The entire BEPS work until 2018 essentially ignored the complementary profit attribution rules that actually determine the new tax base created by the reform of the rules.[193]

On January 29, 2019, the OECD published a policy note on behalf of the inclusive framework concerning the taxation of the digital economy,[194] followed by a Public Consultation Document, published on Feb. 12, 2019,[195] in which it did an about-face, shifting the focus to the profit allocation rules. The consultation document includes some vague, diplomatic language stating in addition that all it says is "on a without prejudice basis," and continuing the commitment to not ring-fence the digital economy. It is clear that it responds to pressure by a few powerful OECD members to change course from the solutions explored by the final action 1 report:[196] the U.S. and U.K. proposals that focus on the profit allocation rules, and the German/French minimum tax proposal.[197]

The policy note states that the purpose of the work on these two solutions is to counter unilateral actions by states, actions that would threaten the stability of the international tax regime to the detriment of all.[198] Unfortunately, the transparent concession to the most powerful nations in the OECD is likely to further weaken the international tax regime, since it signals continuance of the snub of developing countries and their interests in general, and also the fundamental requirement for a fairer division of tax bases in particular. The proposals are not detailed and therefore could not be comprehensively analyzed, yet a few observations could be made, none of which are flattering to the proposals.

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193. On the scarce previous work of the OECD on attribution of profits to a newly created Digital PE, see, e.g., Báez Moreno & Brauner, *Reforming "Nexus*," *supra* note 67.

194. Addressing the Tax Challenges of the Digitalisation of the Economy—Policy Note (Jan. 23, 2019), *available at* http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf [hereinafter Addressing the Tax Challenges of the Digitalisation of the Economy].

195. OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 119.

196. OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT, *supra* note 23.

197. *See infra* Part III.G. The Public Consultation Document includes a lip service to a third solution it names: the "significant economic presence" proposal, which suggests that it will continue to work on the virtual PE solution, yet this proposal is drafted in vague and non-committing language and does not include the analysis that the document engaged in, even if preliminarily, with respect to the other two proposals.

198. Addressing the Tax Challenges of the Digitalisation of the Economy, *supra* note 194.

The refocusing on profit allocation gives one the impression that the consultation document maintains the nexus approach, or the virtual PE as a viable solution. It provides no technical details that are cardinal for any assessment of a threshold rule based on the nexus approach and the condition for its success.[199] The proposal simply shifts the focus to the profit allocation question, using the value creation mantra to camouflage the fact that it proposes no solution for the basic nexus question.[200]

The U.K. proposal, renamed as the "user participation" proposal,[201] calls for an amendment of the profit allocation rules to take account of user participation in the user's country.[202] The proposal is to permit countries where certain users truly provide a benefit to certain businesses of the type that significantly benefit from the contribution of users, such as social media platforms, to automatically declare nexus and require allocation of some profits to such nexus with the view of having consequent jurisdiction to tax such profits. The proposal does not extend the rule to all businesses but rather only to those significantly benefiting from said user participation, an obvious ring-fencing exercise that violates what was supposed to be the one ground rule that could not be broken.

Another, perhaps the most serious difficulty presented by this proposal is that despite the rhetoric about shifting focus to the profit allocation rules it does not offer any insight into how that could practically be done. The proposal acknowledges that the ALS could not be applied, suggesting instead the use of residual profit split with the final residual profit (the "upside") allocated based on a pre-agreed formula. It is unclear how this proposal will fare with the arm's length orthodoxy in the OECD when it comes to specify the detailed rules,[203] yet what is clear

199. Despite the fact that one viable proposal was made and later discussed in multiple fora, it has never been fully adopted (neither has a different proposal been adopted) or elaborated on in the BEPS context. *See* Hongler & Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, *supra* note 17, at 2.

200. As explained below, the proposal mentions that it would be possible to apply the profit allocation rules automatically, which means without determining nexus first, in what is effectively formulary taxation of business income, a solution supported by many (*see, e.g.*, Yariv Brauner, *Formula Based Transfer Pricing*, *in* THE PROPER TAX BASE: STRUCTURAL FAIRNESS FROM AN INTERNATIONAL AND COMPARATIVE PERSPECTIVE—ESSAYS IN HONOR OF PAUL MCDANIEL 149 (Yariv Brauner & Martin M. McMahon eds., 2012) yet repeatedly dismissed by the OECD. *See* OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 28, 43 (2017), *available at* http://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm (last visited Feb. 17, 2019).

