

# OECD BEPS (In)Action 1: Factor Presence as a Solution to Tax Issues of the Digital Economy

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## Abstract

The Organisation for Economic Cooperation and Development (OECD) launched its project to address base erosion and profit shifting (BEPS) in 2013 with an Action Plan of 15 Actions. Action 1 encompasses identifying difficulties the digital economy poses for applying existing international tax rules and developing options to address them. Under current international tax rules, an enterprise generally is not taxed in a country in which it does not have a physical presence. With the economy having evolved so that business can be conducted over the internet with no physical presence in a country, companies have been able to avoid taxation in many jurisdictions from which they generate significant income. The OECD issued a final report on Action 1 in 2015 and a subsequent report in 2018, yet has failed to recommend a solution to address the physical presence issue. In effect, Action 1 has become Inaction 1. Countries and the European Union have grown impatient with the OECD and have taken matters into their own hands, with countries and the European Commission (EC) proposing or enacting legislation to address head on the issue of nontaxation of multinational digital companies, tax authorities assessing tax against multinational companies under the existing rules, and the EC bringing actions against countries for illegal state aid.

This Article proposes that a factor presence standard be used instead of a physical presence standard for nexus based on a model used by states in the United States. Taxable presence for income tax purposes would be determined based on the factors of sales, employees, or property in a jurisdiction. The main objection to such a proposal is that it is too radical an approach to take at this time, even if it would solve the tax problems resulting from the evolution of the economy. The OECD has promised that it will reach a consensus solution by 2020 on how to address tax issues of the digital economy. As the OECD works toward a solution, it should seriously consider a factor

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presence approach that would offer certainty and fairness to multinational companies and their tax administrations.

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## I. Introduction

As a response to concerns raised by the G20 regarding base erosion and profit shifting (BEPS),<sup>1</sup> the Organisation for Economic Cooperation and Development (OECD)<sup>2</sup> launched its “BEPS project” in February 2013 with the issuance of a report entitled *Addressing Base Erosion and Profit Shifting*

<sup>1</sup>G20 Leaders Declaration, Los Cabos, Mexico, June 19, 2012, at ¶ 48, <https://www.treasury.gov/resource-center/international/g7-g20/Documents/Los%20Cabos%20Leaders%27%20Declaration.pdf>.

<sup>2</sup>The OECD was founded in 1961 to promote policies to improve the economic and social well-being of people around the world. The Paris-based organization provides a forum in which governments can work together to share experiences and seek solutions to common problems, including setting international standards on tax. There are currently 36 member countries of the OECD, primarily economically developed countries, but also including Mexico, Chile, and Turkey. See [www.oecd.org/about](http://www.oecd.org/about).

(the 2013 Report).<sup>3</sup> BEPS is tax planning that shifts profits “in ways that erode the taxable base to locations where they are subject to a more favourable tax treatment.”<sup>4</sup> The report emphasizes the “pressing and current issue” of BEPS and the resulting “serious risk to tax revenues, tax sovereignty and tax fairness.”<sup>5</sup> The OECD followed this initial report in July 2013 with an “Action Plan” that sets forth 15 actions to be undertaken to address weaknesses from BEPS in the current international tax structure.<sup>6</sup> After an unprecedented effort on an extremely compressed timeline, the OECD issued final reports on all 15 actions in 2014 and 2015. In September 2015, it consolidated all final reports into the “BEPS package,” hailing the package as “the first substantial—and overdue—renovation of the international tax standards in almost a century.”<sup>7</sup>

Among the “key pressure areas” the OECD notes in the 2013 Report is the “[a]pplication of treaty concepts to profits derived from the delivery of digital goods and services.”<sup>8</sup> The Action Plan seemingly gave this area priority by placing it in Action 1: Address the tax challenges of the digital economy.<sup>9</sup> Although taxation of the digital economy was a major motivating factor behind the BEPS project, the final report on Action 1 (Final Report) failed to take a position on how to address this important matter.<sup>10</sup> The OECD started the BEPS project at a “turning point in the history of international co-operation on taxation,”<sup>11</sup> yet took no action on perhaps the most important issue of the project.

After a two-year period of relative silence by the OECD, interest in addressing digital economy tax issues sprang to life again in 2017. Following a public hearing in November 2017,<sup>12</sup> the OECD released a report in March 2018

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<sup>3</sup>OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING (2013), <http://transferpricing-hub.com/wp-content/uploads/2017/07/OECD-Addressing-Base-Erosion-and-Profit-Shifting-BEPS-2013-02-12.pdf> [hereinafter 2013 REPORT].

<sup>4</sup>2013 REPORT, *supra* note 3, at 13. *See also* OECD, BASE EROSION AND PROFIT SHIFTING, <http://www.oecd.org/tax/beps/> (last visited Sept. 28, 2018); Michael C. Durst, *The Historical Evolution of Base Erosion and Profit Shifting*, 90 TAX NOTES INT’L (TA) 449 (Apr. 16, 2018).

<sup>5</sup>2013 REPORT, *supra* note 3, at 5.

<sup>6</sup>OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013), <https://www.oecd.org/ctp/BEPSActionPlan.pdf> [hereinafter ACTION PLAN].

<sup>7</sup>*See* summary of “BEPS package” in OECD, EXPLANATORY STATEMENT, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT 5 (2015), <https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf> [hereinafter EXPLANATORY STATEMENT].

<sup>8</sup>2013 REPORT, *supra* note 3, at 6, 47.

<sup>9</sup>ACTION PLAN, *supra* note 6, at 14-15.

<sup>10</sup>OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1: 2015 FINAL REPORT, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT (2015), [https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report\\_9789264241046-en#page1](https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page1) [hereinafter FINAL REPORT].

<sup>11</sup>ACTION PLAN, *supra* note 6, at 25.

<sup>12</sup>For a recording of the consultation, *see* BEPS PUBLIC CONSULTATION ON THE TAX CHALLENGES OF DIGITALISATION, <http://www.oecd.org/tax/beps/public-consultation-on-tax-challenges-of-digitalisation-1-november-2017.htm> (last visited Sept. 28, 2018).

