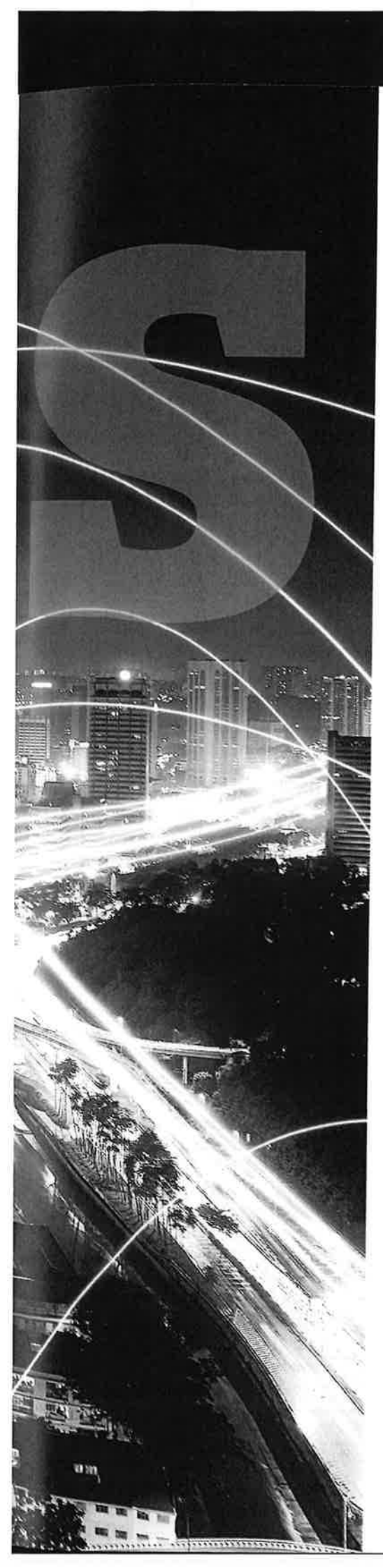
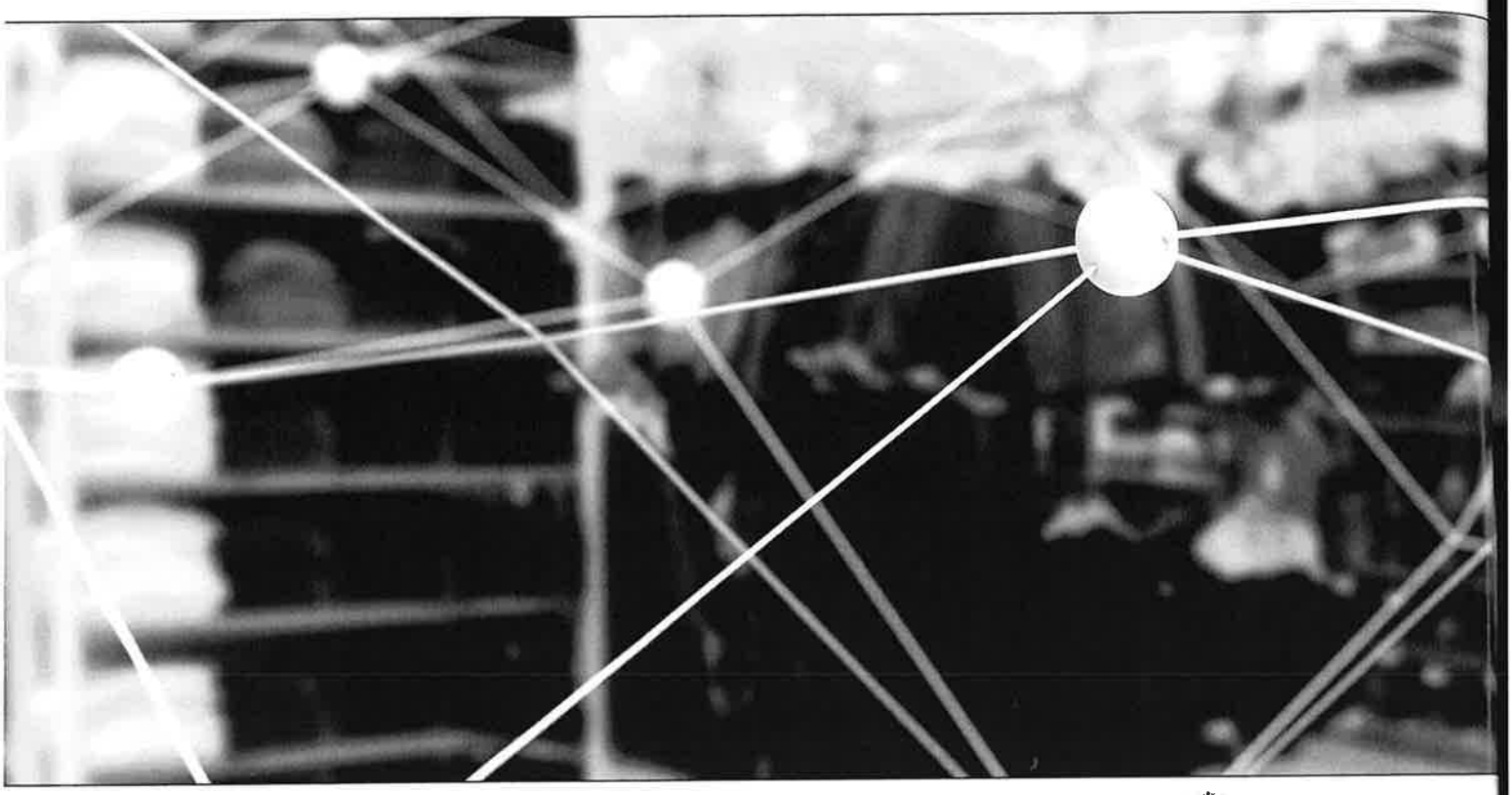


Proposals to Regulate Digital Business

Some Critical Comments

JEAN-LOUIS MEDUS This article analyzes why the digital economy and digital business models are so different from classic business and, as a consequence, how existing tax rules could be irrelevant to regulate this activity.[1] The OECD, through its BEPS project, has identified and addressed the main tax challenges arising from the digital economy. This article focuses on one of these tax challenges, frequently named "taxable nexus," and on the difficulty of defining the tax jurisdiction due to multinational digital companies' structuration of their assets and activities to circumvent permanent establishment (PE) status.

One main characteristic of digital business is the cross-border dissemination of assets through various jurisdictions and a sort of fragmentation of activities entailing a tax-optimized location of profits and permitting digital companies through treaty shopping to avoid establishing a permanent establishment (PE) (thus subject to taxation) in consumer markets, and to attribute the main part of profits to specific entities and jurisdictions (especially those providing IP (intellectual property)-favorable tax regimes). As explained below, OECD, without defining a real new tax paradigm applicable to a digital economy or a concept for value creation in digital business, has nevertheless proposed amendments to the existing international rules to update the definition of PE and tackle tax avoidance practices of a digital economy. The article concludes with some critical comments about the OECD proposals and a review of alternative solutions.



Background—BEPS Action 1

Digitalization is a growing portion of the modern economy[2] and traditional international tax rules and concepts are frequently irrelevant in regulating this new form of business. Investigations into multinational companies in digital business show that they are engaged in very aggressive structuring of their business, taking advantage of a sort of distortion or misalignment between their business models and the existing international tax rules to implement tax-avoidance schemes.

In the BEPS project, the OECD has focused on tax challenges arising from the digital economy (Action 1) because digital business models entail substantial opportunities for tax planning and for lowering tax bases in some countries.[3] Because (1) OECD is a "soft-law" organization proposing mere recommendations, with adoption left to the member states' discretion, rather than an organization producing direct tax policy action;[4] (2) there is also a general consensus to defend the idea that ring-fencing the digital economy for tax purposes is probably not feasible; and (3) OECD is bound by European principles such as "free movement of services and goods," OECD has failed to define a specific tax status and paradigm applicable to digital business and certainly failed to address the core of the problem.

How and Why Digital Business Is Elusive for Tax Systems

International tax planning aims first at taking advantage of tax rate and tax base differentials across countries, frequently called "tax arbitrage." It also seeks to avoid double taxation to prevent investors from being taxed twice on all or part of the same income/profit.

Issues that multinational groups must decide include investment locations, acquisition of foreign companies, financing and profit distribution, offsetting of losses against profits on an international basis, allocation of ownership rights (especially on intangible assets such as patents and IP rights), structure of intragroup assets and services transfers, and the legal form of investment. Regarding legal form of investment, multinational groups generally have the choice between a PE or subsidiary, though these groups have tried in past years to implement specific schemes and business organization to avoid PE status in countries where corporate taxation is considered too high.

Europe is a challenging area for international tax planning because there are significant differences in corporate tax rates and tax base across countries, and there is sometimes a "race to the bottom" despite the creation of a single market within the EU that should have pushed state members to lower the tax competition and harmonize/standardize their tax systems. Due to these various tax systems, foreign companies seeking to establish a business in Europe and choose the most attractive country in connection with the assets involved must plan carefully.

What are digital economy and digital business models? "Digital economy" is usually defined as "the global network of economic and social activities that are enabled by platforms such as the internet, mobile and sensor networks."[5] Digital business is more dependent on IP for creating value—the use of big data collected, diffused, stored, and analyzed— than traditional brick-and-mortar business. Monetization of big data plays a key role, and value creation no longer corresponds to the classic schemes.[6]

Digital business models are frequently characterized as follows:

- Subscription model—users pay a subscription fee to have access to a service or content on a website (e.g., Amazon, Netflix).
- Advertisement model—profits are generated by exposing end-users to advertising in platforms (e.g., Youtube, Dailymotion, Google Search, Facebook).
- Access model—app developers (data analysts, data brokers, and Internet serv-

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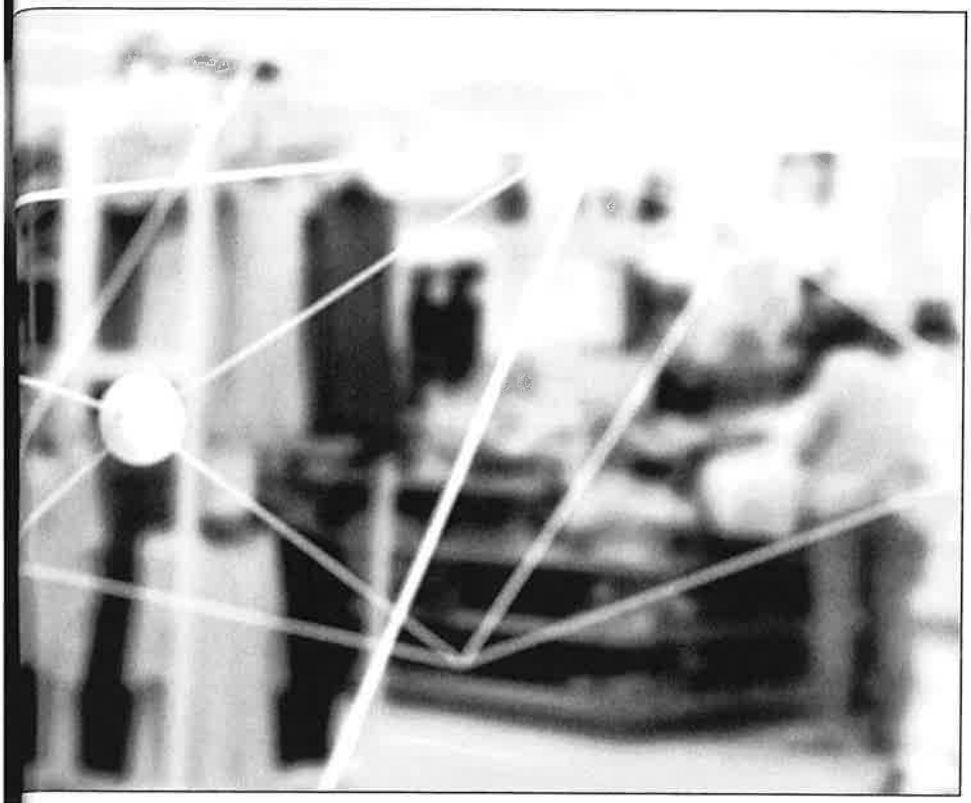

ice providers (ISP)) pay to have access to end-users' data (e.g., Apple's App Store).

However, these digital and online businesses (e.g., marketplaces, dating and meeting sites, online employment agencies, online travel/accommodation sites, peer-to-peer services) are similar or at least comparable to offline businesses.

Another distinction is frequently made by comparing digital B2C models with B2B models. B2C models offer individualized products or services such as advertising or platform services while creating free online services for end-users: the paying customers are mainly commercial company advertising clients and customers of web-based services totally distinct from the physical location of the service provider. The infrastructure is composed of an online platform and the enabling proprietary software with a widespread IT infrastructure running the platform and software applications, with the core physical infrastructure located at the parent company and minor and individual parts (data centers) located in consumer markets.

The essential and significant activity located in a headquarters is the development and maintenance of the IT infrastructure and online services as well as management, sales strategy, and marketing, and most of the revenue is generated by advertising and fees for the use of online services. An external service provider is in charge of hosting and hardware services. Under this model, the main (taxable) nexus is in the country of residence of the parent company entering into direct contractual relations with customers even if some minor activities (e.g., collection of data, customer support, local marketing) are performed at the customer's location. For tax purposes, current rules attribute value (and revenue) to the corporation developing and maintaining the IT infrastructure and software so that local subsidiaries or PEs of the B2C corporation are not deemed to collect significant revenue (and, therefore, do not pay large taxes) except IP box subsidiaries that have been granted a favorable tax regime.

B2B models offer digital goods or services to commercial clients comprising enterprises with Internet access. They suppose a massive server landscape at the main location operating through smaller and complementary hardware components at the location of the final customers, with these components outsourced frequently through subsidiaries or independent agents that facilitate final individualization of the digital solutions. Revenue is generated from the direct sale or licensing of digital products or services. Even if local subsidiaries or PEs inter into direct relations with final customers, they bear some costs and compensate (through royalties) the main corporation for the use and sale of the digital products or services.

For tax purposes, and similar to B2C businesses, current tax rules attribute most of the value to the main corporation developing, owning, and maintaining the IT infrastructure and softwares. When sales are initiated through local subsidiaries and sales contracts concluded between local entities and customers, a portion of the profit is derived from and attributed to the local entities. The profit allocation between entities involved in the business will consequently depend on transfer pricing policy.

As a result, media, advertising, logistical activities, and payments have their modern online tools and versions. Also, profits are generated by charging fees and commissions or usage fees/royalties to services providers and services users or to advertisers—value creation is no longer

1 This article focuses on the concept of PE in relation to digital economy and so will not evaluate other tax challenges that the digital economy poses especially for indirect taxes and transfer pricing rules.

2 European Parliament, Directorate-General for Internal Policies, Policy Department A: Economic and Scientific Policy, Study for the Committee on Economic and Monetary Affairs (ECON), "Challenges for Competition Policy in a Digitalized Economy" (2015), pages 1-79. For a brief, interesting survey of social and economic aspects of digital economy, see Tirole, Economie du Bien Commun, PUF (May 2016), pages 527-596 (chs. 15-16).

3 BEPS Action 1 final report, "Addressing the Tax Challenges of the Digital Economy" (October 5, 2015), http://dx.doi.org/10.1787/9789264241046-en.

4 Brauner, "BEPS: An Interim Evaluation," 6 World Tax J. No. 1 (IBFD, 2014), page 11; EC Fact Sheet, "Questions and Answers on the Action Plan for Fair and Efficient Corporate Taxation in the EU," June 17, 2015, http://europa.eu/rapid/press-release_MEMO-15-5175_en.htm; Englisch, "BEPS Action 1: Digital Economy—EU Law Implications," British Tax Rev. (2015), page 281; Johnston, "What's Next for the OECD and the Digital Economy?," Tax Notes Int'l (Tax Analysts, June 23, 2014), page 1089.

5 ECON study, *supra* note 2, page 22 *et seq.*; U.N. Dep't of Economic and Social Affairs, "Protecting the Tax Base in the Digital Economy," (2014), page 5; see also Brynjolfsson and Kahin, *Understanding the Digital Economy—Data, Tools and Research* (MIT Press, 2002; OECD Digital Economy Outlook, July 15, 2015, page 11, www.oecd.org/internet/ oecd-digital-economy-outlook-2015-9789264232440-en.htm.