201. *See* OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 119, at 9.

202. U.K. Proposal, *available at* https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf.

203. *See* Addressing the Tax Challenges of the Digitalisation of the Economy, *supra* note

is that the proposal results in very little shifting of revenue to source jurisdictions, especially to poor jurisdictions.

The proposal requires many threshold decisions which will determine its impact. This requirement is unlikely to garner support among developing countries lacking trust in a project that had ignored their needs to date. These are the same countries that have rejected mandatory arbitration as a solution for the lacking dispute resolution mechanism of the current international tax regime based on a similar lack of trust.

Ironically, the proposal emphasizes that its success depends on a strong dispute resolution component, but it fails to mention that such component does not exist.[204] Similarly, the proposal ignores the cost of enforcement and administration of such a complex norm which immediately disadvantages the less wealthy countries, and as market economies, will make them dependent on information that is primarily at the disposal of the residence countries or that the residence countries will more simply cheaply obtain through the goodwill of such countries in the exchange of such information.[205] Finally, the proposal definitely does not resolve the challenges presented by digital businesses that do not depend on user participation of the sort mentioned in the U.K. proposal.[206]

The theoretical justification of the United Kingdom is also debatable. It does provide an intuitively appealing rationale for taxation at the source in the absence of physical presence, yet one wonders whether such rationale could and should be translated into an operative rule or simply support the fairness and legitimacy need to augment source taxation. If the latter, then it is useful to garner support for different solutions that increase source taxation, most of all for the virtual PE proposal.

As an operative rule, however, it faces a few difficulties: first, user involvement may not be viewed as unique in the context of the digital economy. The extent of active user involvement in the digital economy and the active production of content by users may be viewed as sufficiently more intensive in the digital economy to justify qualitative distinction from user involvement in the non-digital economy. If this is the argument for an operative rule it could only serve to tax at the source a minor segment of that economy making this indeed consistent with the U.K. proposal.

The focus on user involvement in this context is arbitrary in the sense that one could think of other ways that digital economy firms can get

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204. *See* OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 119, at 11.

205. The Public Consultation Document briefly mentions in the last sentence that work will be done to reduce the administrative burden yet does not provide any detail on the matter. *Id.*

206. *See supra* Part I.B.1 (explaining about the primacy of B2B in the relevant markets and the mistaken focus on the more visible B2C paradigm that must be the basis for the user participation proposal). *See* OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 119, at 10.

involved in the economy of a source country without physical presence as demonstrated by the marketing intangibles. Moreover, both the U.S. and the U.K. proposals are conservative (assuming one is neutral about the political origins of both proposals) in the sense that they accept physical presence as the benchmark trigger for source taxation, using digital proxies for that benchmark rather than rethinking it. One could think about another way of doing the same thing: analogizing the digital business as a whole to a comparable non-digital business. That solution seems too obscure and therefore cannot be proposed in such general terms yet it is exactly what the U.S. and the U.K. proposals attempt to do, just in a more genuine form.

A second difficulty of the user involvement ideas is its necessary reliance on the value creation notion.[207] This may be viewed as positive because that notion is pushed by the OECD as a new foundation of international taxation. However, the notion has received cool reception once it had to be translated into derivative rules,[208] which casts doubt on the practicality of a user involvement rule. A third difficulty of the user involvement ideas is its intuitive, yet misled reliance on the benefit principle to assess taxation at the source. This difficulty pertains to the idea that users in the digital economy perform productive functions to such an extent that they should be compensated for them.

Becker and Englisch, wrote an article that genuinely attempts to advance the discussion of this idea toward a practical solution. The article suggests an attempt to distinguish between most instances of user involvement that they admit is essentially passive (*i.e.*, does not distinguish the digital economy). In those special cases where three conditions are met: (1) stable user relationship, (2) use of the relationship in the firm's value creation, and (3) user network being a sufficient size or intensity, Becker and Englisch conclude that nexus could be declared.[209] This does not extend to the appropriate profit allocation to such nexus, a conclusion that does not fall prey to the confusion between following the benefit principle for justification of taxation and using the principle to calculate the tax, unfortunately, the OECD and the U.K. proposal were not so careful. As to the Becker and Englisch proposal, as such, it is too early to assess it. Without a detailed proposal, one could

207. *See* Becker & Englisch, *Taxing Where Value is Created*, *supra* note 52, at 166-70.