(Interim Report), in which it admits that allocation of taxing rights is the key to solving the digital economy tax issues.<sup>13</sup> Nevertheless, the OECD once again failed to make a recommendation on how to address these issues.<sup>14</sup> Over 100 countries did agree to reach a consensus solution by 2020.<sup>15</sup> With at least two years remaining to the drop dead date for agreeing on a solution (and many doubting whether a consensus can ever in fact be reached), the OECD accepts that countries may enact their own solutions.<sup>16</sup> While refraining from taking a position on whether individual interim solutions are appropriate or advisable, the Interim Report nonetheless provides a framework for countries to use to design such measures.<sup>17</sup> The European Commission (EC) issued its own report several days later, taking the lead on proposing a permanent solution of a new category for taxable nexus—“significant digital presence”—and proposing a temporary solution of a three percent tax on turnover for certain digital services of large digital companies.<sup>18</sup>

This Article addresses the OECD’s inaction regarding tax issues of the digital economy and focuses on direct tax issues<sup>19</sup> and specifically on the issue of nexus. Part II provides a brief summary of current international tax rules and actions countries and the European Union (EU) have taken to enforce existing law. Part III presents a detailed chronology of the actions taken and reports issued by the OECD and the EU to advance Action 1 of the BEPS project, beginning with the 2013 Report. Part IV discusses attempts by countries to extract tax from large multinationals that are not paying sufficient tax in their jurisdictions by unilaterally adopting legislation. Part V discusses the concept of nexus in a digital economy as viewed by the OECD and EU, as well as the states of the United States. To solve the impasse and address head on the issue of the allocation of taxing rights in a digitalized economy, Part VI proposes adoption of a factor presence standard similar to that used to allocate income

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<sup>13</sup>OECD, *TAX CHALLENGES ARISING FROM DIGITALISATION – INTERIM REPORT* Ch. 5 (2018), [https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-interim-report\\_9789264293083-en#page1](https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-interim-report_9789264293083-en#page1) [hereinafter INTERIM REPORT]. See Mindy Herzfeld, *News Analysis: The OECD (Finally) Tackles the Elephant in the Room*, 89 TAX NOTES INT’L (TA) 1254 (Mar. 26, 2018).

<sup>14</sup>INTERIM REPORT, *supra* note 13, at ¶¶ 372, 395.

<sup>15</sup>*Id.* at ¶¶ 395-97, 511-13.

<sup>16</sup>*Id.* at Ch. 6.

<sup>17</sup>*Id.* at ¶¶ 412-63.

<sup>18</sup>EUROPEAN COMM’N, (SWD (2018) 81 FINAL), COMMISSION STAFF WORKING DOCUMENT: IMPACT ASSESSMENT (Mar. 21, 2018), <http://ec.europa.eu/transparency/regdoc/rep/10102/2018/EN/SWD-2018-81-F1-EN-MAIN-PART-1.PDF> [hereinafter IMPACT ASSESSMENT]. See also European Comm’n, Press Release, Digital Taxation: Commission proposes new measures to ensure that all companies pay fair tax in the EU (Mar. 21, 2018), [http://europa.eu/rapid/press-release\\_IP-18-2041\\_en.htm](http://europa.eu/rapid/press-release_IP-18-2041_en.htm); European Comm’n, Fact Sheet, Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market (Mar. 21, 2018), [http://europa.eu/rapid/press-release\\_MEMO-18-2141\\_en.htm](http://europa.eu/rapid/press-release_MEMO-18-2141_en.htm) [hereinafter Fact Sheet].

<sup>19</sup>Direct taxes are taxes levied on the income of the person who pays it; indirect taxes are taxes levied on goods or services.

among states in the United States, which would be used for all companies and not just digital companies. The Article concludes that continued inaction on finding a solution to taxation of the digital economy is unacceptable and can only lead to piecemeal solutions adopted by countries out of necessity, which leaves multinational companies with uncertainty, compliance burdens, and potential double taxation. A factor presence standard provides a proven and relatively simple structure for countries to divide the digital tax pie.

## II. Background

Income tax treaties generally permit a country other than the country of residence of an enterprise to tax business profits only if the enterprise carries on business in that country through a permanent establishment (PE) and the profits are attributable to the PE.<sup>20</sup> A PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on,<sup>21</sup> such as an office, branch, or place of management, either by the enterprise itself or by an agent in certain circumstances.<sup>22</sup> In other words, if a company does not have a physical presence in a country, it does not have a PE and hence no income taxation nexus. This standard came into force at a time when it was generally important to the consummation of a sale that an enterprise have a physical presence where the customer was located. The physical presence requirement has been expanded in some treaties to allow equipment alone to create a

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<sup>20</sup> See COMM. ON FISCAL AFFAIRS, OECD, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, arts. 5(1), 7(1) (Nov. 21, 2017) [hereinafter OECD MODEL TREATY]. See also discussion in FINAL REPORT, *supra* note 10, at ¶¶ 33–40.

<sup>21</sup> OECD MODEL TREATY, *supra* note 20, art. 5(1).

<sup>22</sup> *Id.* arts. 5(2), 5(5), 5(6). Certain types of activities are specifically exempted from creating PEs, such as storage, purchasing, and preparatory or auxiliary activities. *Id.* art. 5(4).

permanent establishment<sup>23</sup> or the performance of certain services,<sup>24</sup> but the general prohibition on imposing income tax on a company that has no physical presence in a country remains.

Frustrations with the current system of taxation (or nontaxation) have been brewing for years as countries, particularly countries in Europe, have seen large multinationals paying little or no corporate income tax in their countries because they lack a physical presence. Angered by the low taxes paid by large digital companies,<sup>25</sup> countries have pursued these companies with large tax assessments. In addition, the EU has attacked as illegal state aid tax benefits granted by several countries to these multinationals.