6 Huws, "The Cybertariat Comes of Age: Labour in the Global Digital Economy," Monthly Review Press (New York, 2014).

derived exclusively from the exchange of goods or services.[7] The digital economy thus supposes and allows a split of functions and fragmentation of the assets involved in the global business among various countries.

Digital businesses are based mainly on:

1. Intangible assets rather than fixed assets (with a few pilot stores instead of multiple retail stores). Intangible assets are key value-drivers (with royalties paid to patent, trademark, and brand name owners),[8] owned and licensed frequently by specific vehicles incorporated in countries that provide an attractive tax rate on profits from these assets.[9] Legal ownership of intangible assets is, therefore, a decisive factor in determining profits from use of these assets. Some EU countries (e.g., Cyprus, Hungary, Luxembourg) offer IP box-favorable tax regimes, and digital companies have a real incentive to locate their IP assets in these low-rate countries.[10] Multinationals, therefore, engage in tax-motivated profit shifting by locating their IP assets in such jurisdictions.[11]

   Investigations of major digital companies (e.g., Google, Uber, Amazon) suggest that they have structured their business for tax optimization by assigning their key IP assets to specific countries providing tax attractiveness, then licensed their patents and copyrights to subsidiaries. This leads to profit erosion in other countries[12] and a convergence of core activities and assets, and thus taxable nexus where the parent company or regional IP special purpose companies are incorporated, while some minor elements of IT infrastructure are located in consumer markets that might constitute taxable nexus but with very low profits attributable to these local entities.
2. Goods and services marketed through websites rather than traditional commercial workforces with a local and physical presence, with goods often stored and maintained close to final customers in specific countries and no substantial physical presence in the end-users' countries.
3. Distribution networks operated through independent distributors or agents receiving commissions and selling goods/services in their own names and on behalf of a third enterprise instead of classic and standard integrated distribution networks.

What are the classic legal framework and concept of PE? Most international tax treaties aiming at reducing and eliminating double taxation are based on the OECD model treaty and follow its structure and wording. The model is not legally binding and its main purpose is to guide state representatives when negociating tax treaties. Two main principles generally govern the OECD model:

1. Acknowledgment that the taxing right of the source country may be restricted from time to time. There are three main categories regarding source-country taxing rights: (a) no taxing right for royalties paid to nonresidents (individuals or corporations) (pursuant to OECD model Article 12) or for capital gains on sale of shares by nonresidents in resident corporations; (b) restricted taxing right for dividends paid to nonresidents (OECD model Article 10) though the distributing corporation can hold a withholding tax; and (c) an unlimited taxing right for real property (OECD model Article 6) and profits that a PE located in that country generates.
2. Acknowledgment of a conditional taxing right of the residence country, in the sense that possible double taxation must be eliminated. The residence country has the right to tax worldwide income of resident taxpayers that are subject to taxation by reason of domicile, residence, place of management, nationality (especially for individuals pursuant to certain tax systems), or similar criteria.

Business profits are taxed in the state of residence of a company unless they are attributable to a PE in the source country (OECD model Article 7), which will be entitled to tax these profits (the PE has no legal identity—see below on fiscal identity). When the source country exercises its taxing right, the residence country avoids double taxation by granting relief for taxes paid in the source country through two methods: (1) the exemption method (defined in OECD model Art. 23A), which

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7 Brynjolfsson and Kahin, *supra* note 5, page 1; Brynjolfsson and McAfee, *The Second Machine Age* (W.W. Norton & Co., Inc., 2014), page 90; OECD Digital Economy Outlook, *supra* note 5, page 11.

8 Sydler, Haefliger, and Pruksa, "Measuring Intellectual Capital With Financial Figures: Can We Predict Firm Profitability?," European Mgmt. J. (April 2014), page 245; White, "Intangible Drive Value in the Digital Age," J. Accountancy (2016), page 21; see also CGMA, "The Digital Finance Imperative: Measure and Manage What Matters Next" (November 2015), www.cgma.org/Resources/Reports/Documents/the-digital-finance-imperative-report.pdf.

9 Evers, "Intellectual Property (IP) Box Regimes," PhD thesis, Mannheim U. (2014). See European Parliament, Directorate-General for Internal Policies, Policy Department A: Economic and Scientific Policy, In-Depth Analysis for the TAXE Special Committee, "Intellectual Property Box Regimes" (October 2015), pages 1-10.

10 Wittendorf, "BEPS Actions 8-10: Birth of a New Arm's-Length Principle," Tax Notes Int'l (Tax Analysts, January 25, 2016), page 331 *et seq.*; Duff and Phelps, *Guide to International Transfer Pricing* (Wolters Kluwer, 2014), pages 70-75; Devereux and Vella, "Are We Heading Towards a Corporate Tax System Fit for the 21st Century?," Oxford U. Centre for Business Taxation working paper (2014), page 4; Cockfield, Hellerstein, Millar, and Waerzeggers, *Taxing Global Digital Commerce* (Kluwer Law Int'l, 2013), page 7.

11 Dharmapala, "What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature," Chicago Unbound, U. of Chicago Law School working paper (2014); Heckemeyer and Overesch, "Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels," ZEW Discussion Paper (2013), page 27.

12 Klassen, Laplante, and Carnaghan, "A Model of Multinational Income Shifting and an Application to Tax Planning With E-Commerce," 36 J. American Tax'n Assoc. (Fall 2014), page 40; Ernst and Spengel, "Taxation, R&D Tax Incentives and Patent Application in Europe," ZEW Discussion Paper (2011); Dischinger and Riedel, "Corporate Taxes and the Location of Intangible Assets Within Multinational Firms," J. Public Economics (2011); Lindsey and Wilson, "Foreign or Domestic Tax Havens: The Location Decision for Intangible Property by U.S. Firms," discussion paper (2015); Böhm, Karkinsky, and Riedel, "The Impact of Corporate Taxes on R&D and Patent Holdings," discussion paper (June 1, 2012); Evers, *supra* note 9.

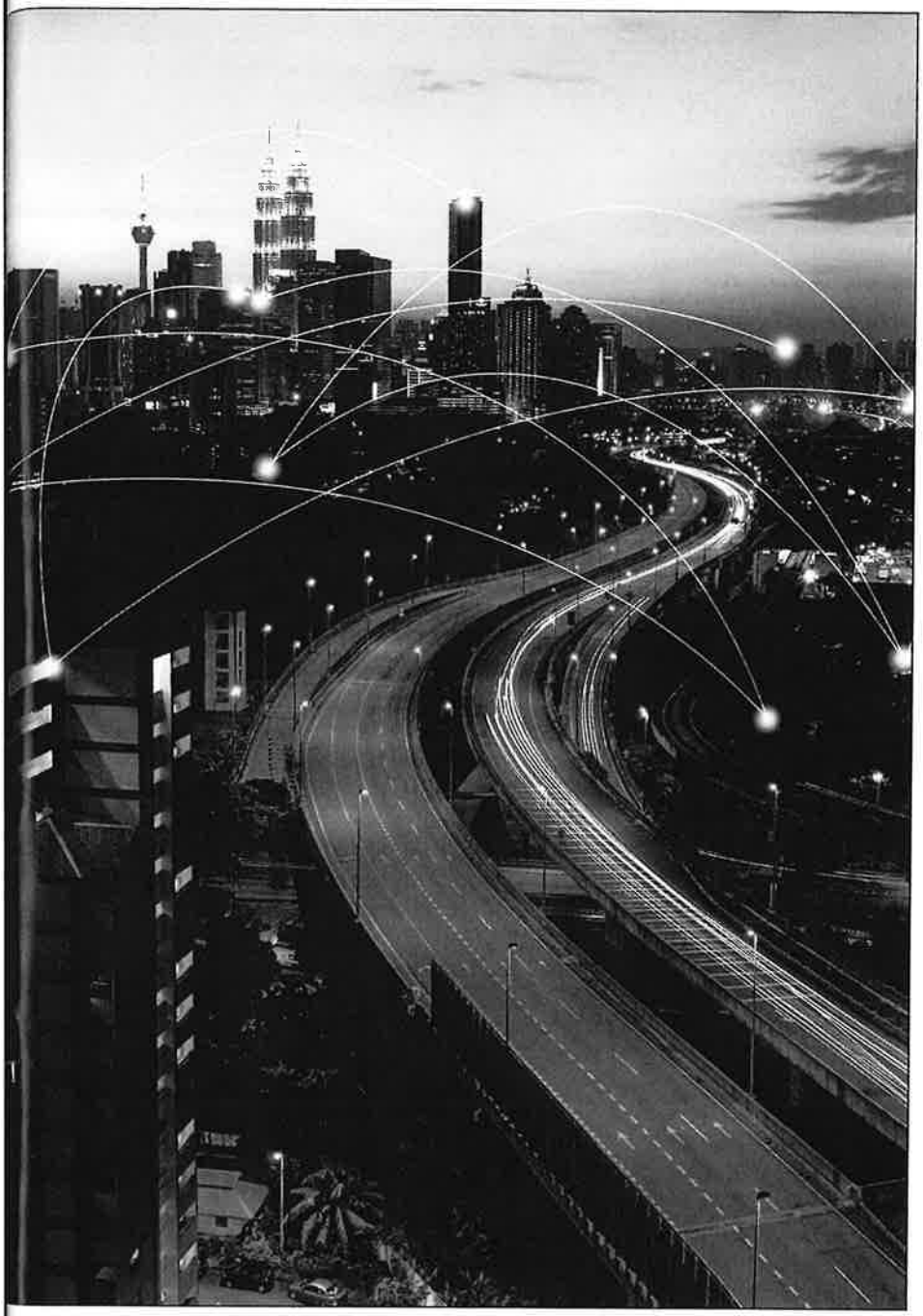
13 OECD model Articles 5(2) and (3) say that "permanent establishment" includes especially place of management; branch; office; factory; workshop; mine; oil or gas well; and quarry or any other place of extraction of natural resources. A building site or construction or installation project constitutes a PE only if it lasts more than 12 months.

14 De Wilde, "Tax Jurisdiction in a Digitalizing Economy: Why Online Profits Are Hard to Pin Down," 43 Intertax No. 12 (2015).

15 BEPS Action 1 final report, *supra* note 3, page 101.

16 Kofler, "The BEPS Action Plan and Transfer Pricing: The Arm's Length Standard Under Pressure?," British Tax Rev., Issue 5 (2013), page 649.

17 For detailed illustrations on the *AirBnB, Uber, Google,* and *Apple* cases, see European Parlia-



permits exemption of the foreign profits and income from the tax base of the residence country; or (2) the credit method (defined in OECD model Art. 23B), which permits a credit for the foreign taxes paid abroad on the source-country income.

A PE[13] could be defined broadly as a fixed place of business through which the business is carried on. The legal term generally includes place of management, branch, office, or factory. Facilities that serve the sole purpose of storage, display, or delivery of goods (or services) are exceptions under OECD model Article 5(4) and so not deemed a PE.

The foreign PE and the domestic corporation (i.e., the head office that initiated the PE) form an economic unit and a single legal unit from a civil perspective. The PE has no veil of incorporation and is not considered a legal entity separate from the head office or domestic company, so it is subject to pass-through taxation, i.e., profits and losses attributable to the PE are deemed taxable income of the domestic head office (main corporation monitoring the group), which will be entitled to avoid (or lower) legal double taxation through either the exemption method or credit method (see above).

As discussed above, however, for tax purposes, the PE is treated as a functionally separate and independent enterprise, so it has a fiscal identity, and the source country where the PE is located has the right to tax the income earned through the PE pursuant to OECD model Article 7(2). The company's total profit, therefore, must be attributed to the domestic and foreign parts of the company, respectively, following the arm's-length principle well known in transfer pricing rules. Thus, the legal definition of PE is crucial in determining whether a nonresident corporation must pay income tax abroad.

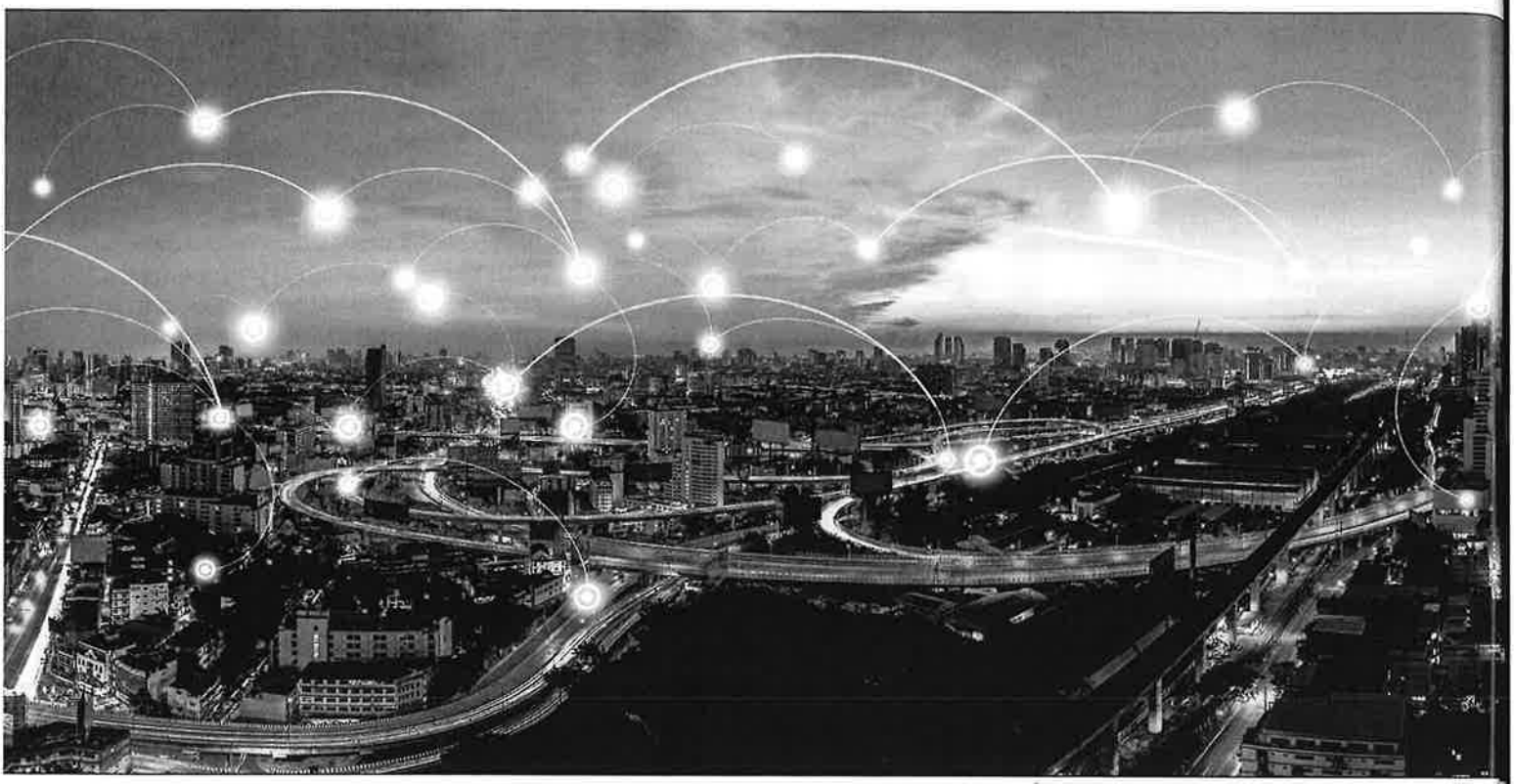
Tax avoidances practices of digital companies—why and how? The OECD categorizes tax challenges arising from digital economy as follows.

Nexus—possibility of conducting business without physical presence through technological devices and tools. Companies traditionally have a physical presence or nexus in a jurisdiction where they are subject to taxation. E-business now permits access to final consumers (through a web store) without necessarily having such a presence.[14] The way that these activities are conducted is shaped by the dissemination of core functions across multiple jurisdictions and countries with a segregation of core activities from consumer markets.[15]

Data and value creation. This relates to the difficulty of attributing value to data generated by using and analyzing collected data of end-users. Data collected, analyzed, and then sold to advertisers and commercial companies and used in online business may not correspond to a mere auxiliary activity but often is the core business and most valuable asset of some digital companies.

Customer data has always been a source of value. The main tax challenge is determining how collected data is monetized, given that most of the time data collected in the consumer market are sent through the Internet to a foreign-based company to be analyzed. To determine the value chain of business collection/data analysis, tax authorities must make a thorough examination of functions performed, assets involved, and risks assumed, though "analysis" of data probably generates more value creation than mere collection of data.