208. *See*, *e.g*., Jonathan Schwarz, *Value Creation: Old wine in new bottles or new wine in old bottles*?, KLUWER INT'L TAX BLOG (May 21, 2018), *available at* http://kluwertaxblog.com/2018/05/21/value-creation-old-wine-new-bottles-new-wine-old-bottles/ (last visited Feb. 17, 2019); Allison Christians, *Taxing According to Value Creation*, 90 TAX NOTES INT'L 1379 (2018); Marcel Olbert & Christoph Spengel, *International Taxation in the Digital Economy: Challenge Accepted*?, 9 WORLD TAX J. 3 (2017); and Michael P. Devereux & John Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System* (July 31, 2018) (disputing the wisdom of relying on "value creation" as a principle for taxing the digital economy).

209. Becker & Englisch, *Taxing Where Value is Created*, *supra* note 52, at 171.

not compare it to other nexus establishing proposals.[210] As a nexus establishing proposal, this Article argues that it is likely to be inferior to the withholding solution explained above.[211]

The U.S. proposal, not yet fully exposed in an official document of that government,[212] uses the same general approach as the U.K. proposal but with a view to apply it to all businesses, avoiding the ring-fencing trap. This proposal views the participation of a business in the source economy in the form of the development of marketing intangibles that makes a link to the market economy sufficient to justify taxation by the latter.[213] The justification is built on the inherent relationship between marketing intangibles and the market economy, a type of relationship that cannot, according to the proposal be identified for other intangibles (intangibles being the productive assets in question since other assets would naturally end up related to physical presence in the market country if they were to create value in such country) and therefore justifies reliance on marketing intangibles as triggers for taxation by the market country.[214]

This proposal is more sophisticated than the user participation proposal (in concept—we have not seen a detailed proposal): first, it avoids ring-fencing; second, it does not reformulate the PE definition but rather suggests to alternatively allocate profits to marketing intangibles automatically (once a marketing intangible is identified, it is qualified for profit attribution) in a manner analogous to allocation of profits to a PE; third, although it is not decisive about it, the proposal essentially suggests to use the current transfer pricing rules, in their current format, with the post-BEPS emphasis on residual profit split to determine proper allocation rather than fall into the formulary allocation trap. The uncommitted language demonstrates an understanding that this exercise will be difficult to implement and even more difficult to standardize, so an alternative reliance on "formulaic approaches" based on "mechanical approximations" is suggested for further study.[215]

The advantages of the marketing intangibles proposal over the user participation proposal do not extend however to the fundamental requirement of a fairer division of tax bases. Similarly to the U.K. proposal, it will clearly result in little shifting of profits to source jurisdictions and may even result in an even less fair division of tax bases

210. *See* Hongler & Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, *supra* note 17.

211. *See infra* Part III.B.

212. *See, e.g.*, Jennifer McLoughlin, *Politics Driving Debate Over Global Digital Taxation*, 93 TAX NOTES INT'L 116 (2019).

213. *See* OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 119, at 11.

214. *Id.* at 12.

215. *Id.* at 15.

than the current regime since the richest countries may claim, as the United States has been claiming for a while—that was the reason for the invention of the marketing intangible concept in the first place—that more profit needs to be allocated to them rather than to traditional source jurisdictions.[216] Even more obviously, the more powerful and more sophisticated jurisdictions will have more resources to fully implement these difficult to implement rules. Another similarity between the marketing intangibles and the user participation proposals is the statement that their success depends on strong dispute resolution,[217] a disingenuous statement as already explained.[218] Finally, similarly to the user participation proposal, the marketing intangibles proposal does not have any comprehensive theoretical basis, being merely one of many options to partially tax the digital economy at the source, ignoring the "bigger picture" fairness and legitimacy requirement from a solution to this problem.