Tax authorities have tried with some success to assess corporate income tax on large digital companies, generally through settlements. The U.K. pursued Google, which negotiated a settlement of £130 million in back taxes and interest for the period 2005 to 2015 and an agreement to pay tax in the future based on revenues from U.K. advertisers.<sup>26</sup> Google also reached a settlement in 2017 with Italy, this time for €306 million of tax.<sup>27</sup> Following an audit of Apple's U.K. subsidiary, Apple paid £217 million in U.K. tax through

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<sup>23</sup> See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 6, 1982, U.S.-Austl., art. 5(4)(b), 35 U.S.T. 1999; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 31, 1984, U.S.-Barb., art. 5(2)(l), T.I.A.S. No. 11,090; Convention with Respect to Taxes on Income, Nov. 20, 1975, U.S.-Isr., art. 5(2)(j), S. Exec. Doc. C, 94th Cong., 2d sess., as amended by the second protocol signed Jan. 26, 1993, S. Treaty Doc. No. 16, 103d Cong., 1st Sess.; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 1, 1977, U.S.-Morocco, art. 4(4), 33 U.S.T. 2545. For whether a server can create a PE, see Monica Gianni, *The OECD's Flawed and Dated Approach to Computer Servers Creating Permanent Establishments*, 17 VANDERBILT J. OF ENTMT & TECH. LAW 1 (2014).

<sup>24</sup> See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 12, 1989, U.S.-India, art. 12, S. Treaty Doc. No. 101-5. Also, the United Nations added a new Article 12A in 2017 to its *Model Double Taxation Convention Between Developed and Developing Countries*, which allows taxation of services even if the provider has no PE in that country. See Comm. of Experts on Int'l Cooperation in Tax Matters, 15th Sess., *The Taxation of Fees for Technical, Managerial and Consultancy Services in the Digital Economy With Respect to Art 12A of the 2017 UN Model*, U.N. Doc. E/C.18/2017/CRP.23 (Oct. 10, 2017). The United Nations' Committee of Experts on International Cooperation in Tax Matters is a subsidiary body of the Economic and Social Council and is composed of 25 experts who are named by their governments to four-year terms. See COMMITTEE OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS, <http://www.un.org/esa/ffd/tax/> (last visited Sept. 27, 2018).

<sup>25</sup> See Paul Tang & Henri Bussink, *EU Tax Revenue Loss From Google and Facebook* (Sept., 2017), <https://static.financieel-management.nl/documents/16690/EU-Tax-Revenue-Loss-from-Google-and-Facebook.pdf> (statistics on revenue, activity, and estimated tax revenue loss).

<sup>26</sup> Kamal Ahmed, *Google agrees £130M tax deal with HMRC*, BBC (Jan. 23, 2016), <http://www.bbc.com/news/business-35381130>.

<sup>27</sup> Mark Scott, *Google Agrees to Pay Italy \$334 Million Back Taxes*, N.Y. TIMES (May 4, 2017), <https://www.nytimes.com/2017/05/04/technology/google-italy-tax.html>.

September 26, 2015.<sup>28</sup> Amazon was challenged by the French tax authorities and settled a claim involving a €200 million dispute for the period 2006 to 2010 for an unknown amount and began reporting French sales through a French branch.<sup>29</sup> France similarly assessed Google's Irish subsidiary €1.6 billion for taxes for the years 2005 through 2010 on sales of advertising.<sup>30</sup> An administrative court held that because Google did not have a PE in France it owed no tax; France plans to appeal if no settlement can be reached.<sup>31</sup>

In addition to actions by tax authorities in individual countries, the EC began investigations in 2014 into tax benefits granted to multinationals as potential illegal state aid.<sup>32</sup> The Netherlands had given Starbucks a ruling on transfer pricing that the EC determined in October 2015 gave a "selected advantage" to Starbucks (*i.e.*, illegal state aid), which reduced taxes by €20 to €30 million since 2008.<sup>33</sup> In the same month, the EC determined that Luxembourg had given Fiat Finance and Trade, which provides financial services such as intracompany loans, a ruling that provided an advantage that constituted illegal state aid.<sup>34</sup> Because of the ruling that endorsed "an artificial and extremely complex methodology" for determining taxable profits, Fiat had reduced its taxes by €20 to €30 million since 2012.<sup>35</sup>

The EC continued its tax state aid investigations in 2016, determining that a ruling granted by Luxembourg to McDonald's Europe Franchising (MEF) based on MEF paying tax in the United States, while in fact not paying such

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<sup>28</sup> Vaness Houlder, *Apple handed over extra £81m to UK tax authority after audit*, FINANC. TIMES (Jan. 15, 2018), <https://www.ft.com/content/21c0db94-f9f7-11e7-9b32-d7d59aace167>.

<sup>29</sup> *Amazon settles tax row with France, value undisclosed*, REUTERS (Feb. 5, 2018), <https://www.reuters.com/article/us-france-amazon-tax/amazon-settles-tax-row-with-france-value-undisclosed-idUSKBN1FP1FU>.

<sup>30</sup> See Ingrid Feuerstein, *Gerald Darmanin: "Il vaut mieux un bon accord avec Google qu'un mauvais proces"*, LES ECHOS (July 24, 2017), [https://www.lesechos.fr/24/07/2017/lesechos.fr/030462934018\\_gerald-darmanin----il-vaut-mieux-un-bon-accord-avec-google-qu-un-mauvais-proces-.htm](https://www.lesechos.fr/24/07/2017/lesechos.fr/030462934018_gerald-darmanin----il-vaut-mieux-un-bon-accord-avec-google-qu-un-mauvais-proces-.htm); *France seeks 1.6 billion euros in back taxes from Google: source*, REUTERS (Feb. 24, 2016), <https://www.reuters.com/article/us-google-france-taxation-idUSKCN0VX1Z5>.

<sup>31</sup> Feuerstein, *supra* note 30.