When comparing "nexus" and "data and value creation" tax challenges, it is



also necessary to consider that the allocation of profits and transfer pricing among various assets (the location of which is split among various countries) and segregation of functions is a major tax issue, though outside the scope of this article. In particular, transfer pricing is used to minimize income attributable to functions and risks in consumer markets with high tax rates, and maximize income allocations to entities owning the IP assets and located in countries with favorable tax regimes for IP boxes and patents/copyrights special purpose vehicles (SPVs).[16]

Characterization of payments. New ways of delivering and storing data and software, and external services (cloud computing), make the characterization of payments uncertain in the digital sector. As there is no intermediary involved, it is difficult to decide whether a company received payments while carrying on business and it is challenging to qualify the payments as royalties (giving rise to withholding tax), fees for technical services, or business profits.

Mobile intangible assets and multisided business models make the digital business elusive for national tax systems. The EU and member states' investigations of some digital companies have revealed tax-avoidance practices including:[17]

- Avoiding withholding tax (when a nonresident company generates profits via payments of interest or royalties in a country, it can be subject to taxation).
- Use of preferential tax regimes e.g., IP or patent boxes in specific countries offering a low tax rate where the main corporation's subsidiaries own intangibles and rent these IP rights (patents, copyrights, brands), and subsidiaries in charge of marketing and technical support pay royalties to the IP box for use of those IP rights[18] (a range of IP box is available in Europe with tax rates including 0% in Malta, 2.5% in Cyprus and Liechtenstein, and 1/5 of the normal corporate tax (which amounts to a 5.6% tax rate) in Luxemburg compared with 15% taxation in France).
- Artificial trading of intangibles such as management fees or international property licensing.

ment, Directorate-General for Internal Policies, Policy Department A: Economic and Scientific Policy, "Tax Challenges in the Digital Economy," Study for the TAXE 2 Committee (2016), pages 18-24 and 37; ECON study, *supra* note 2. For a general survey, see also Rosenbloom, "David R. Tillinghast Lecture: International Tax Arbitrage and the 'International Tax System'," 53 Tax Law Rev. 137 (2000).

18 "Fifty Shades of Tax Dodging: The EU's Role in Supporting an Unjust Global Tax System," Eurodad, November 3, 2015, page 83; see Evers, *supra* note 9.

19 See Rosenbloom, *supra* note 17.

20 Huizinga, Laeven, and Nicodeme, "Capital Structure and International Debt Shifting," 88(1) J. Financial Economics 80 (2008); Dourado and de La Feria, "Thin Capitalization in the Context of the CCCTB " in Lang et al. (eds.), *Common Consolidated Corporate Tax Base* (Vienna: Linde Verlag, 2008); Hinny, General Report, in "New Tendencies in Tax Treatment of Cross-Border Interest of Corporations," 93b IFA Cahiers de Droit Fiscal International (2008) at 15.

21 European Parliament, Directorate-General for Internal Policies, Policy Department A: Economic and Scientific Policy, In-Depth Analysis for the ECON Committee, "Corporate Tax Practices and Aggressive Tax Planning in the EU" (2015), pages 1-27.

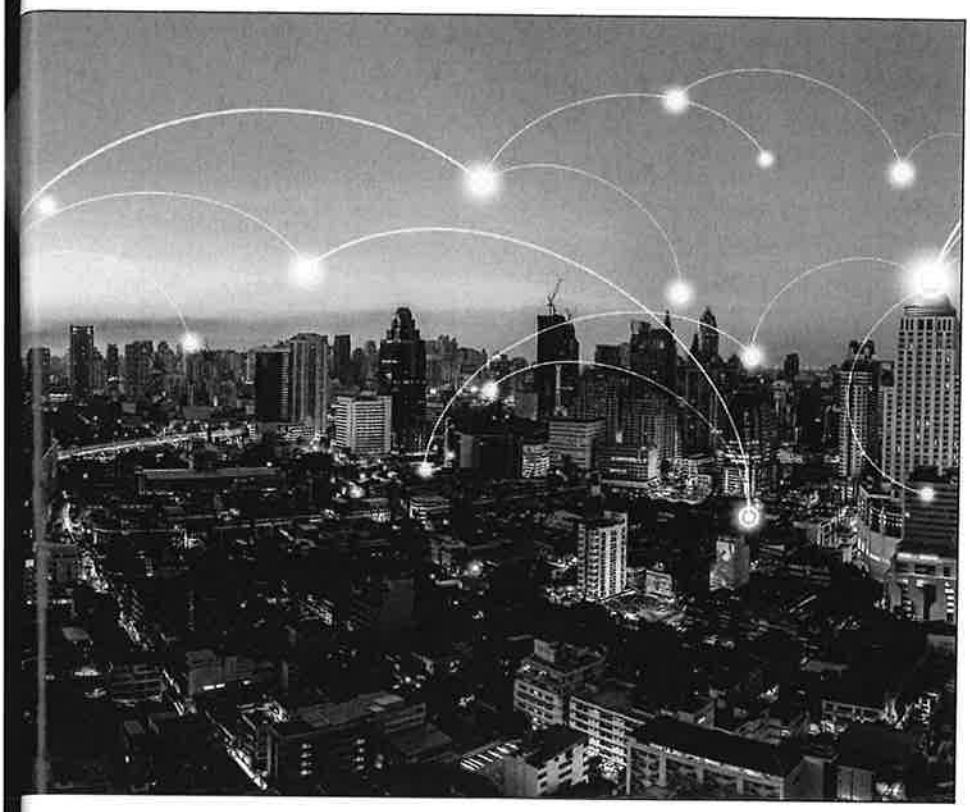
22 Ting, "Ireland's Move to Close the 'Double Irish' Tax Loophole Unlikely to Bother Apple, Google," The Conversation, October 15, (2014); Ting, "Old Wine in a New Bottle: Ireland's Revised Definition of Corporate Residence and the War on BEPS," British Tax Review (No. 3, 2014), page 237. For a general survey on these practices, see Devereux, Freedman, and Vella, "Tax Avoidance," report commissioned by the National Audit Office (2012), www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Reports/TA_3_12_12.pdf; Devereux and Griffith, "Evaluating Tax Policy for Location Decisions," International Tax and Public Finance (No. 10, 2003), 7107-26; ECON analysis, *supra* note 21.

23 Conseil d'Etat, March, 31, 2010, n° 304715 and 308525, Zimmer France Ltd., RJF 6/10 n° 568, holding that a commissionnaire that enters into contracts in its own name does not create a dependent-agent PE unless the commissionnaire is de facto entitled to bind the principal directly through agreements with third parties. (Conseil d'Etat is the French Administrative High Court of Justice, with jurisdiction in most tax matters.)

24 Note 3, *supra*, page 12.

25 CAA Paris 22 janvier 1998 n° 95-3510 and n° 97-637, 2d Chamber, SA Eagle Star Vie, RJF 4/98 n° 383, holding that an agent having no authority to conclude contracts on behalf of a principal cannot be considered a dependent agent and so does not constitue a PE in France of the foreign principal.

26 See, for example, CAA Paris November 26, 2003 n° 00-134 2d chamber, Intercontainer SA, RJF 4/04 n° 404, where the administrative court of Paris decided that a French agent, though empowered to conclude contracts on behalf of a foreign (Belgium) enterprise, did not constitue a PE because the agent did not perform its activities wholly or almost wholly on behalf of a single enterprise.



- Mismatch arrangements that exploit a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes that has the effect of lowering the aggregate tax burden of the parties to the arrangement.[19]
- Thin capitalization and internal debt shifting[20] (a subsidiary indebted to another company in the same group shifts expenses to a high-tax jurisdiction and profits (interest) to a low-tax jurisdiction).[21]
- Transfer pricing, artificial contractual arrangements, circumvention of CFC rules.
- Avoiding taxable presence in the market country due to the difficulty of determining nexus and characterizing a PE.[22]

When comparing the above-mentioned OECD PE concept with the aforesaid economic definition of digital business models, there is no useful and accurate tool in the current OECD concepts to regulate new businesses based on intangibles assets or digital networks, though these businesses now represent a huge part of the economy.

Digital transactions consist of sales through a website (e-commerce transactions), and licensing information and know-how by its dissemination through the Internet. When corporations sell/lease their products or provide services through websites or marketplaces, the income from these transactions is taxable in the source country. Domestic laws of contracting states tax the business income of nonresidents in their states only if the nonresidents have an economic (and thus taxable) presence in the contracting state through a PE.

The existing concept of PE stipulating that an enterprise needs to have a physical presence in the form of "a fixed place of business at its disposal" to be subject to taxation in the source state has made it practically impossible for the source state to tax sales originated through websites in that state. The avoidance of PE status will, therefore, result in a shift of profits out of the country where the sales effectively took place.

In October 2015, OECD published its final reports on the 15 BEPS Actions, including Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status). The usual concept of PE referred to a substantial physical presence in a country, and to various situations in which the nonresident carried on business abroad in the relevant country through a dependent agent. Because digital technology and the Internet now allow nonresidents to carry on business and to be involved in a country's economy without having a taxable presence as in the traditional definition and criteria, OECD determined that the definition of PE had to be updated to prevent abuses.

Artificial Avoidance of PE Status in Digital Economy

Pursuant to the combination of current Article 5(5) and (6) of the OECD model (emphasis added):

5. "...where a person—other than an agent of an independent status to whom paragraph 6 applies—is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise *shall be deemed to have* a PE in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a PE under the provisions of that paragraph.
6. An enterprise *shall not be deemed to have* a PE in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business."

For Article 5(5) to apply, the agent must be dependent, acting on behalf of an enterprise, and empowered to conclude contracts in the name of the enterprise. Many digital companies are avoiding PE status artificially while maintaining minimum physical presence in the customer/market country by use of limited-function distributors. Some enterprises have consequently replaced their local subsidiary selling goods and services and acting as a distributor with commissionnaire arrangements, with a resulting shift of profits out of the country where the sales took place without a substantive change in the functions performed in that country.[23]

Nonresident taxpayers can, therefore, derive substantial profits from transactions with customers located in another country. Although the new rule does not directly aim at changing the existing international standard on allocation of taxing rights on cross-border income, as discussed above, it will restore both source and residence taxation where this cross-border income would go untaxed or be taxed at very low rates.

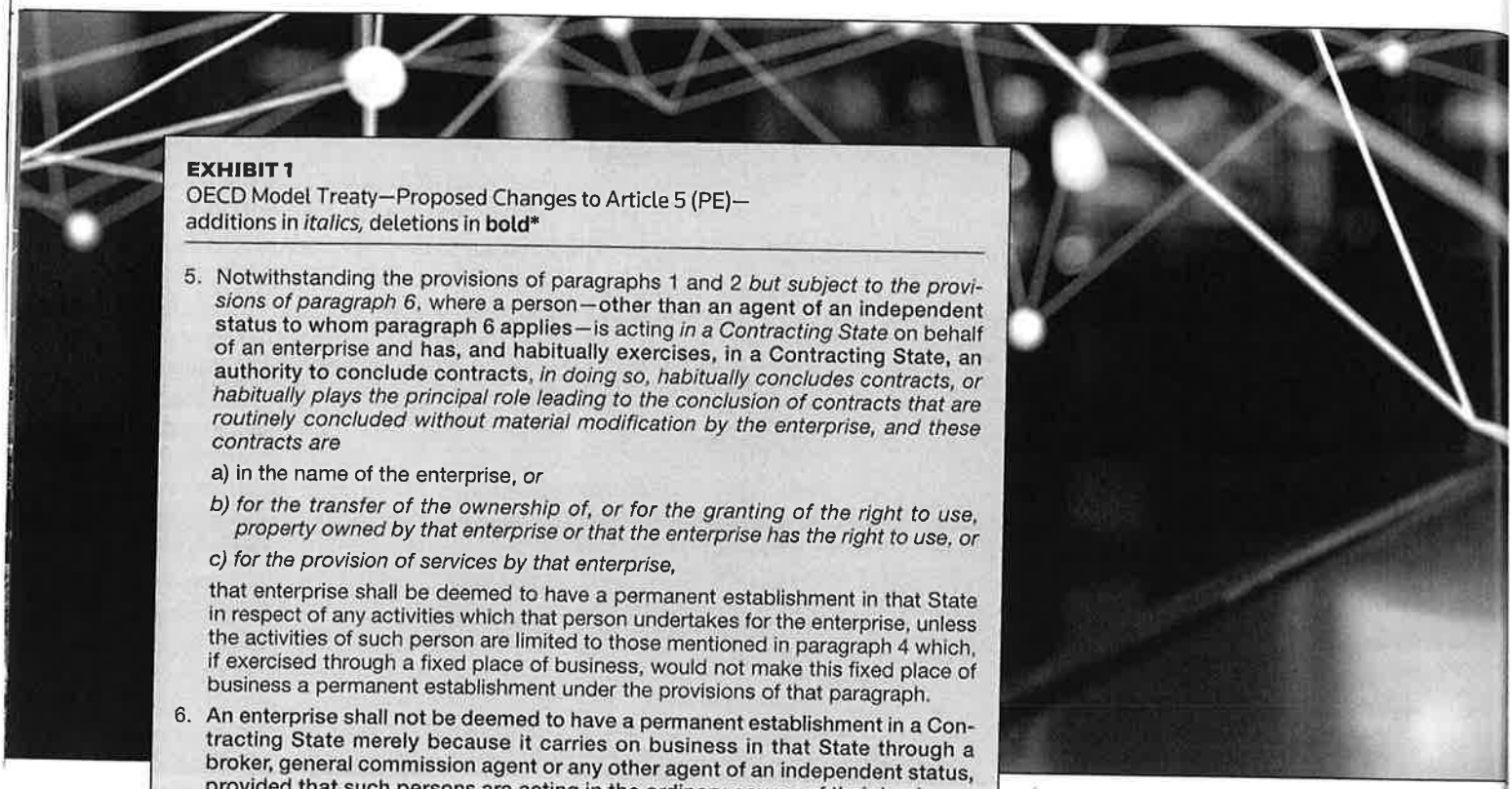


EXHIBIT 1
OECD Model Treaty—Proposed Changes to Article 5 (PE)—
additions in *italics,* deletions in **bold***

5. Notwithstanding the provisions of paragraphs 1 and 2 *but subject to the provisions of paragraph 6,* where a person—**other than an agent of an independent status to whom paragraph 6 applies**—is acting *in a Contracting State* on behalf of an enterprise and **has, and habitually exercises, in a Contracting State, an authority to conclude contracts,** *in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are*

   a) in the name of the enterprise, *or*

   b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

   c) for the provision of services by that enterprise,

   that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. **An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.**

   a) *Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to such enterprise.*

   b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise.

*See OECD, BEPS Action 7 final report, "Preventing the Artificial Avoidance of Permanent Establishment Status" (October 5, 2015), "Changes to Paragraphs 5 and 6 of Article 5."

A commissionnaire arrangement may be defined as an agreement through which a person sells goods in a country (B) in its own name but on behalf of a foreign enterprise, located in another country (C), that is the owner of these goods. It permits the foreign enterprise in country C to sell its goods without having a PE to which such sales would be attributed for tax purposes. The commissionnaire that does not own the goods and is a mere middleman cannot, therefore, be taxed on the profits generated by such sales and will be taxed generally only on the commission that it will earn for its services.

Under current OECD model Article 5(5), the foreign company in country C will be deemed to have a PE in country B when the person selling goods also has authority to conclude contracts on behalf of the foreign company. However, when an agent selling goods abroad also negotiates the main provisions of a contract without concluding the agreement, the agent does not constitute a PE of the foreign enterprise.

Some court decisions illustrate this scheme in which an enterprise (located in a low-tax-rate country) carrying on a business abroad (in country B) through a closely related company (generally a subsidiary member of the same group, thus taxable on profits generated by sales in country B) decided to repatriate fixed assets, inventories, and customer base of the foreign subsidiary and enter into a mere commissionnaire agreement with the foreign sub. The foreign sub then agreed to sell goods and products in its own name but on behalf, and at the risk, of the foreign enterprise, with the foreign commissionnaire (though incorporated as a subsidiary) receiving just a commission.

Other court decisions involve independent agents and situations where contracts are negotiated substantially in country B but executed or made final in (and frequently governed by the law of) country C. Though the foreign company seems to exercise powers and authority to conclude contracts, it constitutes only an independent agent (acting on behalf of the foreign enterprise in country C) to which the existing exception of OECD model Article 5(6) applies even though the agent is related closely to the foreign enterprise in C bound by the contract.