C. *Equalization Levies*

The third alternative mentioned in the final BEPS action 1 report, resembled the withholding option being source-based and generally levied on gross income, yet it differed from both the withholding and the nexus-based solution as anew tax to be introduced, outside the current regime.[219] Typically, equalization levies were introduced as interim solution or quick fixes to pressures related to non-taxation of the digital economy.[220] Interim solutions are generally undesirable, yet particularly undesirable at the present when there is still some political momentum to reach a global solution to the challenges that the digital economy present to the international tax regime, a global solution that is necessary for a challenge that is global in essence. The mobility inherent to the digital economy and the interdependence of countries' economies in its context necessitate a standard solution that would result in acceptable division of the tax base, assuming that countries still wish to refrain from double taxation. Interim solutions distract countries from participation in the global effort, increase biases since amending existing rules may seem costlier to countries than adopting a new rule, and diminish adopting countries perceived benefits from a universal solution. Moreover, the global effort towards a universal solution may not succeed, leaving

216. For a concise history and explanation of the politics involved, see, e.g., Marc M. Levey, Philip W. Carmichael, Imke Gerdes, & Daniel A. Rosen, *Marketing Intangibles — The Expanding Global Analysis* 27 J. INT'L TAX'N 20 (2016).

217. *See* OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 119, at 16.

218. *See supra* text accompanying note 204.

219. *See supra* text accompanying note 26.

220. *See* Mehta, *supra* note 162.

countries with interim measures that they had not originally considered and analyzed as final or long-term measures, making them manifestly sub-optimal.

Pragmatically, some of the levies are applied by recruitment of the domestic payers through either a mechanism akin to withholding taxes or special reporting requirements. They are therefore substantively identical to withholding taxes, which means that first, they are not administratively superior to the withholding solution, and, second, that the claim that they are outside the scope of tax treaties based on Model Article 2 is weak.[221] In any event, they are less likely to be considered creditable at the relevant residence countries than withholding taxes, either because the treaty would not be considered applicable to them or because their design is not sufficiently similar to other creditable taxes.

Playing outside the rules of the game is costly for the international tax regime,[222] and so are equalization levies that present a myriad of potential conflicts with international laws, primarily EU and tax treaties laws that the withholding solution does not present.[223]

In conclusion, on all grounds (leaving speculative political considerations) the withholding solution is superior to the equalization levies solution.

D. *Turnover Taxes*

Turnover taxes resemble the equalization levies in all respects, yet they tend to be designated as such when applied to particular sectors or types of income.[224] These taxes are conceptually indistinguishable from the equalization levies and therefore the same critique is applicable to them.[225]

E. *Value Added Taxes*

Corporate income taxation was not the only concern of BEPS action

221. *See also* Alessandro Turina, *Which 'Source Taxation' for the Digital Economy*?, 46 INTERTAX 495, 518 (2019).

222. *See* explanation in *supra* Part I.B.6.

223. *See, e.g*., Ruth Mason & Leopoldo Parada, *Digital Battlefront in the Tax Wars*, 92 TAX NOTES INT'L 1183 (2018) (arguing that the high revenue triggers in proposed DST may violate state-aid law and prohibitions on nationality discrimination in the Treaty on the Functioning of the European Union, and that if those flaws were corrected, they would be less discriminatory, but also less politically palatable); Brauner & Pistone, *International/European Union/OECD - Adapting Current International Taxation to New Business Models*, *supra* note 182, at 681; Kofler & Sinnig, *Equalization Taxes and the EU's 'Digital Services Tax*,' *supra* note 166.

224. *See, e.g*., *supra* text accompanying note 170 (the French tax on audio-visual content).

225. For a similar approach, see OECD, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018, *supra* note 23, at 140-41.

1: "Issues to be examined include . . . how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services."[226] The relationship between direct and indirect taxation poses numerous and interesting theoretical and practical problems, yet this Article, to be pragmatic, accepts the dominant approach analyzing them separately in the same way that actual policymakers, including the BEPS project, do.

This Article wishes to address, however, two issues related to this choice of approach. First, the withholding solution (and the nexus approach at that) was criticized that it *de facto* creates a quasi indirect tax,[227] a claim that may be viewed as meaningless in our world where policies related to the mix of taxes are simply not considered by politicians. Yet, as already explained by Doernberg with respect to the withholding solution,[228] first, the withholding tax may be creditable in the residence state and hence should not increase the overall tax burden on digital transactions, and, second, the withholding solution retains the right for the taxpayer to file on a net basis in the source country (if the withholding tax burden exceeds the tax burden on net income attributable to activities in that country). Second, the mechanisms of the withholding solution and of a VAT should work in support of each other in the digital economy. Particularly the option to register in the source country should correspond well to the VAT registration requirements and the withholding solution's information exchange mechanism, through the standardization of reporting on both taxpayers and transactions should equally be useful for the enforcement of a VAT, if any.