<sup>32</sup> European Comm'n, Press Release, IP/14/663, The Commission, State aid: Commission investigates transfer pricing arrangements on corporate taxation of Apple (Ireland) Starbucks (Netherlands) and Fiat Finance and Trade (Luxembourg) (June 11, 2014), [http://europa.eu/rapid/press-release\\_IP-14-663\\_en.htm](http://europa.eu/rapid/press-release_IP-14-663_en.htm). See U.S. DEP'T OF THE TREASURY, THE EUROPEAN COMMISSION'S RECENT STATE AID INVESTIGATIONS OF TRANSFER PRICING RULINGS (Aug. 24, 2016), <https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/White-Paper-State-Aid.pdf>; Jeffery M. Kadet, *Thoughts on Treasury's White Paper on EU State Aid*, 152 TAX NOTES INT'L (TA) 1415 (Sept. 5, 2016).

<sup>33</sup> European Comm'n, Press Release, IP/15/5800, Commission decides selective tax advantages for Fiat in Luxembourg and Starbucks in the Netherlands are illegal under EU state aid rule (Oct. 21, 2015), [http://europa.eu/rapid/press-release\\_IP-15-5880\\_en.htm](http://europa.eu/rapid/press-release_IP-15-5880_en.htm).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

tax, constituted state aid.<sup>36</sup> Also in 2016, the EC concluded that Apple owed €13 billion in back taxes to Ireland due to Ireland's giving tax benefits to Apple that allowed it to have a 0.005%-1% corporate income tax rate instead of the usual 12.5% rate.<sup>37</sup> Ireland did not collect the unpaid taxes required by the EC decision, with the result that the EC referred the matter to the European Court of Justice.<sup>38</sup> In another action, the EC held in 2017 that Luxembourg had to collect €250 million from Amazon for back taxes during the period 2006 through 2014 due to a 2003 ruling that granted "undue tax benefits" to Amazon that allowed it to "pay substantially less tax than other businesses."<sup>39</sup> Although the EC decisions did not specifically address digital economy tax issues, they were just one more piece of fuel, in addition to tax assessments in Europe, that increased the fire of agitation over large multinational companies not paying their fair share of taxes. Against this backdrop of EC state aid decisions and tax assessments by European countries, the BEPS project played out.

### III. Action I Chronology

The OECD began its quest to find a solution to tax issues resulting from the perceived unfairness of the international tax system with the launch of

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<sup>36</sup>European Comm'n Decision C(2015) 83443 final (Dec. 3, 2015). See European Comm'n, Press Release, IP/15/6221, The Commission, State aid: Commission opens formal investigation into Luxembourg's tax treatment of McDonald's (Dec. 3, 2015), [http://europa.eu/rapid/press-release\\_IP-15-6221\\_en.htm](http://europa.eu/rapid/press-release_IP-15-6221_en.htm). See also Fadi Shaheen, *Tax Treaty Aspects of the McDonald's State Aid Investigation*, 86 TAX NOTES (TA) 331 (Apr. 24, 2017).

<sup>37</sup>European Comm'n, Press Release, IP/16/2923, The Commission, State aid: Ireland gave illegal tax benefits to Apple worth up to €13 billion (Aug. 30, 2016), [http://europa.eu/rapid/press-release\\_IP-17-3702\\_en.htm](http://europa.eu/rapid/press-release_IP-17-3702_en.htm). Apple brought an action against the EC in December 2016 to have its decision annulled in whole or in part. Case T-892/16, *Apple Sales Int'l and Apple Operations Europe v. Comm'n* (Dec. 15, 2017). The United States attempted to intervene in the case on the grounds that its economic situation would be harmed by the foreign tax credit Apple could claim upon repatriation of its offshore profits; the request for intervention was denied. *Id.*

<sup>38</sup>European Comm'n, Press Release, IP/17/3702, The Commission, State aid: Commission refers Ireland to Court for failure to recover illegal tax benefits from Apple worth up to €13 billion (Oct. 4, 2017), [http://europa.eu/rapid/press-release\\_IP-17-3702\\_en.htm](http://europa.eu/rapid/press-release_IP-17-3702_en.htm). Apple and Ireland entered into an escrow agreement in April 2018 for the payment of the taxes, with full payment expected by the end of September 2018. See Colin Gleeson & Joe Brennan, *Apple pays €1.5bn into escrow account in first tranche of tax bill*, THE IRISH TIMES (May 18, 2018), <https://www.irishtimes.com/business/technology/apple-pays-1-5bn-into-escrow-account-in-first-tranche-of-tax-bill-1.3500133>.

<sup>39</sup>European Comm'n, Press Release, IP/17/3701, The Commission, State aid: Commission finds Luxembourg gave illegal tax benefits to Amazon worth around €250 million (Oct. 4, 2017), [http://europa.eu/rapid/press-release\\_IP-17-3701\\_en.htm](http://europa.eu/rapid/press-release_IP-17-3701_en.htm). Both Luxembourg and Amazon have appealed this decision. See Nicolas Hirst, *Luxembourg appeals Amazon's EU tax verdict*, POLITICO (Dec. 15, 2017), <https://www.politico.eu/article/luxembourg-appeals-amazons-eu-tax-verdict/>; Natalie Olivo, *Amazon Appeals EU Ruling On Tax Treatment By Luxembourg*, LAW360 (May 24, 2018), <https://www.law360.com/tax-authority/federal/articles/1047216/amazon-appeals-eu-ruling-on-tax-treatment-by-luxembourg>.

its BEPS project in 2013. Although the BEPS project extends far beyond digital economy tax issues, Action 1, which is devoted to digital economy tax issues, was an area of high importance. The OECD's Final Report for Action 1, issued in 2015, however, failed to arrive at a solution. Because of this failure, individual countries have taken uncoordinated and unilateral actions to address the issues, and the EU has proposed its own long-term solution as well as an interim measure. The following chronology describes major actions taken and reports issued by the OECD and EU from 2013 through the first half of 2018 to address tax issues of the digital economy.