The OECD/G20 BEPS discussion draft of March, 24, 2014, was very creative and proposed a new standard nexus—"significant digital presence"—based on a test for the presence of a virtual PE. However, the Action 1 final report[24] discarded this new, specific definition and came up with a less ambitious "modified nexus approach," under which the existing exceptions to the current definition of PE should be updated and amended to meet new tax challenges inherent to the digital sector. As a

consequence, the definition of "independent agent" has been modified slightly to address the situation where this agent is related closely to an enterprise and can no longer be deemed "independent." OECD then decided to modifiy model treaty Article 5(5) and (6) and the definition of PE. See Exhibit 1. Below are some comments and conclusions regarding these proposed modifications.

Meaning of "habitually concluding contracts" and "playing the principal role leading to the conclusion of contracts routinely concluded." The BEPS Action 7 final report says that, for proposed Article 5(5) to apply, the following cumulative conditions must be met:

- A person acts in a contracting state on behalf of an enterprise.
- In doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts, that are concluded routinely without material modification by the enterprise.
- These contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property that the enterprise owns or has the right to use, or for the provision of services by that enterprise.

Even if those conditions are met, the activities that this person performs on behalf of an enterprise will not be covered by paragraph 5 if the activities are made as a real independent agent (and thus the exception in paragraph 6 will apply) or are limited to activities in paragraph 4 (which covers situations in which an activity is exercised through a fixed place of business solely for the purpose of preparatory (e.g., market studies) or auxiliary activities (such as storage). A person generally cannot be said to be acting on behalf of an enterprise if the enterprise is not affected directly or indirectly by the actions that the person performs.

The phrases "habitually concludes contracts" and "habitually plays the principal role leading ..." are aimed at situations where the conclusion of contracts results directly from the action that an agent performs in a contracting state on behalf of an enterprise, even contracts that the person does not conclude in that state. This new definition now covers cases where person A solicits customers and receives orders that are then sent to a warehouse from which products belonging to person B are delivered and where B routinely approves these transactions—A's actions go beyond mere promotion and marketing of goods and services. It clearly applies to digital businesses.

OECD cites the case where company B distributes its products or services worldwide through its websites, and its wholly owned subsidiary A located in State A, through its employees, send e-mails and calls or visits customers to convince them to buy B's products. A's employees are in contact with local account holders and when an A employee persuades an account holder to purchase goods or services, the employee provides all financial and legal details relating to the sale and indicates that a standard contract (the terms of which the employee cannot modify) must be concluded online with B before B can provide goods or services. A's employees thus play the principal role leading to the conclusion of the contracts between local customers (the account holders) and B, and such contracts are concluded routinely without material modifications by B. B would then be deemed to have a PE in the state where A operates.

One effect of this new definition will be that the rights and obligations resulting from these contracts will be allocated to the PE, though there must be a split to allocate the global profit between all entities. The determination of the profits attributable to the PE resulting from the application of paragraph 5 will be governed by OECD model Article 7, and activities performed by all enterprises to which the PE belongs must be remunerated properly and only a portion of the total profit will be attributable to the PE (determined as if it were a separate and independent enterprise performing the activities attributed to the PE). However, the fact that a person has merely attended or even participated in negotiations in a state between an enterprise and a customer is not sufficient to conclude that the person has concluded contracts or played the principal role leading to contracts that are concluded routinely without material modifications by the enterprise.

Most digital businesses operated on behalf of a B enterprise through the combination of its foreign websites and local warehouses with local commercial action of A's employees are at least now concerned by this new definition of PE, and the new definition does not fully solve the issue. The allocation of the global profit from digital business among segregate entities is not a trivial task.

The cases on which OECD focuses must be distinguished from situations where a person concludes contracts in its

own name and then requests and obtains goods or services from an enterprise or arranges for other enterprises to deliver such goods or services. That person does not act on behalf of these other enterprises and contracts concluded are neither in the name of these other enterprises nor for the transfer to third parties of the ownership or use of property that these enterprises own or have the right to use. That means that schemes based on a "low-risk distributor" are still valid and will not result in a PE attributed to the foreign manufacturer. Under such a scheme, person A—neither acting on behalf of a foreign enterprise nor selling property (tangible or intangible) that the foreign enterprise owns—sells to customers goods or services that it buys from an enterprise (that can even be associated). The transfer of title to property that the low-risk distributor sold passed first from the enterprise to the distributor, and this operation will generate a profit from the final sale to local customers as opposed to remuneration in the form of a commission. Thus, there must be a clear distinction of rules governing the PE on one hand and those governing transfer pricing on the other.

Meaning of "independence" and "independent agent." When a person acts on behalf of an enterprise in the course of carrying on a business as an independent agent,[25] this status is an exception to OECD model Article 5 PE qualification. The "independence" of an agent will depend on the extent of the obligations and duties that the agent has vis-a-vis the enterprise.[26] Are the agent's activities for the enterprise subject to detailed instructions or to comprehensive control by the enterprise? Does the enterprise that the agent represents bear the entrepreneurial risk? In such situations, the agent would not be deemed to be independent.

An agent can be responsible to its principal for the results of its work, though not subject to significant control with respect to how its work is carried out, without loosing its independence. An agent providing substantial information to a principal in connection with its business and work conducted under the agreement is not a sufficient criterion to decide that the agent is not independent[27] unless the information is provided in the course of seeking approval from the principal for how the business is to be conducted.

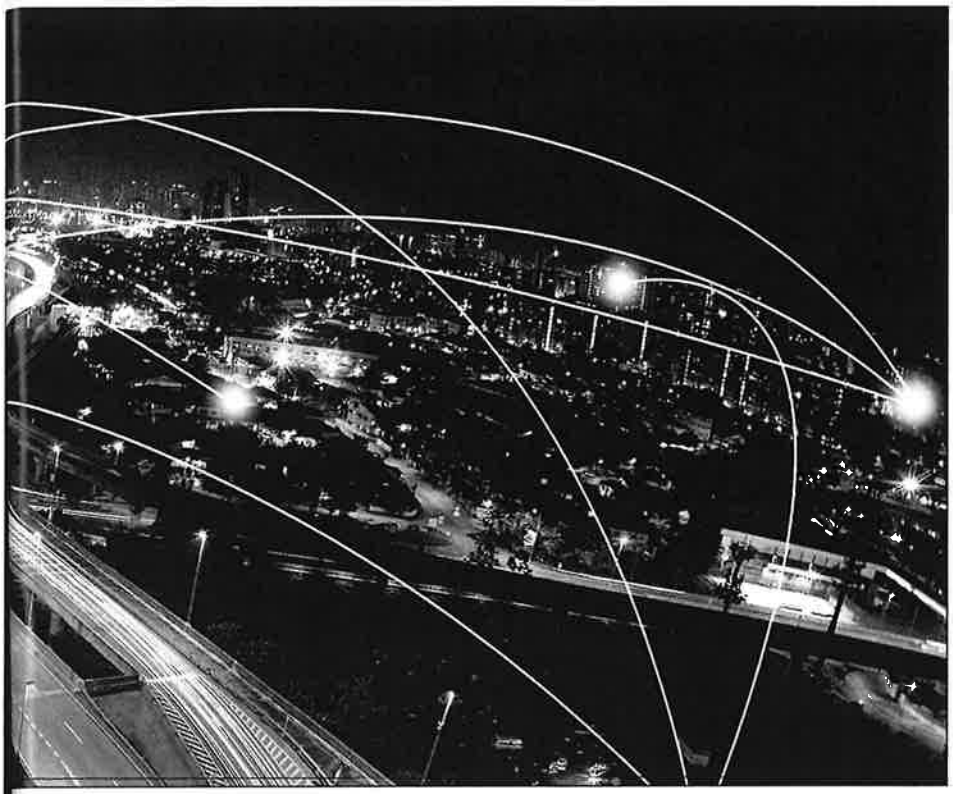
Factors to be considered in assessing the agent's independence are limitations on the scope of business that the agent may conduct; freedom in the conduct of the agent's work; risks that that the agent bears; number of principals that the agent represents (i.e., independence is less likely if the agent performs its activities wholly or almost wholly on behalf of a one enterprise over a long period).[28]

Meaning of "person closely related to an enterprise." The concept of "person closely related to an enterprise" seems very similar to the concept of "associated enterprises" (in OECD model Article 9) but it is different. A person will not be considered an independent agent when acting exclusively or almost exclusively for one or more enterprises to which it is closely related. A person would be deemed "closely related" to an enterprise if, based on all facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. This rule cover situations in which the control derived from a special agreement granting rights similar to those that a party would hold if it held, directly or indirectly, 50% of the beneficial interest in the enterprise. This definition will be satisfied automatically when one person holds, directly or indirectly, more than 50% of the beneficial interests in the other or a third party holds, directly or indirectly, more than 50% of the beneficial interests in both the person and the enterprise.

Abusive Exploitation of "Specific Activity Exemptions" and Other Strategies

OECD also focused on three situations, two of which concern the digital economy:

1. Use of specific activity exemptions according to which a PE is deemed not



to exist when a place of business is used solely for activities listed in Article 5(4).
2. Fragmentation of activities between closely related parties.
3. The very specific issue of splitting up contracts, which is outside the scope of this article.

Preparatory or auxiliary activities and specific exemptions. Under current Article 5(4) of the OECD model, some situations or activities constitute an exception to PE status. The OECD model includes a list of exceptions that correspond to activities having merely a preparatory or auxiliary character and that are not deemed to constitute a PE.

Activities considered preparatory or auxiliary according to Article 5(4) might constitute more important parts of digital business models and hence trigger PE status. For example, collection of data is frequently seen as a routine activity that does not necessarily contribute to value creation, and as an auxiliary activity that does not alone justify a tax liability or substantial allocation of income, because data are collected automatically by standardized hardware devices and transmitted through the Internet to central computing data centers. For taxing income, current rules tend generally to attribute the value to entities owning, developing, and sometimes maintaining the software with skilled staff. By using these OECD exceptions and applying classic definitions to new functions and business models, digital companies thus circumvent the PE status.

OECD has proposed a new Article 5(4) as follows:[29]

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of preparatory or auxiliary character.

An activity having a "preparatory character" is one done in contemplation of carrying on of what constitutes the core business—the enterprise's essential and significant activity. It generally precedes another activity and will also be carried on during a relatively short period. An activity having an "auxiliary character" is generally carried on to support the enterprise's core business without being part of the essential and significant activity. These definitions, therefore, require defining "core business" or "essential and significant activity" of the enterprise. It is always a matter of facts.

A warehouse is generally an auxiliary activity that can also be subcontracted to an independent company. However, when enterprise A maintains in foreign state B a large warehouse with a significant number of employees storing and delivering goods that A owns and sells online to customers *(continued on page 62)*

[27] *Id.*, where the French agent (an LLC) concluding contracts in France on behalf of a Belgium principal carried on its business by providing substantial reporting and information to the principal but under the sole authority and responsibility of its French directors so that it remained an independent agent.

[28] CAA Paris, July 2, 1996 n° 94-765, 3d Chamber, SA New Building Promotion Ltd., RJF 11/96, where a French commissionnaire was deemed a dependent agent constituting a PE of a Swiss company (Roche) in France, even though the Swiss company was legally and economically distinct from the commissionnaire, because the commissionnaire not only sold goods of the Swiss company in its own name but was also empowered to (1) conclude contracts on behalf of, and bind, the Swiss company; and (2) manage real estate assets that the Swiss company owned in France.

[29] Revised discussion draft, "BEPS Action 7: Preventing the Artificial Avoidance of PE Status, 15 May 2015-12 June 2015."

[30] See De Wilde, *supra* note 14, on *Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13 (1993), a Supreme Court of South Carolina decision taxing a company that had an "intangible presence." The court said that with regard to nexus in South Carolina, its customers were the real source of income.

[31] See Craig and de Burca, *EU Law: Text, Cases, and Materials* (Oxford U. Press, 6th ed., 2015), ch 22; Barnard, *The Substantive Law of the EU: The Four Freedoms* (Oxford U. Press, 4th ed., 2013), chs 10-11, 13. See also Lee-Makiyama and Verschelde, ECIPE (European Center for International Political Economy) Occasional Paper No. 4/2014, "OECD/BEPS: Reconciling Global Trade, Taxation Principles and the Digital Economy."

(continued from page 45) in state B, storage and delivery activities will be deemed an important asset of A and to constitute a significant part of its activity and, therefore, not still have an auxiliary character.

The mere existence and presence in state B of goods and merchandise belonging to enterprise A (located in state A) does not mean that the fixed place of business where those goods and merchandises are stored is at the permanent disposal of enterprise A so that there is a fixed place of business attributable to A. But if A is allowed unlimited access to a separate part of the facilities located abroad for the purpose of maintaining and inspecting the goods stored therein, and these premises are also used to purchase goods and merchandises on behalf of A with employees visiting suppliers in state B or other foreign countries (and employees entering into contracts for the acquisition of goods and merchandises), even if the sole activity performed through this office is a purchasing activity, the office will nevertheless constitute a PE because the purchasing activity is an essential and significant part of A's overall activity.

Enterprise A's maintenance of an office in a foreign state for several years for the purpose of prospecting a market and lobbying the public authorities, which could allow A to establish its business abroad, is a preparatory activity. Setting up an office abroad to collect information on the potential market or possible investment opportunities in that foreign state, or for the purpose of advertising, supply of information, scientific research, or servicing a patent or know-how contract, is also generally deemed a preparatory activity, and such an office would not constitute a PE. However when servicing patents or know-how is the core business of an enterprise, or when the fixed place of business of the enterprise has the main function of managing an enterprise or a group of companies (i.e., management office), the activity no longer has a preparatory or auxiliary character and the office/management office will be treated as a PE.

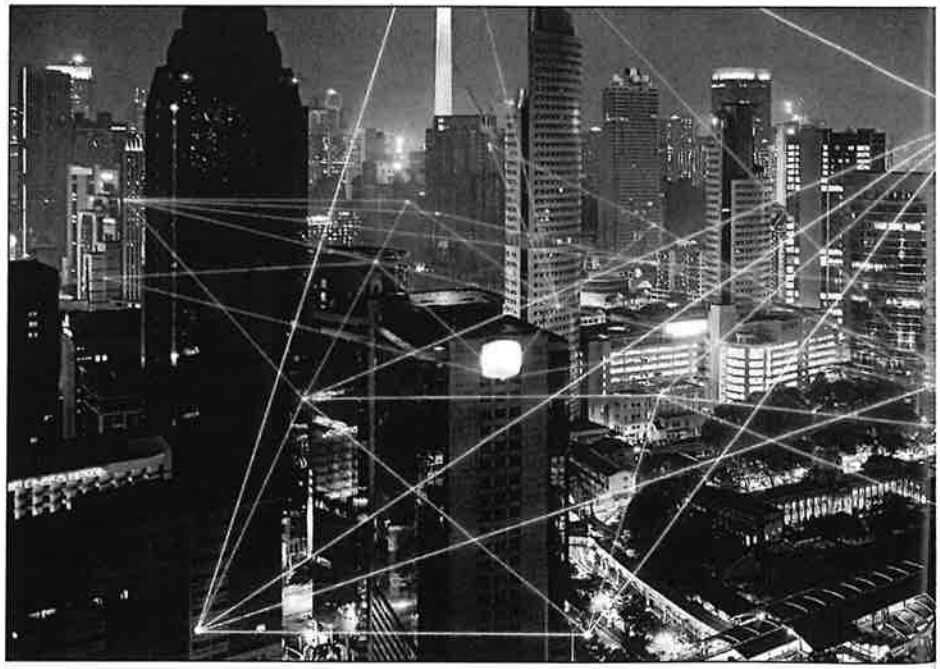
Regarding cables or pipelines that cross the territory of a country, the answer is different depending on whether these facilities are used to transport properties belonging to a third party, or belong to the enterprise operating the cables and pipelines for the purpose of transporting its own merchandises. In the latter situation, the enterprise has the cables or pipelines at its disposal and the facilities can be considered a PE.

Anti-fragmentation rule. OECD aims at preventing an enterprise from fragmenting a cohesive and global operating business into several separate operations so as to argue that each is merely engaged in a preparatory or auxiliary activity. There would be a sort of fraud by splitting the global business into several separate operations, especially when the same enterprise maintains and operates different places of business in a country or when those places of business belong to closely related enterprises.