F. *The DBCFT*

The destination based cash flow tax (DBCFT) is essentially a VAT with a separate, progressive wage tax. It is similar to past proposals to replace the U.S. corporate tax and hence required to avoid being branded as a VAT, assuming that such branding would make any proposal politically infeasible.[229] It has been promoted by Professor Mike Devereux and co-authored in various forms and occasions in recent years.[230] In 2017, Devereux and co-author Professor John Vella, argued

226. The final report has dedicated significant attention to this issue. OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 – 2015 FINAL REPORT, *supra* note 25, at 133-38, 147-48 & 152.

227. *See, e.g.*, PINTO, *supra* note 192, at 183.

228. *See* Doernberg, *Electronic Commerce and International Tax Sharing*, *supra* note 30, at 1013.

229. *See, e.g.*, DAVID F. BRADFORD, UNTANGLING THE INCOME TAX (1986) (proposing the X-Tax, a consumption tax with a progressive wage tax component as a replacement for the corporate income tax).

230. *See, e.g.*, Alan J. Auerbach, Michael P. Devereux, Michael Keen, & John Vella,

that the DBCFT is superior to other international tax reform proposals to tackle the challenges presented by the digital economy.[231] Much of their analysis conceptually resembles the analysis of this article: the analysis recognizes the inability of the current rules to effectively tax the digital economy, the DBCFT does not ring-fence the digital economy, it is a destination based tax (although the motivation of the DBCFT is efficiency based, while the withholding solution is primarily driven by fairness, legitimacy and effectiveness of the tax), it works best for B2B while suggesting that B2C could be handled using similar measures in combination with regulatory requirements of facilitating financial institutions

Despite the similar approaches, and the merits of the DBCFT as a policy alternative, it goes beyond the scope of the analysis of this article since it would replace the corporate income tax which preservation was a basic condition of the BEPS project and this article. Note that this condition is not merely technical; playing outside "the rules of the game" should open a much wider discussion that requires evaluation of the risks involved in a more fundamental reform, especially destabilization of the international tax regime and conflict with other international legal regimes, such as the WTO.[232] From the perspective of the taxation of the digital economy the withholding solution achieves much of the same benefits by playing within the rules of the game, and therefore is also more likely to gain legitimacy than the DBCFT that has not been welcomed by any country to date.[233]

An additional advantage of the withholding solution over the DBCFT is its actual division of the tax base among market and residence countries, division reflected in the relative low rate of withholding and the use of withholding which is a universally accepted tax "in lieu of an income tax"[234] and therefore acceptable for double tax relief even in

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International Tax Planning under the Destination-Based Cash Flow Tax, 70 NAT'L TAX J. 783 (2017).

231. Michael P. Devereux & John Vella, *Implications of Digitalization for International Corporate Tax Reform*, 46 INTERTAX 550 (2018). This Article is a shorter version of Michael P. Devereux & John Vella, *Implications of Digitalization for International Corporate Tax Reform*, *in*, DIGITAL REVOLUTIONS IN PUBLIC FINANCE 91 (Sunjeev Gupta, Michael Keen, Alpa Shah, and Geneviève Verdier eds., 2017).

232. *See, e.g.*, Wolfgang Schön, *Destination-Based Income Taxation and WTO Law: A Note*, *in*., PRACTICAL PROBLEMS IN EUROPEAN AND INTERNATIONAL TAX LAW, ESSAYS IN HONOUR OF MANFRED MÖSSNER 429 (Heike Jochum, Peter Essers, Michael Lang, Norbert Winkeljohann, Bertil Wiman eds., 2016); Reuven S. Avi-Yonah & Kimberly Clausing, *Problems with Destination-Based Corporate Taxes and the Ryan Blueprint*, 8 COLUM. J. TAX L. 229 (2017).