### A. 2013 Report

The OECD began its BEPS project with the 2013 Report, in which it unequivocally states that current international tax rules have not kept up with changes in global business practices and specifically emphasizes that such changes include the development of the digital economy.<sup>40</sup> As an example, the report describes a company's ability to be "heavily involved in the economic life of another country" yet have no taxable presence.<sup>41</sup> In a business environment where digital transactions can occur with no physical presence, current taxation rules do not result in a fair allocation of taxing rights on business profits, particularly if the profits are not being taxed in any country.<sup>42</sup> The OECD acknowledges that digital economy developments have placed "increasing pressure" on established principles of international taxation, including PE principles,<sup>43</sup> and emphasizes the urgent need to arrive at a comprehensive and holistic approach.<sup>44</sup>

Sounding the alarm, the OECD maintains that what is at stake is "the integrity of the corporate income tax"—giving competitive advantage to multinational enterprises, distorting investment decisions, and undermining voluntary tax compliance.<sup>45</sup> The OECD implores its stakeholders to devise "innovative approaches to implement comprehensive solutions" and "out of the box" thinking<sup>46</sup> but warns that double taxation can result if governments take unilateral actions to address the issues.<sup>47</sup> The report recommends, as a first step, the development of an Action Plan, with the purpose of "aligning rights to tax with real economic activity" to provide solutions to "realign international standards with the current global business environment."<sup>48</sup> Specifically with reference to the digital economy, the Action Plan should

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<sup>40</sup> 2013 REPORT, *supra* note 3, at 7, 47, 49.

<sup>41</sup> *Id.* at 7, 35-36.

<sup>42</sup> *Id.* at 36.

<sup>43</sup> *Id.* at 35.

<sup>44</sup> *Id.* at 7-8, 50.

<sup>45</sup> *Id.* at 8, 50.

<sup>46</sup> *Id.* at 8-9, 51.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

include proposals to develop updated solutions that could include revisions to treaties.<sup>49</sup>

## B. *Action Plan*

The OECD issued the Action Plan in July 2013, in which it identifies 15 actions to address BEPS, sets deadlines to implement the actions, and identifies resources needed and the methodology to implement the actions.<sup>50</sup> The OECD concedes that fundamental changes to the existing international tax structure are required to combat BEPS and hails the need for a realignment of taxation to follow new business models and technological developments.<sup>51</sup>

Of the 15 actions the OECD determined were necessary to combat BEPS, it selected the tax challenges of the digital economy to be Action 1.<sup>52</sup> Highlighting the expansion of the digital economy as a challenge for international taxation, the Action Plan declares:

It is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS.<sup>53</sup>

Action 1 was designed to address this issue, and its stated mission is to

[i]dentify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.<sup>54</sup>

The OECD formed the Task Force on the Digital Economy (TFDE), a subsidiary of the OECD's Committee on Fiscal Affairs, to identify issues raised

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<sup>49</sup> *Id.* at 10, 52.

<sup>50</sup> ACTION PLAN, *supra* note 6. The G20 approved the Action Plan at its St. Petersburg Summit in September 2013. See Tax Annex to the St. Petersburg G20 Leaders' Declaration (Sept. 2013), <https://www.oecd.org/g20/summits/saint-petersburg/Tax-Annex-St-Petersburg-G20-Leaders-Declaration.pdf>.

<sup>51</sup> ACTION PLAN, *supra* note 6, at 13.

<sup>52</sup> *Id.* at 14-15.

<sup>53</sup> *Id.* at 10.

<sup>54</sup> *Id.* at 14-15.

by the digital economy<sup>55</sup> and prepare a report that details options to address them, setting a deadline of September 2014.<sup>56</sup>

### C. OECD Action 1 2014 Deliverable

The OECD issued a public discussion draft of its Action 1 report in March 2014<sup>57</sup> and the planned deliverable report in September 2014 (2014 Deliverable).<sup>58</sup> The 2014 Deliverable presents several options to address the tax challenges of the digital economy for direct taxes.<sup>59</sup>

Modifications to Exemptions from PE Status. Article 5(4) of the OECD Model Treaty provides that certain activities do not constitute a PE: use of facilities for storage, display, or delivery of goods; maintenance of a stock of goods solely for storage, display, delivery, or processing by another enterprise; maintenance of a fixed place of business solely for purchasing or collection information; or any preparatory or auxiliary activity.<sup>60</sup> The 2014 Deliverable opines that activities in a traditional economy that were formerly preparatory or auxiliary may be core activities under digital economy business models.<sup>61</sup> Options that would modernize the PE definition include elimination of all PE exceptions, elimination of delivery as an exception, or requiring all exceptions to be restricted to preparatory or auxiliary activities.<sup>62</sup>

New Nexus Based on Digital Presence. Instead of requiring a physical presence for a business to have a PE,<sup>63</sup> an alternative nexus would be created for a “significant digital presence” for “fully dematerialised digital activities.”<sup>64</sup> A significant digital presence could be created by exceeding specified thresholds such as website visitors, contracts concluded remotely, or levels of consumption.<sup>65</sup> Fully dematerialized digital activities could include the core business

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<sup>55</sup> *Id.* at 14.

<sup>56</sup> *Id.* at 29, Annex A.

<sup>57</sup> OECD, BEPS ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY, PUBLIC DISCUSSION DRAFT (2014).

<sup>58</sup> OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1: 2014 DELIVERABLE (2014), <https://www.oecd-ilibrary.org/docserver/9789264218789-en.pdf?expires=1538412615&id=id&accname=ocid177495&cchecksum=8214644F2C866B974D1C095DD20DD17B> [hereinafter 2014 DELIVERABLE].

<sup>59</sup> *Id.* at Ch. 8. Although indirect taxes are also included within the scope of Action 1 (*see id.* at § 8.2.2), this Article restricts its discussion to direct taxes. For indirect tax options, *see* FINAL REPORT, *supra* note 10, at ¶¶ 5.3, 6.3, and Ch. 8. *See also* Guidelines 2 and 4 of OECD, INTERNATIONAL VAT/GST GUIDELINES (April 12, 2017) (discussing the allocation of taxing rights for VAT to the jurisdiction where the customer is located, or if more than one jurisdiction, to the jurisdiction where the customer’s establishment uses the service or where the intangible is located, both of which are of particular relevance to online purchase and delivery of goods and services).

<sup>60</sup> OECD MODEL TREATY, *supra* note 20.