Some digital businesses are based on such an operational scheme splitting the overall business in various segregate functions through either subsidiaries or closely related companies.

Example. Enterprise A (in State A) manufactures and sells devices or software. Enterprise A (1) has a subsidiary B in state B that owns and operates stores (or a single pilot store) where B sells (as a retailer) devices or softwares acquired from enterprise A; and (2) owns a warehouse in state B, where it stores a few large items identical to those displayed in the pilot store belonging to subsidiary B. B employees are allowed to take possession of large items in A's warehouse (located in state B) for customers and subsidiary B acquires (from a legal point of view) these items when they leave the A warehouse.

Enterprise A and subsidiary B are closely related enterprises and the business activities that enterprise A carries on in its B warehouse, and that subsidiary B carries on in its pilot store, are comple-



32 Hongler and Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy," IBFD working paper (January 20, 2015), page 10.

33 Avi-Yonah, "Virtual PE: International Taxation and the Marketplace Fairness Act," Public Law and Legal Theory Research Paper Series No. 328 (April 2013), page 3.

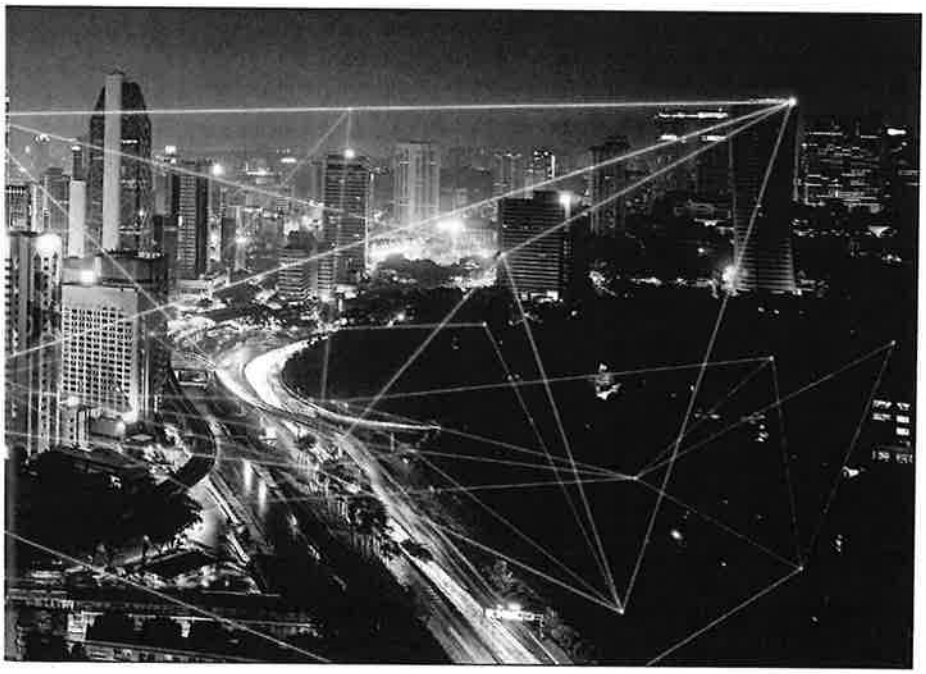
34 See Popa, "International—Taxation of the Digital Economy in Selected Countries—Early Echoes of BEPS and EU Initiatives," 55 European Tax'n No. 1 (IBFD, 2016), pages 38-41; Westberg, "European Union—Taxation of the Digital Economy—An EU Perspective," 54 European Tax'n No. 12 (IBFD, 2014), page 544.

35 See "U.K.'s 'Diverted Profits Tax' Proposes a 25% Tax Rate but Leaves Open Questions," *PwC In & Out*, 26 JOIT 26 (February 2015).

36 Butler, Jennison, and Neilson, "Australia—Important International Tax Developments—Foreign Capital Gains Withholding Tax, and Anti-Google, Netflix and Amazon Taxes," 22 Asia-Pacific Tax Bulletin No. 2 (IBFD, 2016), section 5; Butler and Danby, "Australia—Draft Legislation for 'Anti-Google' Tax," 22 Int'l Transfer Pricing J. No. 6 (2015), page 349.

mentary activities that form part of a cohesive business operation. Thus, the anti-fragmentation rule should apply and these activities could not be considered different and separate preparatory (pilot store) or auxiliary (warehouse) exceptions. Under the new anti-fragmentation rule, exceptions under Article 5(4) for preparatory or auxiliary activities will not apply and at least one of the places of business must constitute a PE, or the combination of the relevant activities may constitute a PE.

Once introduced in existing (and future) tax treaties, these new OECD rules and definitions should permit revision of international tax rules with a consistent goal—profits are expected to be reported and taxed where the economic activities that generate them are carried out and where value is created, thus addressing new forms of business such as the digital economy. Because OECD is a "soft-law" organization, it now remains to implement BEPS recommendations through changes in domestic laws and practices via treaty provisions with a global dialogue to be established between countries that goes beyond OECD. OECD has concluded that ring-fencing the digital economy was not feasible so its final proposals certainly do not go far enough and are subject to some critical comments.



Alternative Strategies and Comments on Relevance of the OECD Approach

As the PE concept (even amended by OECD recommendations) always supposes a physical presence, some criticisms can be levelled at these final proposals, which will probably fail to solve the tax challenges from digital business. At the same time, some countries have introduced initiatives and laws to tax the digital business directly instead of applying the classic concept of PE.

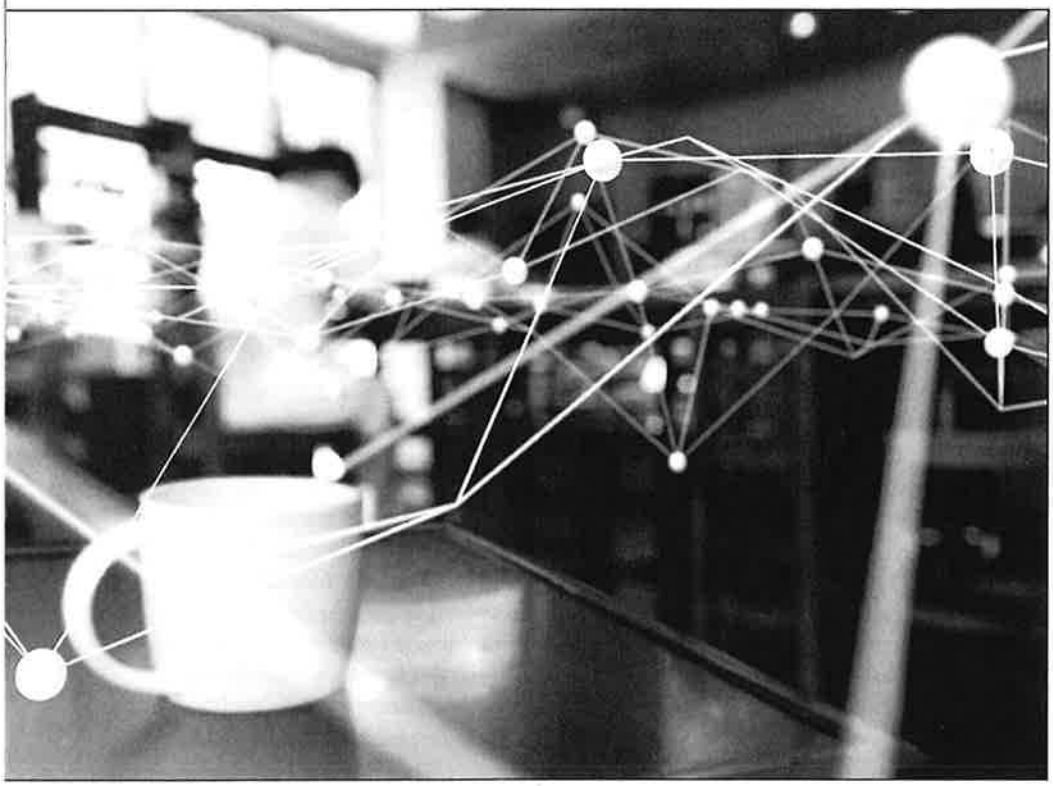
Virtual PE. The OECD BEPS discussion draft dated March 24, 2014, mentioned several options for amending the definition of a PE, particularly (as noted above) a very creative option of a new nexus standard called "significant digital presence," based on a test for the presence of a virtual PE. When a digital business did not necessarily require a taxable presence according to existing tax principles, OECD suggested that "fully dematerialized digital activities" could constitute a PE if a significant digital presence is maintained in a country's economy. Pursuant to this approach, a website could constitute a virtual PE.

Some countries like Saudi Arabia did establish the concept of virtual PE based on the U.N. model tax treaty.[30] This significant digital presence could be deduced from factors including frequency of digital transactions and number of users. A ratio of the revenue generated within the market of the significant presence would be used to determine the profit attributable to such country.

This concept raised various criticisms. First, it would create distortion—a separate tax regime applicable only to the digital economy could contradict some EU principles like free movement of services within the single market pursuant to Article 56 of the Treaty on the Functioning of the European Union.[31] Moreover, once nexus was established, the determination of attributable and taxable income would be tricky: the concept supposed the comparison of digital business with traditional business operations to determine appropriate margins.

Some commentators also proposed revising the principles for allocating taxing rights and a more drastic approach pursuant to which a company operating in a country with electronic apps, databases, online marketplaces, storage rooms, and platforms for advertising would be deemed to operate a PE in that country if it reached a threshold of 1,000 users per month and a stated minimum revenue.[32] Such a proposal, however, would have required revising the traditional profit split method to allocate fairly the profit from this business by taking into account both assets involved and the value creation of the market. Other commentators suggested a "digital service PE" and proposed not relying on physical presence or specific transactions but merely on a certain sales volume that would trigger a digital service taxable PE.[33]

The OECD BEPS project did not discuss further the concept of "virtual presence" and decided finally to discard the concept of virtual PE. Discussions moved toward establishment of a "deemed PE" and the amendment of Article 5(5), which includes the dependent agent provision (see above). OECD certainly considered that a virtual PE concept would ring-fence some cyber-physical transactions and that business involving both digital and physical presence would require a sort of mixed treat-



ment hard to define and implement. One can nevertheless object that the amended PE concept discussed above will probably have limited impact on digital business since the concept of physical presence is still prevalent despite it being fully irrelevant for online marketplaces and websites.

Some alternatives to the PE concept. Because the OECD amendments to the current definition of PE in OECD model Article 5 will probably not be sufficient to regulate digital business, is the PE concept still useful and relevant for such activity? Below are some proposed alternative solutions.

Equalization levy. Instead of implementing new profit allocation mechanisms, OECD proposed an equalization levy to tax profits of digital business in relation to their significant digital presence in a market. OECD said that some digital multinational companies (e.g., Facebook, Amazon, Google), though having numerous customers in foreign countries, had a substantial physical presence in only a single country, and profits generated in these foreign markets did not result in taxation in the residence market because the companies operated abroad through a website. Some countries, e.g., India, then decided to implement an equalization tax that would be charged on fees paid by advertisers. Another form of equalization levy could be calculated on the amount of data collected from customers, which obviously accounts for value creation. Because such consumption-based taxes would conflict with international and bilateral trade agreements, and require cooperation between different countries, OECD renounced exploring these options.

Transaction tax and diverted profits tax (Google tax). Various countries (Australia, Hungary, Israel, Italy, Luxembourg, the Netherlands) have introduced tax initiatives or effective laws through different methods targeting digital business.[34] For example, the U.K. established the "bit" tax or "Google tax" as of April 2015 at the rate of 25%.[35] Australia adopted the Tax Integrity Multinational Anti-Avoidance Law as of January 1, 2016. Hungary levied a 5% tax on net sales from advertising.[36]

These initiatives are aimed at circumventing the PE principle and permitting local tax authorities to tax digital companies with significant economic activity in the country. As a reaction to the U.K. decision, some digital companies (e.g., Amazon) modified their assets and tax structuring while others (e.g., Google) merely determined that they were not subject to the tax. OECD did not take the option of elaborating on the prospects of such a tax concept because it would conflict with the single-market principles.

Bandwidth tax. Some members states proposed taxing the digital economy through a corporate tax on bandwidth so that corporate taxation would move from source jurisdiction to residence jurisdiction where the market is located, as with VAT. A double digital tax was proposed, one based on revenues (sales or advertising) and the second on activity relating to the collection of data (number of end-users, flow of data, number of advertisers).[37] Because the proposal could clearly result in ring-fencing of the digital economy, it has never been effectively adopted.

Conclusion

OECD has proposed recommendations to amend the definition of PE status and define restrictively auxiliary and preparatory activities when implemented by digital companies and corresponding to their core business. These recommendations will certainly not affect the tax situation of digital companies, especially those operating web stores without physical presence, and they could lead to distortion and misalignment of the allocation of taxing rights and difficulties in enforcing taxation.[38] A possible solution could be a suitable definition of transfer pricing but it would impose a common definition of digital business and of the process of value creation in the digital economy.[39] ●

[37] See "France Strategie, "Taxation and the Digital Economy: A Survey of Theoretical Models" (February 26, 2015), https://ec.europa.eu/futurium/en/system/files/ged/ficalite_du_numerique_9_mars_13_h.pdf.

[38] Hellerstein, "OECD—Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments," 68 Bull. Int'l Tax'n No. 6/7 (IBFD, 2014), page 348; Olbert and Spengel, "International Taxation in the Digital Economy: Challenge Accepted?," U. of Mannheim Business School (August 22, 2016), pages 1-42.

[39] From a general perspective, see Avi-Yonah, Clausing, and Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," Fla. Tax Rev. 9, no. 5 (2009), pages 497-553; on digital economy, see Olbert and Spengel, *supra* note 38, pages 21 and 30-38.

DIGITAL BUSINESS AND PERMANENT ESTABLISHMENT [1]

(*some critical comments of BEPS' proposals to regulate digital business*)

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Abstract

This paper analyses why the digital economy and digital business models are so different from classic business and as a consequence how existing tax rules could be irrelevant to regulate this activity. The OECD, through BEPS (Base Erosion Profit Shifting) project, has identified and addressed the main tax challenges arising from the digital economy. Our article focuses on one of these tax challenges frequently named "taxable nexus" and on the difficulty to define the tax jurisdiction due to the structuration of their assets and activities by multinational digital companies to circumvent the permanent establishment ("PE") status. One main characteristic of digital business is the cross-border dissemination of assets through various jurisdictions and a sort of fragmentation of activities entailing a tax-optimized location of profits and permitting digital companies through treaty shopping to avoid from establishing a permanent establishment (thus subject to taxation) in consumer markets and to attribute the main part of their profits to specific entities and jurisdictions (especially those providing IP (intellectual property) favourable tax regimes). We explain how OECD without defining a real new tax paradigm applicable to digital economy nor a concept for value creation in digital business, has nevertheless proposed some amendments to the existing international rules to up-date the permanent establishment status and to tackle tax avoidance practices of digitalization economy. We are concluding with some critical comments about the OECD proposals and with a short review of alternative solutions.

[1] This article focuses on the concept of PE in relation with digital economy and will therefore not evaluate other tax challenges that the digital economy poses especially for indirect taxes, transfer pricing rules …

It is patently obvious that digitalization is a growing portion of our modern economy[2] and in the same time that traditional international tax rules and concepts are probably rather irrelevant to regulate this new form of business. The investigations against multinational companies involved in digital business are showing that these companies are engaged in very aggressive structuring of their business, taking advantage of a sort of distortion, a misalignment, between their business models and the existing international tax rules to implement tax avoidance schemes.

In the BEPS project, the OECD has focused on tax challenges arising from the digital economy as the first Action, because digital business models entail substantial opportunities for tax planning and for lowering tax bases in some countries[3].

After defining what means "digital business" from a tax perspective and explaining why the existing concept of PE is certainly irrelevant and un-appropriate to regulate the digital business (I), this articles aims at explaining how OECD, through the action plan on Base Erosion and Profit Shifting (BEPS), called for a review of the PE's definition and criteria to prevent the use of certain tax avoidance strategies currently used to circumvent the PE status, such as replacement of subsidiaries acting as distributors by *commissionnaire* arrangements (II) and the abnormal exploitation of the specific legal exceptions to the PE definition (this mainly concerns « specific activity exemptions » such as fixed facilities) provided by Art. 5(4) of the OECD-MT, and the fragmentation of activities between closely related parties (III)).