233. In the United States, it was part of House Speaker Ryan's tax reform agenda for a while, yet never gained tract. It was eventually replaced by the initiative that became P.L. 115-97. *See* A Better Way: Our Vision for a Confident America, GOP Tax Reform Task Force (June 24, 2016), *available at* http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

234. *See, e.g.*, 26 U.S.C. § 903; 26 C.F.R. § 1.903-1.

credit jurisdictions. The DBCFT is the only and final tax proposed. Devereux and Vella acknowledge what they call the arbitrariness of taxing solely based on destination, yet, they provide a few justifications for pursuing the tax regardless: the location of customer-based intangibles usually at the source country, benefit principle justifications for taxation at source (destination in their case), the curtailing of the race to the bottom triggered by tax competition, and the realization that allocation of taxing rights is largely arbitrary anyway. This article agrees with these observations yet notes that beyond support of taxation at source these observations do not disprove of residual residence taxation for which the DBCFT does not provide.[235]

Finally, Devereux and Vella answer a potential challenge to the DBCFT based on a scenario when a payment is made in one country yet the related economic activity/customers are located in another country, arguing that the practical and conceptual difficulties of taxing such economic activity are significant, probably making such taxation prohibitive. This scenario is related to the user participation problem when it comes in isolation from payments and the direct answers to that problem based on a nexus approach. Like Devereux and Vella, this article does not dismiss such taxation in principle, yet argues that the mentioned difficulties seem prohibitive at the present and that the withholding solution is therefore superior, adding that user activity without payment and hence without taxing rights may be viewed as problematic yet it may not be significantly distortive (from a tax base division perspective)[236] and it does not present a base erosion problem.

G. *GILTI & Co*.[237]

The recent TFDE Public Consultation Document states that the OECD is now working on a second solution,[238] suggested by the French and German governments,[239] and is fashioned after the so-called GILTI rules

235. *See* Andrés Báez Moreno, *A Note on Some Radical Alternatives to the Existing International Corporate Tax and Their Implications for the Digital(ized) Economy*, 46 INTERTAX 560 (2018).

236. *See, e.g*., Becker & Englisch, *Taxing Where Value is Created*, *supra* note 52, at 171. Even these supporters of taxation in the following of user involvement explain that such taxation would be justified only in a few, specific cases.

237. Some of the thoughts presented in this Part were previously published in Yariv Brauner, *Editorial*, 47 INTERTAX (2019).

238. Addressing the Tax Challenges of the Digitalisation of the Economy, *supra* note 194.

239. *See, e.g*., Stephanie Soong Johnston, Germany, France Explore GLOBE Proposal to Tax Digital Economy, 2018 WTD 221-3; Johannes Becker & Joachim Englisch, *The German Proposal for an Effective Minimum Tax on MNE Profits*, KLUWER INT'L TAX BLOG (Jan. 17, 2019), *available at* http://kluwertaxblog.com/2019/01/17/the-german-proposal-for-an-effective-minimu m-tax-on-mne-profits/ (last visited Feb. 17, 2019).

adopted in 2017 by the United States in TJCA.[240] The solution, called the "Global Anti-Base Erosion Proposal" is a minimum tax imposed by the residence country of a corporate taxpayer on income of foreign branches and entities controlled by the taxpayer when the branch of controlled entity's country does not tax or has low-taxes on such income.[241]

GILTI is a minimum (yet final) flat tax on foreign income of U.S. Shareholders that is not otherwise already taxed in the United States.[242] It was presented as a tax on profit shifting of intangibles, hence the GILTI acronym (for "Global Intangible Low-Taxed Income). Its design points to a different policy: expansion of the U.S. worldwide income taxation, in line with minimum tax on foreign income proposals that have been promoted for many years by politicians from both sides of the aisle with no success until the passage of TJCA.[243] The attraction of the U.S. reform, done unilaterally without regard to the global cooperation efforts in the BEPS context, to other developed countries, particularly to countries where multiple, large MNE reside, was in its legitimation of the capture of more foreign profits in the guise of an anti-profit shifting measure.

Indeed, the Public Consultation Document explicitly states the purpose of the work on this solution is to address concerns of the rich countries about the lack of focus of prior TFDE work on profit shifting.[244] The basic idea is that MNE will be taxed at a minimum level on a non-deferral basis by their residence jurisdiction, and therefore should not have the incentive to shift profits to low-taxed jurisdictions. The proposal naturally shifts taxes to residence rather than to source jurisdictions, defying, similarly to the other solutions considered by the OECD, the fundamental goal of fairer division of tax jurisdiction and more source taxation. To ostensibly balance the distributional implications of the minimum tax, the proposal accompanies it with a denial of deductions (or treaty benefits) to base-eroding payments not sufficiently taxed.