<sup>61</sup> 2014 DELIVERABLE, *supra* note 58, at § 8.2.1.1.

<sup>62</sup> *Id.*

<sup>63</sup> OECD MODEL TREATY, *supra* note 20, art. 5.

<sup>64</sup> 2014 DELIVERABLE, *supra* note 58, at § 8.2.1.2.

<sup>65</sup> *Id.* at 145, Box 8.2.

relying on digital goods or services, contracts concluded remotely, and a website being the sole means to enter into a relationship with the company.<sup>66</sup> This alternative nexus would be limited to businesses that have minimal physical elements to perform their core functions in a country.<sup>67</sup> A variation of this option would target businesses that use personal data obtained by “regular and systematic monitoring of Internet users in that country.”<sup>68</sup>

Replacing PE with Significant Presence. The physical presence test for PEs would be replaced by a “significant presence” test to recognize the changing customer relationship in the digital economy but would still rely partially on physical presence.<sup>69</sup> The requirements for meeting this test could include a relationship with a customer for a period of time plus some physical presence; sales involving close relationships with customers in a country such as through a website in the country’s language, delivery from suppliers in the country, using banking and other facilities from suppliers in the country, or selling goods or services from local suppliers; and selling goods or services to customers in the country as a result of systematic data-gathering or content contributions from persons in the country.<sup>70</sup>

Creation of a Withholding Tax on Digital Transactions. A withholding tax could be imposed on payments for digital goods or services to a foreign provider, potentially enforced through withholding by financial institutions.<sup>71</sup> The withholding tax could either be used to enforce payment of tax based on a new economic nexus standard or as a stand-alone provision.<sup>72</sup>

Introducing a Bandwidth or “Bit” Tax. Under this option, the bandwidth use of a website would be taxed based on the number of bytes.<sup>73</sup> Different tax levels would apply based on the size of the company and its turnover.<sup>74</sup>

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<sup>66</sup> *Id.* at 144, Box 8.1

<sup>67</sup> *Id.* at § 8.2.1.2.

<sup>68</sup> *Id.* This possibility was extensively analyzed in an International Bureau of Fiscal Documentation (IBFD) paper that proposes a new PE nexus to be added to treaties as follows:

If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a PE in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting States exceeds XXX ... per annum.

Peter Hongler & Pasquale Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, IBFD working paper (Jan. 20, 2015) at 3.

<sup>69</sup> 2014 DELIVERABLE, *supra* note 58, at § 8.2.1.3.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at § 8.2.1.4. See Yariv Brauner & Andres Baez Moreno, *Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy*, WU Int’l Taxation Research Paper Series, Paper No. 2015-14 (Feb. 2, 2015), <http://ssrn.com/abstract=2591830>.

<sup>72</sup> 2014 DELIVERABLE, *supra* note 58, at § 8.2.1.4.

<sup>73</sup> *Id.* at § 8.2.1.5.

<sup>74</sup> *Id.* at § 8.3.

To evaluate the potential options, the TFDE agreed on a framework encompassing the following basic tax principles: “neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability,” and proportionality.<sup>75</sup>

Despite introducing potential options to address tax issues of the digital economy, in a preview of what was to come in the Final Report, the TFDE posits in the 2014 Deliverable that if opportunities for BEPS are sufficiently addressed by other BEPS Actions, tackling the tax challenges of the digital economy “may become less pressing,” perhaps even to the point that such challenges would be “reduced in scale to the point that no further action was necessary in the area of direct taxation.”<sup>76</sup> Apparently to provide some comfort to stakeholders that are proponents of changing tax rules to accommodate the digital economy, the 2014 Deliverable promises that if BEPS issues are not adequately addressed, dealing with the digital economy challenges “could become a more pressing issue.”<sup>77</sup> The 2014 Deliverable directs the TFDE to evaluate the volume of sales by companies operating in the digital economy in countries in which they do not have a physical presence and to further develop potential options.<sup>78</sup>

#### D. Action 1 Final Report

In September 2015, the OECD issued the BEPS package—final reports on all 15 BEPS Actions, including Action 1, and consolidated them in its Explanatory Statement.<sup>79</sup> The OECD portrayed the adoption of the BEPS package as laying “the foundations of a modern international tax framework under which profits are taxed where economic activity and value creation occurs.”<sup>80</sup> This result had certainly been the hope when the BEPS project began and the OECD issued the Action Plan, declaring at that time that the BEPS project was a “turning point in the history of international cooperation on taxation.”<sup>81</sup>

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<sup>75</sup> *Id.* These are the same principles adopted at the OECD Ministerial Conference on Electronic Commerce, held in October 1998 in Ottawa, Canada. See COMM. ON FISCAL AFFAIRS, OECD, ELECTRONIC COMMERCE: TAXATION FRAMEWORK CONDITIONS (1998).

<sup>76</sup> 2014 DELIVERABLE, *supra* note 58, at § 8.4.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at § 8.4.2.

<sup>79</sup> EXPLANATORY STATEMENT, *supra* note 7. The G20 endorsed the reports at the Antalya Summit in November, 2015. G20 Leaders Communique, Antalya Summit, Nov. 15-16, 2015, at ¶ 15, <http://www.consilium.europa.eu/media/23729/g20-antalya-leaders-summit-communique.pdf>. See STAFF OF THE JOINT COMM. ON TAX'N, BACKGROUND, SUMMARY, AND IMPLICATIONS OF THE OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT (JCX-139-15, Nov. 30, 2015), <https://www.jct.gov/publications.html?func=fileinfo&id=4853> (providing background on the BEPS project, overview of findings and recommendations, and discussion of potential implications for U.S. tax policy).

<sup>80</sup> EXPLANATORY STATEMENT, *supra* note 7, at 9.

<sup>81</sup> ACTION PLAN, *supra* note 6, at 25.