Because OECD is a soft-law organization proposing mere recommendations whose adoption is left at its Member States' discretion rather than an organization producing direct tax policy action[4], because there is also a general consensus to defend the idea that ring-fencing the digital economy for tax purposes is probably not feasible, and because OECD is bound by European principles such as "free movement of services and goods", OECD has failed to define a specific tax status and paradigm applicable to digital business and certainly failed to address the core of the problem (IV).

I) HOW AND WHY DIGITAL BUSINESS IS ELUSIVE FOR TAX SYSTEMS ?

International tax planning aims first at taking advantage of tax rate as well as tax base differentials across countries : that is frequently named tax arbitrage. It also aims at avoiding legal double taxation to prevent investors from being taxed in all or part twice on the same income/profit.

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[2] European Parliament Directorate General for Internal Policies. Policy Department A : Economic and Scientific Policy in-depth Analysis for the ECON Committee (2015) Presentation : Challenges for a Competition Policy in a Digitalised Economy, pp. 1-79 ; For a brief and interesting survey of social and economic aspects of digital economy, see J. Tirole, Economie du Bien Commun, PUF May 2016, pp.527 to 596 (Chapters 15 & 16).

[3] OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 Deliverable, Paris (2014) p. 51 ; OECD, Addressing Base Erosion and Profit Shifting, February 12, 2013, (http://dx.doi.org/10.1787/9789264192744-en) ; OECD, Addressing the Tax Challenges of the Digital Economy, Action 1, Final Report, October 5, 2015 (http://dx.doi.org/10.1787/9789264241046-en).

[4] Y. Brauner, BEPS : an Interim Evaluation, 6 World Tax Journal 1 (2014), p. 11, Journal IBFD : European Commission, questions and Answers on the Action Plan for Fair and Efficient Corporate Taxation in the EU, Factsheet June 17, 2015 (http://europa.eu/rapid/press-release_MEMO-15-5175_en.htm) ; J. Englisch, BEPS Action 1 : Digital Economy – EU Law Implications, British Tax Review (2015) p. 281 ; S.S. Johnston, What's next for the OECD and the Digital Economy, Tax Notes International (2014) p. 1089.

Multinational groups decide on investment locations, acquisition of foreign companies, financing and profit distribution, losses compensation, allocation of ownership rights (especially on intangible assets such as patents, IP rights), the structure of intra-group assets and services transfers, and on the *legal form on investment.*

Regarding the legal form of investment, we generally consider that multinational groups have the choice between a *permanent establishment* (hereafter "PE") or a *subsidiary,* though these groups have tried over the past years to implement specific schemes and business organization to avoid the PE status in countries where corporate taxation is considered to be too high.

Europe is a challenging area for international tax planning because there are significant differences in corporation tax rates and tax base across european countries : there is sometimes a « race to the bottom » despite the creation of a single market within the European Union (« EU ») that should have pushed state members to lower the tax competition and harmonize/standardize their tax systems.

Due to these various tax systems, Europe is obviously an interesting tax aera for foreign companies aiming at establishing a business and choosing the most attractive country in connection with the assets involved.

1) What are digital economy and digital business models ?

Digital economy is usually defined as "the global network of economic and social activities that are enabled by platforms such as the internet, mobile and sensor networks"[5]. The digital business is more dependent on intellectual property, the use of big-data collected, diffused, stored and analysed for creating value, rather than traditional brick-and-mortar business. The monetisation of these big data plays a key role and the value creation does not any more correspond to the classic schemes[6].

Digital business models are frequently characterized as follows :

- The *subscription model* where users pay a subscription fee to have access to a service or content on a website (Amazon, Netflix) ;
- The *advertisement model* where profits are generated by exposing end-users to advertising in platforms (Youtube, Dailymotion, Google Search, Facebook) ;
- The *access model* where app developers (data analysts, data brokers and ISP) pay to have access to end-users' data (Apple's App Stores) ;

However these digital and online businesses (marketplaces, dating and meeting sites, online employment agencies, online travel and/or accommodation sites, peer to peer services) are similar or at least comparable to offline businesses.

An other distinction is frequently made by opposing digital B2Cmodels to B2B models.

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[5] European Parliament Directorate General for Internal Policies. Policy Department A : Economic and Scientific Policy in-depth Analysis for the ECON Committee (2015) Presentation : Challenges for a Competition Policy in a Digitalised Economy, p. 22 and seq ; United Nations Department of Economic and Social Affairs (2014) Protecting the Tax Base in the Digital Economy, p. 5 ; see also E. Brynjolfsson & L. M. Kahin, Understanding the Digital Economy – Data, Tools and Research, 2000, p. ; OECD, OECD Digital Economy Outlook 2015, July 15, 2015, p. 11 (http://www.oecd.org/internet/oecd-digital-economy-outlook-2015-9789264232440-en.htm)

[6] U. Huws, the Cybertariat Comes of Age : Labour in the Global Digital Economy, Monthly Review Press, New-York 2014 ;

B2C models offer individualized products or services such as advertising or platform services while creating free online services for end users: the paying customers are mainly commercial companies advertising clients and customers of web-based services totally distinct from the physical location of the service provider. The infrastructure is composed of an online platform and the enabling proprietary software with a widespread IT infrastructure running the platform and software applications with core physical located at the parent company and minor and individual parts (data centers) located in consumer markets.

The essential and significant activity located in a headquarter is the development and maintenance of the IT infrastructure and online services as well as management, sales strategy and marketing and most of the revenue is generated by advertising and fees for the use of online services. An external service provider is in charge with hosting and hardware services.

Under this model a main (taxable) nexus is incorporated in the country of residence of the parent company entering into direct contractual relations with customers notwithstanding the geographical markets even if some minor activities (collection of data, customer support, local marketing) are performed at the location of the customer.

From a tax purpose, current rules attribute the value (and the revenue) to the corporation developing and maintaining the IT infrastructure and software so that local subsidiaries or permanent establishments of the B2C corporation are not deemed to collect significant revenues (and therefore do not pay large amounts of taxes) except IP Boxes subsidiaries which have been granted a favourable tax regime.

B2B models offer digital goods or services to commercial clients comprising enterprises with access to internet; it supposes a massive server landscape at the main location operating through smaller and complementary hardware components at the location of the final customers, these components being frequently outsourced through subsidiaries or independent agents which facilitate the final individualization of the digital solutions. Revenue is generated from the direct sale or the licensing of digital products or services. Even if local subsidiaries or permanent establishments inter into direct relations with final customers, they bear some costs and compensate (through royalties) the main corporation for the use and sale of the digital products or services.

From a tax purpose, and similar to B2C businesses, current taxation rules attribute most of the value to the main corporation developing, owning and maintaining the IT infrastructure and softwares. When sales are initiated through local subsidiaries and sales contracts concluded between local entities and customers, a portion of the profit is derived and attributed to the local entities ; the profit allocation between entities involved in the business will consequently depend on transfer pricing policy.

As a result media, advertising, logistical activities, payments have their modern online tools and versions. As an other consequence, profits are generated by charging fees and commissions or usage fees/royalties to services providers and services users or to advertisers : the value creation is no more exclusively derived from exchange of goods or services[7].

The digital economy thus supposes and allows a split of functions and the fragmentation of the assets involved in the global business among various countries.

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[7] E. Brynjolfsson and L. M. Kahin, Understanding the Digital Economy - Data, Tools, and Research, 2000, p.1 ; E. Brynjolfsson and McAfee, The Second Machine Age, 2015, p. 90 ; OECD, OECD Digital Economy Outlook 2015, July, 15, 2015 p. 11 ;

Digital businesses are mainly based :

- On intangible assets rather than on fixed assets (except a few pilot stores instead of several retail stores). Intangible assets are key value drivers (with royalties paid to patents, trademarks and brandnames' owners)[8] frequently owned and licensed by specific vehicles incorporated in countries which provide attractive rate of taxation on profits derived from these assets[9]; legal ownership of intangible assets is therefore a decisive factor in determining profits stemming from the use of these assets; some EU countries (Cyprus, Hungary, Luxembourg) offering IP box favourable tax regimes, digital companies have a real incentive to locate their IP assets in such low rate countries[10]. Multinationals therefore engage in tax-motivated profit shifting by located their IP assets in such jurisdictions.[11]

  Investigations on major digital companies (like Google, Uber, Amazon) suggest that these digital corporations have structured their business in a tax-optimized manner by assigning their key IP assets to specific countries providing a tax attractiveness and then licensed their patents and copyrights to subsidiaries and leading to an erosion of profits in other countries.[12]

  It leads to a convergence of core activities and assets and thus a taxable nexus where the parent company or regional IP special purpose companies are incorporated, while some minor elements of IT infrastructure are located in consumer markets which might constitute a taxable nexus with however a very few amount of profits attributable to these local entities.

- On goods and services marketed through websites rather than through traditional commercial workforces with a local and physical presence, goods being frequently stored and maintained close to final customers in specific countries with no substantial physical presence in the end-users countries,

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[8] R. Sydler & al., Measuring Intellectual Capital with Financial Figures : can we predict firm profitability ? European Management Journal (2014), p.245 ; S. White, Intangible drive value in the digital age, Journal of Accountancy (2016), p. 21 ; see alo CGMA, the Digital Finance Imperative :Measure and Manage what Matters Next, 2015 ; (http://www.cgma.org/Resources/Reports/Documents/the-digital-finance-imperative-report.pdf)

[9] Lisa K. Evers (2014) Intellectual Property (IP) Box Regimes (Tax Planning, Effective Tax Burdens and Tax Policy Options) PhD Thesis, Mannheim University (http://un-madoc.bib.uni-mannheim.de/37562/4/Dissertation_Lisa_Evers_IP_Box_Regimes.pdf); for a survey, European Parliament, Directorate-General for Internal Policies, Policy Department Economic and Scientific Policy A, Intellectual Property Box Regimes, In-Depth Analysis for the TAXE Special Committee (2015) pp. 1-10 ;

[10] Wittendorf, BEPS Actions 8-10 ; Birth of a New Arms's Length Principle, Tax Notes International (2016), n° 39, p.330 and seq ; Duff & Phelps, Guide to International Transfer Pricing, 2015, pp. 70-75 ; M.P. Devereux & J. Vella, Are we heading towards a corporate tax system fit for the 21st century ? OUCBT Working Paper (2014), p. 4 ; A. Cockfield & al., Taxing Global Digital Commerce, 2013, p.7 ;

[11] D. Dharmapala, What do we know about Base Erosion and Profit Shifting, a Review of the Empirical Littérature, Fiscal Studies (2014) ; J.H. Heckemeyer & M. Overesch, Multinationals' Profit Response to Tax Differentials : Effect Size and Shifting Channels, ZEW Discussion Paper (2013), p. 27 ;

[12] Klassen and al. A Model of Multinational Income Shifting and an Application to Tax Planning with e.commerce, Journal of the American Taxation Association (2014), p. 40 ; C. Ernst & C. Spengel, Taxation, R&D Tax Incentives and Patent Application in Europe, ZEW Discussion Paper (2011) ; M. Dischinger & N. Riedel, Corporate Taxes and the location of intangible assets within multinational firms, Journal of Public Economics (2011) ; B.P. Lindsey & W.M. Wilson, Foreign or Domestic Tax Havens ; the Location Decision for Intangible Property by US Firms, Discussion Paper (2015) ; Böhm & al. The Impact of Corporate Taxes on R&D and Patent Holdings, Discussion Paper (2012) ; Lisa K. Evers (2014) op.cit ;

- On distribution networks operated through independent distributors or agents receiving commissions and selling goods and/or services on their own names and on behalf of a third enterprise instead of classic and standard integrated distribution networks ;

2) What are the classic legal framework and concept of Permanent Establishment ?

Most international taxation treaties aiming at reducing and eliminating double taxation are based on the model treaty of the OECD and follow the structure and wording of the OECD Model Treaty (hereafter « OECD-MT ») ; though this model is not legally binding, its main purpose is to give a sort of guidance for State representatives when negociating tax treaties.

Roughly speaking we can consider that two main principles govern the OECD-MT :

- On the one hand, the aknowledgment of the taxing right of the *source country*, that may be restricted from time to time ; Three main categories can be distinguished regarding its taxing right. The source country has no taxing right for *royalties* paid to non residents (either individuals or corporations) (pursuant to Art. 12 of OECD-MT) nor for *capital gains* on sale of shares by non-residents in resident corporations ; its taxing right is also restricted for *dividends* paid to non-residents (Art. 10 of OECD-MT) though a whithholding tax can be held by the distributing corporation ; the source country has finally an unlimited taxing right for *real property* (Art. 6 OECD-MT) and for **profits generated by a *permanent establishement* located in the said country** ;

- On the other hand, the aknowledgment of a conditional taxing right of the *residence country*, in that sense that possible double taxation must therefore be eliminated. The residence country has the right to tax worldwide income of resident taxpayers who are subject to taxation by reason of domicile, residence, place of management, nationality (especially for individuals pursuant to certain tax systems) or similar criteria.
Business profits are taxed in the state of residence of a company unless these profits are attributable to a PE outside in the source country (Art. 7 of the OECD-MT) where the said source country will be entitled to tax these profits; the PE having no legal personality, when the source country exercises its taxing right, then the residence country avoids double taxation by granting relief for taxes paid in the source country through two methods, i) the *exemption method* (defined in Art. 23A of OECD-MT which permits to exempt the foreign profits and income from the tax base of the residence country) or ii) the *credit method* (defined in Art. 23B of OECD-MT which permits to credit the foreign taxes paid abroad on the source income)

A PE [13]could be roughly defined as a fixed place of business through which the business is carried on : the legal terms PE generally include *a place of management, a branch, an office or a factory. Facilities which serve the sole purpose of storage, display or delivery of goods* (or services) are exceptions provided by Article 5(4) and consequently not deemed to be a PE.

The foreign PE and the domestic corporation (ie : the head-office which has initiated the PE) form together an economic unit as well as a single legal unit from a civil point of view.

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[13] Article 5, paragraphs 2 & 3 of the OECD MT :
2) The term "permanent establishment" includes especially: a) a place of management; b) a branch ; c) an office ; d) a factory ; e) a workshop ; f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3) A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months ;

The PE has no veil of incorporation and is not considered as a legally distinct entity separate from the head-office or the domestic company, so that the foreign PE is thus subject to pass-through taxation [ie : profits and losses attributable to the PE are deemed to be taxable income of the domestic head-office (main corporation monitoring the group) which will be entitled to avoid (or to lower) legal double taxation either through the exemption method or through the credit method].

As seen previously, from a tax point of view and definition, the PE is however treated as a functionally separate and independent enterprise, so that the PE has a fiscal personality and the source country where this PE is located has the right to tax the income earned through the PE pursuant to Art. 7 paragraph 2 OECD-MT ; the company's total profit must therefore be attributed to the domestic and the foreign part of the company respectively following the dealing at *arm's lenght principle* well known in transfer pricing rules.

The legal definition of PE is therefore crucial in determining whether a non-resident corporation must pay income tax abroad.

3) Tax avoidances practices implemented by digital companies : why and how ?

The OECD categorises tax challenges arising from digital economy as follows :

- Nexus which is the possibility to conduct business without physical presence through technological devices and tools ; companies traditionally have a physical presence or a nexus in a jurisdiction where they are subject to taxation. E business now permits to have access to final consumers (through a web store) without having necessarily such a presence[14]. The way of conducting these activities is shaped by the dissemination of core functions across multiple jurisdictions and countries with a segregation of core activities from consumer markets.[15]

- Data and value creation which is relating to the difficulty to attribute value to data generated by using and analysing collected data of end-users ; data collected, analysed, and then sold to advertisers and commercial companies and used in online business do not correspond anymore to a mere auxiliary activity but is often the core business and most valuable asset of some digital companies ;

  Customer data has always been a source of value ; the main tax challenge consists in determining how collected data is monetized, knowing that most of the time data collected on a consumer market are sent through internet to a foreign-based company to be analysed. In order to determine the value chain of business collection/analysis of data, tax authorities must make a thorough analysis of functions performed, assets involved and risks assumed, though "analysis" of data probably generates more value creation than the mere collection of data ;

[14] M. De Wilde ; Tax Jurisdiction in a Digitalizing Economy : Why Online Profits are hard to pin down, *Intertax*, Vol. 43, n° 12, 2015 ;

[15] OECD, Addressing the Tax Challenges of the Digital Economy, Action 1, ; 2015 Final Report, October 5, 2015 p. 101 (http://dx.doi.org/10.1787/9789264241046-en);

(When comparing "nexus" and "data and value creation" tax challenges, we must also estimate that the *allocation of profits and transfer pricing* between various assets (whose location is split among various countries) and segregate functions is a major tax issue, though outside the scope of our article ; in particular transfer pricing are used to reduce and minimize income attributable to functions and risks in consumer markets with high rates of taxation and to maximize income allocations to entities owning the IP assets and located in countries with favourable tax regimes afforded to IP boxes and patents/copyrights SPV[16]).