The real devil however is truly in the details of such a proposal: it would require a set of decisions, each of which will be politically contentious and result in significant impact on different countries (what is sufficient taxation at the source, for example). Who decides which countries win and which lose? The response of the OECD to the richest

240. P.L. 115-97. The GILTI rules are in 26 U.S.C. § 951A.

241. OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 119.

242. *See also* NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON THE GILTI PROVISIONS OF THE CODE (May 4, 2018), 2, *available at* https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2018/1394_Report.html (last visited Feb. 16, 2019).

243. *See, e.g.*, Victor Fleischer, *Obama's Budget Seeks International Minimum Tax for Corporations*, N.Y. TIMES, Deal Book (Feb. 3, 2015), *available at* https://dealbook.nytimes.com/2015/02/03/obamas-budget-proposal-would-create-an-international-minimum-tax-for-corporations/ (last visited Feb. 16, 2019).

244. OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 119, at 24.

countries in the Public Consultation Document, shifting the work of the TFDE to their proposals and abandoning prior, more balanced options, raises the concern that the old bias in favor of residence, primarily OECD, raised its head again at the BEPS project. The biased response further dismantles the international tax regime as developing (and other) countries with an ability to respond will continue to act unilaterally. This has been clearly demonstrated by past unilateral actions, such as India's equalization levy.[245]

Note also that this proposal is complementary to the BEPS work on action 3 and the push for standard, universal CFC rules,[246] which was basically rejected by BEPS stakeholders and should fare worse in the inclusive framework.[247] Such an attempt to bring this idea in the backdoor *via* the action 1 work is both disingenuous and unlikely to convince its original opponents. Supporters of the proposal may argue that it is, like the GILTI rules, complementary to the CFC rules, and would operate in symbiosis with them, side-by-side. However, CFC rules are very different in different countries and many countries do not use them, making the proposal incompatible with most countries' tax systems. One of the reasons for not adopting CFC legislation or adopting minimal CFC legislation is the cost of enforcement and the sophistication required by revenue agents auditing MNE on deferred income, which obviously disadvantages the poorer countries and make such legislation often wasteful for them. This proposal should be similarly unattractive to such countries, and therefore cannot expect to receive their support.

The complementary anti base erosion element does not compensate for the unattractive impact of the minimum tax on source countries: first, because it requires the source jurisdictions to deny a deduction, consistent with the anti-hybrids rule of BEPS action 2.[248] This rule is very problematic and unlikely to be in the interest of developing countries that

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245. *See infra* Part III.C.

246. *See* OECD, DESIGNING EFFECTIVE CONTROLLED FOREIGN COMPANY RULES, ACTION 3 - 2015 FINAL REPORT.

247. *See, e.g*., ActionAid, The BEPS process: failing to deliver for developing countries (Sept. 16, 2014), *available at* https://www.francophonie.org/IMG/pdf/beps_16th_sept_2014_actionaid.pdf (last visited Feb. 16, 2019) (demonstrating that developing countries do not trust the richest nations that they would equally shoulder the burden and fight BEPS, rather believing that the latter would take advantage of concessions made by developing countries in the process for their own short term interests). For more conceptual critique of the work on action 3, see, e.g., Kimberly S. Blanchard, *BEPS Action 3: How Not to Engage with CFC Rules*, BLOOMBERG (July 1, 2015), *available at* https://www.bna.com/beps-action-not-n17179928956/ (last visited 2/16/2019); and Daniel W. Blum, *Controlled Foreign Companies: Selected Policy Issues—or the Missing Elements of BEPS Action 3 and the Anti-Tax Avoidance Directive*, 46 INTERTAX 296 (2018).

248. *See* OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, ACTION 2 - 2015 FINAL REPORT.

starve for foreign investment. It will complicate the source country's tax system (*i.e*., a domestic entity doing exactly the same thing and claiming the exact same expense will get the deduction for it while the equivalent foreign investor will not). Second, a heavy administrative burden is imposed on the source jurisdiction, most importantly to determine whether the payment is subject to sufficient taxation in the payment's target jurisdiction. Better cooperation among jurisdictions, including more effective exchange of information about taxation of cross-border payments would be a valiant goal, but it could not be made the sole responsibility of the source jurisdiction. The withholding solution achieves more with less burden on the source jurisdictions, and with an inherent interest for residence jurisdictions to cooperate as well. In conclusion, this solution is clearly inferior to the withholding solution on the base erosion front and clearly unacceptable in terms of fairer division of taxing rights, having an opposite effect.