In the Final Report,<sup>82</sup> the TFDE divides the main policy challenges for direct taxation in the digital economy into three categories: nexus, data,<sup>83</sup> and characterization.<sup>84</sup> These challenges raise the overall issue as to whether current tax rules can deal with the changes brought about by the way business is conducted in the digital economy and additionally bring into question the allocation of taxing rights between source and residence jurisdictions.<sup>85</sup> Perhaps most importantly, the place where economic activities are carried out and value is created is not the same as in a traditional economy, realities that could necessitate changes in analyzing functions performed, assets used, and risks assumed.<sup>86</sup> Of the three policy challenges described in the Final Report, this Article focuses on the nexus challenge.

The Final Report reached one definitive conclusion: Because the digital economy is rapidly becoming the economy itself, one cannot “ring-fence” a solution strictly for the digital economy.<sup>87</sup> The position of the OECD shifted from finding a solution to tax issues of the digital economy to tax issues of all sellers that sell using digital means, not just sellers of digital products or services.<sup>88</sup> In effect, “there is no such thing as digital companies.”<sup>89</sup>

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<sup>82</sup> FINAL REPORT, *supra* note 10.

<sup>83</sup> The ability of companies in the digital economy to gather and use information raises the issues of how to attribute value created from the generation of data and how to characterize the supply of data in a transaction. *Id.* at ¶ 248.

<sup>84</sup> New digital products and means of delivering services, particularly regarding cloud computing, create uncertainty as to how income therefrom should be characterized. *Id.* Although recognizing the three challenges as distinct, the Final Report contends that they also may overlap with each other:

For example, the characterization of payments may trigger taxation in the jurisdiction where the payor is resident or established and hence overlap with the issue of nexus. Similarly, the collection of data from users located in a jurisdiction may trigger questions regarding whether it should give rise to nexus with that jurisdiction, and if so, whether and how the income generated from the use of these data should be attributed to that nexus. It also raises questions regarding how income from transactions involving data should be characterised for tax purposes.

*Id.* at ¶ 250.

<sup>85</sup> *Id.* at ¶ 249.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at ¶¶ 115, 364; EXPLANATORY STATEMENT, *supra* note 7, at 8, 13. See also Arthur Cockfield, *BEPS and Global Digital Taxation*, 75 TAX NOTES INT’L (TA) 933, 938 (Sept. 15, 2014) (“The better approach lies in developing broad tax rules that can be directed at substantively similar economic activities generated by both digital and traditional businesses”). The OECD subsequently changed its framing of the issue to one of tax issues of “digitalisation.” See INTERIM REPORT, *supra* note 13. This Article uses the terms “digital economy” and “digitalization of the economy” interchangeably, with no meaning intended with respect to the appropriateness of either term in the discussion of relevant tax issues.

<sup>88</sup> FINAL REPORT, *supra* note 10, at ¶ 364.

<sup>89</sup> See V. Houlder, *Special tax rules for internet companies “not viable,”* FINANC. TIMES (Jan. 20, 2014), <http://www.ft.com/content/ec659cec-81ef-11e3-a600-00144feab7de> (quoting Pascal Saint-Amans, the Director of the OECD Centre for Tax Policy and Administration).

The Final Report affirms that although the digital economy does not “generate unique BEPS issues,” it does “exacerbate BEPS risks.”<sup>90</sup> Following the foreshadowing in the 2014 Deliverable, the Final Report maintains that these exacerbated risks are substantially addressed by other Actions.<sup>91</sup> In particular, Action 7 modified the PE definition such that the exceptions to PE status would not apply unless they are of a preparatory or auxiliary character.<sup>92</sup> Under this revision, an online seller of physical products, for example, would have a PE in a country in which it maintains a “very large” warehouse in which a “significant number” of employees work.<sup>93</sup> Under current standard PE provisions, the online seller would not have a PE in the country if its only activity was delivery.<sup>94</sup> Modifying the PE definition was one of the options considered in the 2014 Deliverable<sup>95</sup> and by all measures should be considered an accomplishment for Action 1 (assuming of course the PE provision is in fact so revised in existing and future tax treaties).<sup>96</sup> The Final Report also notes revisions to transfer pricing guidance (Actions 8-10) and recommendations for controlled foreign corporation rules (Action 3) as other actions that address digital economy tax issues.<sup>97</sup>

The TFDE declined to recommend any of the options for any of the challenges that were considered in the 2014 Deliverable. It had further refined the options contained in the 2014 Deliverable and combined them in the Final Report into three possibilities—significant economic presence nexus, withholding tax on digital transactions, and an equalization levy designed to address the disparity in the tax treatment between domestic businesses and

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<sup>90</sup> FINAL REPORT, *supra* note 10, at 11, ¶¶ 115, 181, 193, 220, 241, 257, 258, 353.

<sup>91</sup> *Id.* at 12, ¶¶ 241, 370-75.

<sup>92</sup> *Id.* at 12, ¶¶ 215-17, 273-308, 371; OECD, PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS, ACTION 7 – FINAL REPORT (2015).

<sup>93</sup> FINAL REPORT, *supra* note 10, at 12, ¶ 217.

<sup>94</sup> OECD MODEL TREATY, *supra* note 20, art. 5(4)(a).

<sup>95</sup> See *supra* text accompanying notes 60-62.

<sup>96</sup> The OECD developed a multilateral convention to enable countries to streamline the implementation of results from BEPS into existing treaties. See OECD, MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BASE EROSION AND PROFIT SHIFTING (Nov. 24, 2016), <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf>. As of September 27, 2018, there were 84 signatories to the convention, not including the United States. See OECD, SIGNATORIES AND PARTIES TO THE MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BASE EROSION AND PROFIT SHIFTING (Sept. 27, 2018), <http://www.oecd.org/tax/treaties/beps-ml-signatories-and-parties.pdf>. The Convention entered into force on July 1, 2018.

<sup>97</sup> FINAL REPORT, *supra* note 10, at 12, ¶¶ 225-33; EXPLANATORY STATEMENT, *supra* note 7, at 8; OECD, ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION (2015). The Final Report also parenthetically mentions in the Executive Summary other actions that address BEPS issues exacerbated by the digital economy: the minimum standard to address treaty shopping (Action 6), best practices on interest deductions (Action 4), and the application of a substantial activity requirement to intellectual property regimes (Action 5). FINAL REPORT, *supra* note 10, at 12.

foreign businesses that are not subject to tax in the country.<sup>98</sup> But, not only did the OECD not adopt any of the proposed solutions, the Final Report failed to propose new solutions to address the issues.