- Characterisation of payments because news ways of delivery, storage of data and softwares at external services (cloud computing) make the characterization of payments uncertain in digital sector. As there is no intermediary involved, it is difficult to decide whether a company received payments while carrying on business; it is a challenging task to qualify the payments as royalties (giving rise to withholding tax), fees for technical services or business profits.

Mobile intangible assets and multi-sided business models make the digital business easily elusive for national tax systems. The EU and Member States' investigations on some digital companies have revealed some tax avoidance practices such as:[17]

- Avoiding withholding tax (when a non-resident company generates profits via payments of interest or royalties in a country, it can be subject to taxation);
- The use of preferential tax regimes [like IP or Patent boxes incorporated in specific countries offering a low rate of taxation where the main corporation detains subsidiaries having the ownership of intangibles and renting these IP rights (patents, copyrights, brand) and then subsidiaries in charge with marketing and technical support will pay royalties to the IP box for the use of those IP rights][18] (a various range of IP box is available within Europe with tax rates of 0% in Malta, 2,5% in Cyprus and Liechtenstein, 1/5 of the normal corporate tax which amounts to a 5,6% rate of taxation in Luxemburg compared to a 15% taxation in France) ;
- Artificial trading of intangibles such as management fees or international property licensing ;
- Mismatch arrangements which exploits a difference in the tax treatment of an entity or instrument under the law of two or more tax jurisdictions to produce a mismatch in tax outcomes where the mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement;[19]
- Thin capitalization, internal debt shifting [20](where a subsidiaries is indebted to another company of the same and then shifts expenses (to a highly taxed jurisdiction) and profits (interest) to a low taxed jurisdiction;[21]

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[16] G. Kofler, the BEPS Action Plan and Transfer Pricing : the Arm's Length Standard under Pressure ? British Tax Review (2013), p.649 ;

[17] For detailed illustrations on *AirBnB, Uber, Google, Apple cases*, see European Parliament Directorate General for Internal Policies. Policy Department A : Economic and Scientific Policy, Tax Challenges in the Digital Economy, June 2016 pp. 18 to 24, p. 37 ; European Parliament Directorate General for Internal Policies. Policy Department A : Economic and Scientific Policy in-depth Analysis for the ECON Committee (2015) Presentation : Challenges for a Competition Policy in a Digitalised Economy ; see also for a general survey H.D. Rosenbloom, International Tax Arbitrage and the International Tax System, David R. Tillinghast Lecture on International Taxation (1998) n° 53 Tax Law Review 137 ;

[18] Eurodad (2015), Fifty Shades of Tax Dodging ; the EU's role in supporting an unjust global tax system, p. 83 ; Lisa K. Evers (2014) Intellectual Property (IP) Box Regimes (Tax Planning, Effective Tax Burdens and Tax Policy Options) PhD Thesis, Mannheim University.

[19] See H.D. Rosenbloom, International Tax Arbitrage and the International Tax System, op. cit ;

- Transfer pricing, artificial contractual arrangements, circumvention of CFC rules ;
- *Avoiding taxable presence in the market country due to the difficulty to determine the nexus and to characterize a PE,*[22] [23]

When comparing the above mentioned OECD concept of PE with the aforesaid economical definition of digital businessmodels, we must admit that there is no useful and accurate tool in the current OECD concepts to regulate new businesses based on intangibles assets or on digital network though these businesses now represent a huge part of our economy.

Digital transactions consist in sales through a website (e commerce transactions), and licensing information and know-how by its dissemination through internet. When corporations sell / lease their products or provide services through websites or marketplaces, the income derived from such transactions is taxable in the source country; domestic laws of contracting state tax the business income of the non-residents in their states only if the non-residents have an economic (and thus taxable) presence in the contracting state through a PE.

The existing concept of PE which stipulates that an enterprise needs to have a physical presence in the form of "a fixed place of business at its disposal" to be subject to taxation in the source state has made it practically impossible for the source state to levy taxes on the sales originated through websites in that state.

The avoidance of the PE status will therefore result in a shift of profits out of the country where the sales effectively took place.

As of October 2015, OECD published its final report on these topics and 15 actions have been completed among which Action 7 dealing with PE status.

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[20] H, Huizinga, L. Laeven, G. Nicodeme, Capital structure and International Debt Shifting (2008) 88(1), Journal of Financial Economics 80 ; AP Dourado, R. de La Feria, Thin Capitalization in the Context of the CCCTB' in M. Lang et alii Common Consolidated Corporate Tax Base (Linde Verlag 2008) ; P. Hinny, General Report, in IFA, New Tendencies in tax treatment of cross-border interest of corporations (IFA Cahiers de Droit Fiscal International, 2008), Vol. 93b, 15 ;

[21] European Parliament Directorate General for Internal Policies. Policy Department A : Economic and Scientific Policy in-depth Analysis for the ECON Committee (2015) Corporate Tax Practices and Aggressive Tax Planning in the EU, pp. 1-27 ;

[22] A. Ting, Ireland's move to close the « double Irish » tax loophole unlikely to bother Apple, Google, the Conversation, October 15, (2014 c) ; from the same author, Old Wine in a new bottle : Ireland's revised definition of corporate residence and the war on BEPS (2014b) British Tax Review, n° 3 237 ;

[23] For a general survey on these practices see M.P. Devreux, J. Freedman, J. Vella, Tax Avoidance, Report Commissioned by the National Audit Office (2012) available at (http//www.sbs.ox.ac.uk/sites/default/files/business_Taxation/Docs/Publications/Reports/TA_3_12_12.pdf) ; and M.P. Devreux, R. Griffith Evaluating Tax Policy for Location Decisions (2003) International Tax and Public Finance 10(2), 107-26 ; European Parliament Directorate General for Internal Policies (2015) Corporate Tax Practices and Aggressive Tax Planning in the EU op.cit ;

The usual concept of PE referred to a substantial physical presence in a country, and also to various situations where the non-resident carried on business abroad in the said country through a dependent agent. Because new technologies such as internet or digital means now allow non residents to carry on business and to be involved in the economy of a country without having a taxable presence as regards to the aforesaid traditional definition and criteria, OECD thus considered that the definition of PE had to be updated to prevent abuses.

II) ARTIFICAL AVOIDANCE OF PE STATUS IN DIGITAL ECONOMY

Pursuant to the combination of current Article 5 paragraphs 5) & 6) of the OECD MT,

- 5) *"where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph ;*

- *6) An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business ».*

For article 5 paragraph 5 to apply, the agent must be dependent, acting on behalf of an enterprise and empowered to conclude contracts in the name of the said enterprise.

Many digital companies are artificially avoiding the PE status while maintaining a minimum form of physical presence in the customer/market country by use of limited-function distributors;

Some enterprises have consequently replaced their local subsidiary selling goods and services and acting as a distributor, by *commissionnaire* arrangements with a resulting shift of profits out of the country where the sales took place without however a substantive change in the functions performed in the said country[24].

Non-residents taxpayers can therefore derive substantial profits from transactions with customers located in another country ; though the new rule does not directly aim at changing the existing international standard on allocation of taxing rights on cross-border income (as mentioned here before), it will restore both source and residence taxation where this cross-border income would go untaxed or would be taxed at very low rates.

A *commissionnaire* arrangement may be defined as an agreement through which a person sells goods in a country (B) *in its own name* but on behalf of a foreign enterprise located in another country (C) which is the owner of these goods.

[24] Conseil d'Etat March, 31, 2010 n° 304715 and 308525, Zimmer France ltd, RJF 6/10 n° 568 has decided that a commissionnaire can not constitue a PE because its sells on its own name, except if this commissionnaire is de facto entitled to directly bind the enterprise through agreements entered with third parties. (Conseil d'Etat is the French Administrative High Court of Justice having jurisdiction in most of tax matters).

It obviously permits the foreign enterprise located in country C to sell its goods without having a PE to which such sales would be attributed for tax purpose.

The commissionnaire which does not own the goods and which is a mere middleman, cannot therefore be taxed on the profits generated by such sales and will generally only be taxed on the commission it will earn for its services.

Under the current paragraph 5 of Art.5 of OECD MT, the foreign company located in country C will be deemed to have a PE in country B where the person selling goods has also authority to conclude the contracts on behalf of the foreign company.

However, when an agent selling goods abroad, also negotiates the main provisions of a contract without concluding this agreement, then this agent still does not constitute a PE of the foreign enterprise.

Some court decisions illustrate this scheme where sometimes an enterprise (located in a low rate taxed country) carrying on a business abroad (in country B) through a closely related company (generally a subsidiary member of the same group, this subsidiary being thus taxable on profits generated by the sales in country B), decided to repatriate fixed assets, inventories and customers base of the foreign subsidiary and to enter in a mere *commissionnaire* agreement with this latter which then agreed to sell goods and products in its own name but on behalf, and at the risk, of the foreign enterprise … the foreign commissionnaire (though incorporated as a subsidiary) receiving a mere commission.

Some other court decisions involve « *independent agents* » and situations where contracts are substantially negotiated in a country B but not concluded in that country B and at the end executed outside this country and finalised or just authorised abroad (in country C) (and frequently governed by the law of country C) : though the foreign company seems to exercice powers and authority to conclude contracts, it only constitues an independent agent (acting on behalf of the foreign enterprise located in country C) to which the existing exception of Art.5(6) of OECD MT applies event though this agent is closely related to the foreign enterprise C bound by the contract.

The OECD/G20 BEPS discussion Draft as of March, 24, 2014 was very creative and proposed a new standard nexus called "*significant digital presence*" based on a test for the presence of a virtual PE ; however the final OECD/G20 BEPS Report dated October 2015[25] on the digital economy discarded this new and specific definition by coming up to a less ambitious approach with a "*modified nexus approach*" according to which the existing exceptions to the current definition of PE should be updated and amended to meet new tax challenges inherent to the digital sector.

As a consequence, the definition of an « independent agent » has been slightly modified to address the situation where this agent is closely related to an enterprise and can no more be deemed to be « independent ».

[25] OECD Final Report (2015) Addressing the Tax Challenges of the Digital Economy, Action 1, p.12 ;

OECD has then decided to modifiy paragraphs 5 and 6 of Art.5 and the definition of PE as follows (changes appear in *italics* for additions and yellow highlighted for deletions) :

«5.) notwithstanding the provisions of paragraphs 1 and 2 *but subject to the provisions of paragraph 6*, where a person – other than an agent of an independent status to whom paragraph 6 applies - is acting *in a Contracting State* on behalf of an enterprise and has, and habitually exercises, in a Contracting State, an authority to conclude contracts, *in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are*

a) In the name of the enterprise, *or*
b) *For the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or*
c) *For the provision of services by that enterprise,*

That enterprise should be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6.) An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

a) *paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to such enterprise.*

b) for the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise [...] »

What are the first comments that can be made and conclusions that can be drawn, regarding these proposed modifications ?

1) **The meaning of « *habitually concluding contracts* », « *playing the principal role leading to the conclusion of contracts routinely concluded …* »**

OECD comments states that, for paragragh 5 to apply, some cumulative conditions must be met.

- A person acts in a Contracting State on behalf of an enterprise,
- In doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and
- These contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise ;

Even those conditions are met, the activities performed by this person on behalf of an enterprise will however not be covered by paragraph 5 if those activities are made as a real independent agent (and thus exception provided by paragraph 6 will apply) or are limited to activities mentioned in paragraph 4 (it covers situations where an activity is exercised through a fixed place of business solely for the purpose of *preparatory* (market studies …) or *auxiliary* activities (such as storage).

Roughly speaking, a person cannot be said to be acting on behalf of an enterprise if this latter is not directly or indirectly affected by the action performed by the person.

The phrases "habitually concludes contracts" and "habitually plays the principal role leading …" are aimed at situations where the conclusion of contracts directly results from the action that an agent performs in a Contracting State on behalf of an enterprise even contracts are not concluded by that person in that State.

This new definition covers now cases where a person A solicits customers and receives orders which are then sent to a warehouse from which products belonging to a person B are delivered and where this latter routinely approves theses transactions : the action performed by person A goes beyond the mere promotion and marketing of goods and services.

It clearly applies to digital businesses.

OECD points out the case where a company B distributes its products or services worldwide through its websites : its wholly-owned subsidiary named A and located in State A, through its employees, send emails, make calls to customers, or visit customers to convince them to buy B's products. A's employees are in contact with local holders of accounts : when an account holder is persuaded by an employee of A to purchase goods or services, this employee gives all financial and legal details relating to the sale and indicates that a standard contract (whose terms can not be modified by this employee) must be concluded online with B before goods or services can be provided by B. A's employees thus play the principal role leading to the conclusion of the contracts between local customers (the account holders) and B and such contracts are routinely concluded without material modifications by B : B would then be deemed to have a PE in the State where A operates.

Obviously one effect of this new definition will be that the rights and obligations resulting from these contracts will be allocated to the PE, though there must be a split to allocate the global profit between all entities : the determination of the profits attributable to the PE resulting from the application of paragraph 5 will be govern by the rules of Article 7 of OECD-MT, and activities performed by all enterprises to which the PE belongs must be properly remunerated and only a portion of the total profit will be attributable to the PE (determined as if it were a separate and independent enterprise performing the activities attributed to the PE).

However the mere fact that a person has attended or even participated in negotiations in a state between an enterprise and a customer is not sufficient to conclude that this person has concluded contracts or played the principal role leading to the conclusion of contracts that are routinely concluded without material modifications by the enterprise.

But most of digital businesses operated on behalf of a B enterprise through the combination of its foreign websites and local warehouses with a local commercial action of A's employees are at least now concerned by this new definition.

As a result this new definition of PE does not fully solve the issue. The allocation of the global profit derived from digital business between segregate entities is a non-trivial task.

However the cases on which OECD focuses must be distinguished from situations where a person concludes contracts on its behalf and then requests and obtains goods or services from an enterprise or arrange for other enterprises to deliver such goods or services : the said person does not act on behalf of these other enterprises and contracts concluded are neither in the name of these other enterprises nor for the transfer to third parties of the ownership or use of property that these enterprises own or have the right to use.

That means that schemes based on a "low-risk distributor" are still valid and will not result in a PE attributed to the foreign manufacturer. Under such a scheme, a person A - neither acting on behalf of a foreign enterprise nor selling property (either tangible or intangible) that is owned by that foreign enterprise – sells goods or services to customers that it buys from an enterprise (that can even be associated) : the transfer of the title to property sold by that low-risk distributor passed first from the enterprise to the distributor and this operation will generate a profit from the final sale to local customers as opposed to a remuneration in the form of a commission.

There must thus be a clear combination of rules governing the PE on the one hand, and those governing transfer pricing on the other hand.

2) The meaning of « *independence* » and « *independent agent* »

Where a person acts on behalf of an enterprise in the course of carrying on a business as an independent agent[26], this status is an exception to Art.5 of the OCDE MT excluding the qualification of PE.

[26] CAA Paris 22 janvier 1998 n° 95-3510 and n° 97-637, 2d Chamber, SA Eagle Star Vie, RJF 4/98 n° 383 deciding that an agent having no authority to conclude contracts on behalf of a principal can not be considered as a dependent agent and therefore does not constitue a PE in France of the foreign principal ;

The « independence » of an agent will depend on the extent of the obligations and duties which this agent has vis-à-vis the enterprise[27]. Are the agent's activities for the enterprise subject to detailed instructions or to comprehensive control by the enterprise ? is the entrepreneurial risk borne by the enterprise the agent represents ? In such situations, the agent would not be deemed to be independent.

An agent can be responsible to his principal for the results of its work though not subject to significant control with respect to the manner its work is carried out, without loosing its independence.

The providing of substantial information to a principal by an agent in connection with its business and work conducted under the agreement, is not a sufficient criterion to decide that this agent is not independent[28] unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted.

Factors to be considered to assess the independence of the agent are the following one ; limitations on the scope of business which an agent may conduct, the freedom in the conduct of its work, the risks borne by the agent, the number of principals the agent represents (considering that its independence is less likely if the activities of the agent are performed wholly or almost wholly on behalf of one single enterprise over a long period of time[29]).