CONCLUSION

Almost seven years have passed from the launch of the BEPS project that is considered by most the most dramatic international tax coordination effort, perhaps ever.[249] It resulted in unprecedented community of over 100 nations participating, and the majority of them signing the first (if partial) multilateral tax treaty, the MLI.[250] Yet, the international community still struggles with what had been the impetus for the project—insufficient taxation of the digital economy. The technical challenge is significant due to the complexity of the underlined transactions and the lack of simple bases for taxation, and most notably the insignificance of physical presence, which has been the most important basis for taxation of business income in the international tax regime. The political challenge however dwarfs the technical challenge because simply taxing the digital economy is not enough, countries wish to do so and at the same time preserve the international tax regime, the

249. *See, e.g*., Matheson, BEPS webpage ("The OECD BEPS process is the most important development in international taxation in decades."), *available at* https://www.matheson.com/legal-services/beps (last visited Feb. 24, 2019). Itai Grinberg & Joost Pauwelyn, *The Emergence of a New International Tax Regime: The OECD's Package on Base Erosion and Profit Shifting (BEPS)*, 19 ASIL INSIGHTS (Oct. 28, 2015), *available at* http://ilreports.blogspot.com/2015/11/grinberg-pauwelyn-emergence-of-new.html ("unprecedented standard-setting effort").

250. *See* OECD, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm. (last visited Feb. 24, 2019) (OECD webpage, regularly updated with links to the official MLI texts, signatories and country commitments). *See also* Yariv Brauner, *McBEPS: The MLI – The First Multilateral Tax Treaty That Has Never Been*, 46 INTERTAX 6 (2018).

stability it provides to international trade and investment and the ensuing economic and political benefits; that could only be done if the regime maintained its legitimacy that suffered as emerging economies, most importantly the BRICS countries, began, prior to BEPS, to demand voice in the setting of the agenda of the regime, and fairer allocation of taxing rights, meaning particularly more source taxation.[251]

The geopolitical changes that gave the emerging economies the power to make such demands were coupled with economic changes, not the least of them was the ascent of the digital economy that left the uncoordinated international tax regime highly vulnerable and inadequate, leaving all productive countries unable to raise sufficient revenue after the global financial crisis, and incapable of implementing unilateral policies to change that. Yet, old habits die hard. Within the BEPS project, countries with power continuously attempted to improve their relative positions, often at the expense of delays in the collaborative effort. Nowhere has this been more pronounced than in the work on the challenges presented by the digital economy. Multiple solutions and analyses have been presented, together with unilateral actions by countries "jumping the gun" to improve their own positions, yet at the same time providing insights on the various options for reform. The TFDE however seems to have leaped from work on one solution to another, with no commitment or rigorous work on any of them. The political pressures faced by the TFDE are unquestionably massive, yet are they insurmountable? This article argues that this is not the case, arguing that the withholding solution it advocates is feasible (since it does not require wide consensus over a complex web of rules) and currently superior to all other reform options.

Withholding taxes are the beating heart of source taxation, and the only technical solution that would guarantee source taxation of the digital economy, which has been the primary goal of the entire BEPS action 1 exercise, simultaneously maintaining both the legitimacy and the integrity of the international tax regime. It tackles the core issues heads on and in a transparent manner, using measures familiar and internal to the regime, and hence measures that would augment the stability of the regime rather than threaten it. Finally, the withholding solution also operates "within the system" by addressing the core BEPS challenges, base erosion and profit shifting, focusing on the big ticket of B2B transactions and refraining from populist pseudo solutions that ring fence the digital economy (in violation of the core principle of the BEPS work on action 1).

The key contributions of this Article to the international tax scholarly discourse are: first, a demonstration of the necessity of reform, rejecting

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251. *See, e.g.*, Pistone & Brauner, THE BRICS AND THE EMERGENCE OF INTERNATIONAL TAX COORDINATION, *supra* note 12.

the conservative approach that advocates mere tweaking of the current rules of the international tax regime to face the challenges presented by the digital economy; second, the Article is the first to provide a detailed prescription for the adoption of a withholding solution, including design considerations that no alternative proposal provides; third, the Article is the first to provide a comprehensive review and analysis of all the realistic reform proposals and actual country actions, ultimately comparing them to the withholding solution and demonstrating the superiority of the latter.