3) The meaning of a « *person closely related to an enterprise* »

The concept of « person closely related to an enterprise » seems very similar though different from the concept of « associated enterprises » (used in Art.9 of OECD MT).

A person will not be considered to be an independent agent where this person acts exclusively or almost exclusively for one or more enterprises to which it is closely related.

A person would be deemed to be « closely related » to an enterprise if, based on all facts and circumstances, one has the control of the other or both are under the control of the same persons or enterprises ; this rule cover situations where the control derived from a *special agreement* granting rights

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[27] See for example CAA Paris November 26, 2003 n° 00-134 2d chamber, Intercontainer SA, RJF 4/04 n° 404 where the administrative court of Paris decided that a French agent though empowered to conclude contracts on behalf of a foreign (belgium) enterprise did not constitue a PE of this foreign enterprise because the activities of this Fench agent were not performed wholly or almost wholly on behalf of one single enterprise ;

[28] CAA Paris, November 26, 2003, op.cit. where the french agent (a limited liability company) concluded contracts in France on behalf of a belgium principal, carried on its business by providing substantial reporting and information to the principal but under the sole authority and responsability of its French directors so that it remained an independent agent ;

[29] CAA Paris, July 2, 1996 n° 94-765, 3rd Chamber, SA New Building Promotion Limited, RJF 11/96 where a French commissionnaire has been requalified as a dependent agent constituing a PE of a Swiss company in France because this commissionnaire not only sold goods of a Swiss company (Roche) on its own name but was also empowered i) to conclude contracts on behalf of the Swiss company binding this latter and ii) to manage real estate assets owned by the Swiss company in France. Even though the Swiss company was legally and economically distinct from the French commissionnaire, the commissionnaire was deemed to be the French dependent agent of the swiss company.

similar to those that a party would hold if it possessed directly or indirectly 50 per cent of the beneficial interest in the enterprise ;

This definition will be automatically satisfied when one person possesses directly or indirectly more than 50 per cent of the beneficial interests in the other or if a third party possesses directly or indirectly more than 50 per cent of the beneficial interests in both the person and the enterprise ;

III) ABUSIVE EXPLOITATION OF THE "SPECIFIC ACTIVITY EXEMPTIONS" AND OTHER STRATEGIES

OECD also focused on three situations among which two are concerning the digital economy ; the use of specific activity exemptions according to which a PE is deemed not to exist where a place of business is used solely for activities listed in Article 5 (4) on the one hand (a), and the fragmentation of activities between closely related parties on the other hand (b).

(It also focuses on a third situation consisting in the very specific issue of the splitting up of contracts which is out of the scope of this article).

1) Preparatory or auxiliary activities and specific exemptions

Under current Article 5 paragraph 4 of the OECD MT[30] some situations or activities constitute an exception to the PE status. OECD MT convention includes a list of exceptions that correspond to activities having merely a *preparatory or auxiliary character* and that are not deemed to constitute a PE.

Activities considered as *preparatory or auxiliary* according to this paragraph 4 of Article 5 of the OECD MT might constitute more important parts of digital business models and hence trigger the PE status. For example collection of data is frequently seen as a routine activity that does not necessarily contribute to value creation and seen as an auxiliary activity that does not alone justify a tax liability nor substantial allocation of income because data are automatically collected by standardized hardware devices and transmitted through internet to central computing data centers. For taxing income, current rules tend generally to attribute the value to entities owning, developing and sometimes maintaining the software with skilled staff.

By using these OCED exceptions and applying classic definitions to new functions and business models, digital companies thus circumvent the PE status.

OCED has then proposed a new drafting of this Article 5(4) is as follows :

4). Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include :

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise ;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery ;

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[30] OECD (2014) Model Convention with Respect to Taxes on Income and on Capital (https://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf)

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise ;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise ;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity ;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e),

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of preparatory or auxiliary character.

The first comments that can be drawn are as follows.

An activity having a "*preparatory character*" is one carried on in the perspective and contemplation of the carrying on of what constitutes the core business, the essential and significant part of the activity of the enterprise ; it generally precedes another activity and will also be carried on during a relatively short period of time.

An activity having an "*auxiliary character*" generally corresponds to an activity carried on to support the core business of the enterprise without being part of the essential end significant part of the activity.

These definitions therefore impose to define what is the "core business" or the essential and significant activity of the enterprise.

It's always a matter of facts.

A warehouse is generally supposed to be an auxiliary activity that can also be sub-contracted to an independent company. However where an enterprise A maintains in a foreign state B a large warehouse with a significant number of employees working for storing and delivering goods owned by the said enterprise A and sold online by this latter to customers located in state B, then storage and delivery activities will be deemed to represent an important asset of the enterprise A and to constitute a significant part of its activity and do not therefore still have an auxiliary character.

The mere existence and presence in state B of goods and merchandises belonging to an enterprise A (located in a state A) does not mean that the fixed place of business where those goods and merchandises are stored is at the permanent disposal of enterprise A and there is therefore no fixed place of business attributable to the said enterprise ; if however enterprise A is now allowed unlimited access to a separate part of the facilities located abroad for the purpose of maintaining and inspecting the goods stored therein, and when these premises are also used to purchase goods and merchandises on behalf of enterprise A with employees visiting suppliers in state B or in other foreign countries (and employees entering into contracts for the acquisition of goods and merchandises), even if the sole activity performed through this office is a purchasing activity, this office will nevertheless constitute a PE because the purchasing activity forms an essential and significant part of enterprise A's overall activity.

The maintenance by enterprise A of an office in a foreign state during a several years period for the purpose of prospecting a market and lobbying the public authorities that could allow enterprise A to establish its business abroad is a preparatory activity.

The setting up of an office abroad to collect information on the potential market or on possible investment opportunities in that foreign state, or for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract is also generally deemed to be a preparatory activity, and this office does not constitute a PE.

However where the servicing of patents or know-how is the core business of an enterprise, or when the fixed place of business of such enterprise has the main function of managing an enterprise or a group of companies (ie a *management office*), then this activity has no more a preparatory nor an auxiliary character and the said office or management office will be treated as a PE.

Regarding cables or pipelines that cross the territory of a country, the situation is different whether these facilities are used to transport properties belonging to a third party or when these facilities belong to the enterprise operating the cables and pipelines for the purpose of transporting its own merchandises. In the last situation the enterprise has the cables or pipelines at its disposal and these facilities can be considered as a PE.

2) The anti-fragmentation rule

OECD aims at avoiding an enterprise to fragment a cohesive and global operating business into several separate operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

There would be a sort of "fraud" by splitting the global business into several separate operations, especially when the same enterprise maintains and operates different places of business in a country or when these places of business belong to closely related enterprises.

Some digital businesses are based on such an operational scheme splitting the overall business in various segregate functions either through subsidiaries or through closely related companies.

Such a situation may occur when an enterprise A (located in State A) manufactures and sell devices or softwares and when enterprise A i) detains a subsidiary located in B State owning and operating stores (or a single *pilot store*)where B sells (as a retailer) devices or softwares acquired to enterprise A, and ii) owns a warehouse in B State where it stores a few large items identical to those displayed in the pilot store belonging to B subsidiary : B employees are allowed to take possession of large items in A warehouse (located in B State) for customers and B subsidiary acquires (from a legal point of view) these items when they leave the A warehouse.

Because A enterprise and B subsidiary are closely related enterprises and the business activities carried on by enterprise A in its B warehouse on the one hand, and by B subsidiary in its pilot store constitute complementary activities that form part of a cohesive business operation, then the anti-fragmentation rule should apply and these activities could not be considered as different and separate preparatory (pilot store) nor auxiliary (warehouse) exceptions.

The new anti-fragmentation rule aims thus at preventing an enterprise or a group of closely related enterprises from fragmenting a cohesive business operation ; under this new rule, exceptions provided for by article 5 paragraph 4 (for *preparatory or auxiliary activities*) will not apply and at least one of the places of business must constitute a PE, or the combination of the relevant activities may constitute a PE.

Once introduced in the existing (and future) tax treaties, these OECD new rules and definitions should permit to renovate the international tax rules with a constant goal : profits are expected to be reported and taxed where the economic activities that generate them are carried out and where value is created … addressing notably new forms of business such as digital economy.

Because OECD is a soft-law organization, it now remains to implement BEPS recommendations and package via changes in domestic laws and practices via treaty provisions with a global dialogue to be established between countries which goes beyond OECD.

Because OECD has come to the conclusion that ring-fencing the digital economy was not feasible, its final proposals are certainly too shy and subject to some critical comments.

IV) ALTERNATIVE STRATEGIES AND COMMENTS ON THE RELEVANCE OF THE OECD'S APPROACH

As the PE concept even amended by OECD recommendations always supposes a physical presence, some criticisms can be levelled at these final proposals that will probably fail to solve the tax challenges arising from digital business.

In the same time some countries have introduced initiatives and laws to directly tax the digital business instead of applying the classic concept of PE

1) The virtual permanent establishment

The OECD/G20 BEPS Discussion Draft dated March 24, 2014 had mentioned several options to amend the definition of a PE and especially discussed a very creative option consisting in defining a new standard for nexus called "significant digital presence" which was based on a test for the presence of a virtual permanent establishment.

Where digital business did not necessarily require a taxable presence according to the existing tax principles, OECD suggested that "fully dematerialised digital activities" could constitute a PE if they maintain a significant digital presence in the economy of a country.

Pursuant to this approach a website could constitute a virtual PE.

Some countries like Saudi Arabia did establish the concept of virtual permanent establishment based on the UN Tax Model.[31]

This significant digital presence could be deducted from different factors like the frequency of digital transactions, the number of users, etc.. : a ratio of the revenue generated within the market of the significant presence would be used to determine the amount of profit attributable to such country.

It raised various criticisms.

First such a concept would create a distortion and a separate tax regime applicable only to digital economy which could contradict some EU principles like the free movement of services within the single market pursuant to Article 56 of the Treaty on the Functioning of the European Union [32] [33].

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[31] See M. De Wilde, op. cit, about a decision rendered by the Supreme Court of South Carolina in 1993 deciding to tax a company which had an intangible presence showing its customers as a real source of income ;

[32] See P Craig and G de Búrca, EU Law: Text, Cases, and Materials (6th edn 2015) ch 22. C Barnard, The Substantive Law of the EU: The Four Freedoms (4th edn 2013) chs 10-11 and 13 ;

Moreover once a nexus would be established, the determination of attributable and taxable income was a tricky task : it supposed to compare digital business with traditional business operations to determine appropriate margins.

Some authors also made a proposal to revise the principles for allocating taxing rights and proposed a more drastic approach pursuant to which a company operating in a country electronic apps, databases, online marketplaces, storage rooms, platforms for advertising would be deemed to operate a PE in such country if a monthly users base of 1,000 and a minimum threshold revenue were reached in the said country.[34]

However such a proposal would have imposed to revise the traditional profit split method to fairly allocate the profit derived from this business by taking into account both assets involved and the value creation of the market.

Some others authors suggested a "digital service PE" and proposed not to rely on physical presence nor on specific transactions but merely on a certain sales volume which would trigger a digital service taxable PE[35].

OECD's BEPS did not further discuss the concept of "virtual presence" and finally decided to discard this concept of virtual PE and discussions evolved towards the establishment of a "deemed PE" and to the amendment to Article 5 paragaph 5 which sets forth the dependent agent (see above part II).

OECD certainly considered that such a concept of virtual PE would ring-fence some cyber-physical transactions and that business involving both digital and physical presence would require a sort of mix-treatment hard to be defined and implemented.

We can nevertheless object that the amended PE concept (see II) will probably have limited impacts on the digital business since the concept of physical presence is still prevalent despite it is fully irrelevant for online marketplaces and websites.

2) Some alternatives to the concept of PE

Because the OECD amendments to the current definition of PE drafted in Article 5 of OECD MT will probably not be sufficient to regulate digital business, we must wonder if the PE concept is still useful and relevant for such activity and at least mention some proposed alternative solutions.

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[33] See ECIPE Occasional Paper n° 4 (2014) OECD/BEPS : Reconciling Global Trade, Taxation Principles and the Digital Economy ;

[34] P. Hongler & P. Pistone, Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy, IBFD White Papers (2015), p.10 ;

[35] R. Avi-Yonah, A Virtual PE : International Taxation and the Marketplace Fairness Act, 2013, Public Law and Legal Theory Research Paper Series n° 328, p. 3 ;

a) Equalisation Levy

Instead of implementing a new profit allocation mechanisms, OECD proposed an equalization levy to tax profits of digital business in relation with their significant digital presence in a market.

OECD highlighted that some digital multinational companies (like Facebook, Amazon, Google) though having numerous customers in foreign countries only had a substantial physical presence in a single country and profits generated in these foreign markets did not result in taxation in residence market because they operated abroad through a website ; countries like India then decided to implement an equalization tax that would be charged on fees paid by advertisers.

As another form this equalization levy could be calculated on the amount of data collected from customers which obviously accounts for the value creation by collecting data.

Because such consumption-oriented taxes would conflict with international and bilateral trade agreements, and they require a cooperation between the different countries, OECD renounced to explore these options.

b) Transaction Tax and Diverted Tax Profit (Google tax)

Various countries (Australia, Hungary, Israël, Italy, Luxemburg, The Netherlands) have also introduced initiatives or effective laws through different methods always targeting to tax digital business[36].

As an illustration the "bit" tax, also called "Google tax", was established by UK as of April 2015 at the rate of 25%. Australia also decided to adopt the Tax Integrity Multinational Anti-Avoidance Law as of January 1, 2016. Hungary decided for levying a 5% tax on net sales from advertising.[37]

It always aimed at circumventing the PE principle and permitting the local tax authorities to impose digital companies having a significant economic activity in the country (as a reaction to the UK decision, some digital companies (Amazon) modified their assets and tax structuring while some others (Google) merely considered that they were not subject to this tax !).

OECD did not take the option to elaborate on the prospects of such concept of taxation because it would conflict with the single market principles.

c) Bandwidth Tax

Some Members States proposed to tax digital economy through a corporate tax levied on the bandwidth so that corporate taxation would move from source jurisdiction to residence jurisdiction where market is located as it is the case for VAT. A double digital tax was proposed, one based on revenues (sales or advertising) and the second one based on activity relating to the collection of data (number of end-users, flow of data, number of advertisers)[38].

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[36] See Popa, Taxation of the Digital Economy in Selected Countries – Early Echoes of BEPS and EU Initiatives, 55 Eur. Txn. 1 (2016) pp. 38-41 Journals IBFD ; B. Westberg, Taxation of the digital Economy – an EU Perspective, 54 Eur. Txn. 12 (2014), p.544 Journals IBFD.

[37] M. Butler and al., Important International Tax Developments – Foreign Capital Gains Withholding Tax, and Anti-Google, Netflix and Amazon Taxes, Asia-Pacific Tax Bulletin (2016), Chapter 5, Journals IBFD ; M. Butler & M. Danby, Draft Legislation for « Anti-Google » Tax, 22 Int. Transfer Pricing J. 6 (2015), p. 349

[38] See France Strategie (2015) Taxation and the Digital Economy. A survey of theoretical models (http://ec.europa.eu/futurium/en/system/files/ged/fiscalité du numérique 9 mars 2013 h.pdf)

Because it clearly could result in a ring-fencing of digital economy, this proposal has never been effectively adopted.

As we saw, OECD has taken the option of proposing recommendations to amend the definition of PE status and to define restrictively the auxiliary and preparatory activities when implemented by digital companies and corresponding to their core business.

We must however admit that these recommendations will certainly not affect the tax situation of digital companies especially those operating websites stores without physical presence and that it could probably lead to a distortion and misalignment of the allocation of taxing rights and difficulties to enforce taxation[39].

A possible solution could consist in a suitable definition of transfer pricing but it will impose a common definition of digital business and of the process of value creation in the digital economy.[40]

[39] W. Hellerstein, Jurisdiction to Tax in the Digital Economy : Permanent and Other Establishments, 68 Bull. Int. Txn. 6/7 (2014), pp. 348, Journals IBFD ; M. Olbert and C. Spengel, International Taxation in the Digital Economy : Challenge Accepted ? University of Mannheim Business School pp. 1-42.

[40] From a general perspective, see Avi. Yonah, R.S ; Clausing K.A. and Durst, M.C. Allocating Business Profits for Tax Purposes : A Proposal to Adopt a Formulary Profit Split, La. Tax Review 9, n° 5 (2009), pp. 497-553 ; on digital economy see M. Olbert and C. Spengel, op. cit. p. 21 and pp. 30-38.