The OECD justified its inaction on Action 1 by claiming that steps taken under other Actions would have a “substantial impact” on BEPS issues arising from the digital economy and would “mitigate some aspects of the broader tax challenges.”<sup>99</sup> Pressure by the United States, so as not to expand the tax base of other jurisdictions, is likely another factor for the OECD failing to recommend a course of action. Robert Stack, who was at that time the Deputy Assistant Secretary for International Tax Affairs in the Office of Tax Policy at the U.S. Department of the Treasury and the U.S. delegate to the OECD’s Committee on Fiscal Affairs, essentially confirms this point, stating: “it seemed that a lot of the digital work was aimed at U.S. companies, and we simply were being very practical and didn’t want to see the digital work become a way to take away from the U.S. tax base.”<sup>100</sup> Some had projected the OECD would not recommend major changes to international tax rules under Action 1, including Professor Yariv Brauner, who noted that the OECD’s Action 1 mandate was “treading in the familiar territories of traditional and limited doctrinal analysis,” which would be “unlikely to lead to a change in paradigm.”<sup>101</sup>

As a further justification for not recommending a solution, the OECD maintains that the options “raise systemic issues . . . that go beyond BEPS issues,” *i.e.*, allocating taxing rights among countries,<sup>102</sup> which was expressly excluded by the Action Plan.<sup>103</sup> The OECD admits that features of the digital economy have changed the paradigm used to establish the place where economic activities are carried out and where value is generated, which is determined under current rules based on an analysis of functions, assets, and risks.<sup>104</sup> Instead of traditional features of the economy, the digital economy relies heavily on intangibles, mobility of people, use of machines and automation, the ability to transact with customers without a physical presence, and

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<sup>98</sup> FINAL REPORT, *supra* note 10, at 13, ¶¶ 356-57, 383. For a discussion of these options, see George Kofler, Gunter Mayr & Christoph Schlager, *Taxation of the Digital Economy: “Quick Fixes” or Long-Term Solution?*, 57 EURO. TAX’N 523 (Dec. 2017); Marcel Olbert & Christoph Spengel, *International Taxation in the Digital Economy: Challenge Accepted?*, 9 WORLD TAX J. 3 (Feb. 2017).

<sup>99</sup> FINAL REPORT, *supra* note 10, at 13, ¶ 357.

<sup>100</sup> *Conversations: Jeffrey Owens and Robert Stack*, 87 TAX NOTES INT’L (TA) 715 (Aug. 14, 2017).

<sup>101</sup> Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55, 72 (2014).

<sup>102</sup> ACTION PLAN, *supra* note 6, at 13; FINAL REPORT, *supra* note 10, at ¶¶ 340, 376.

<sup>103</sup> ACTION PLAN, *supra* note 6, at 11 (BEPS Actions “are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.”). See David Spencer, *BEPS and the Allocation of Taxing Rights – Part 1*, 28 J. INT’L TAX’N 36 (Apr., 2017); *Part 2*, 28 J. INT’L TAX’N 46 (May, 2017); *Part 3*, 28 J. INT’L TAX’N 46 (June, 2017).

<sup>104</sup> FINAL REPORT, *supra* note 10, at ¶ 341.

“the changing role of customers.”<sup>105</sup> Nevertheless, the OECD balked because the options presented in the 2014 Deliverable would require substantial changes to current rules.<sup>106</sup> In addition, the OECD maintained that data and more work were needed to determine if changes were warranted.<sup>107</sup>

The OECD followed its failure to adopt a solution to digital economy tax issues to formally giving its approval for individual countries to use any of the options it had considered in their domestic laws (provided that they respect their treaty obligations) or in treaty modifications.<sup>108</sup> One of the goals of the BEPS project was to ward off individual countries crafting their own solutions, which could increase the possibilities of double or multiple taxation.<sup>109</sup> Refusing to adopt a specific approach to address issues caused by the digital economy is in itself a complete failure in addressing Action 1. But, by sanctioning a violation of a basic BEPS principle of adopting a unified approach, the OECD itself contributed to BEPS exacerbation.

The OECD did agree to continue to monitor developments and analyze data, with a future determination to be made as to whether further work on the options should be undertaken based on “a broad look at the ability of existing international tax standards to deal with the tax challenges raised by developments in the digital economy.”<sup>110</sup> Such a plan sounds exactly like the reasons for which the BEPS project was undertaken, not a conclusion of a much-studied Action. The Final Report sets the year 2020 as the time for issuing a report on its continuing work in this area. To monitor the implementation of the BEPS Project, the OECD established the Inclusive Framework on BEPS, which has more than 100 members.<sup>111</sup>

#### E. *Post-Final Report 2016-2017*

Since the issuance of the Final Report in 2015 until the beginning of 2017, it seemed that all were resolved to the OECD status quo. In 2017, however, the relative silence was broken and digital economy tax issues came back to life with a vengeance. In March 2017, the Finance Ministers of the G20 confirmed the importance of tax issues in the digital economy and asked the OECD to provide an update on advancements in this area for delivery

<sup>105</sup> *Id.*

<sup>106</sup> *Id.* at ¶ 357.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* Ironically, Pascal Saint-Amans, the OECD Director for Tax Policy and Administration, stated in a September 13, 2017, press conference with respect to countries taking actions to address taxation issues in the digital economy that “unilateral actions are not good.” See Stephanie Soong Johnston, *Saint-Amans Warns Against Unilateral Moves to Tax Digital Economy*, 87 TAX NOTES INT’L (TA) 1157 (Sept. 18, 2017).

<sup>109</sup> 2013 REPORT, *supra* note 3, at 8-9, 51. See also Brauner & Baez, *supra* note 71, at 7 (“[I]f BEPS teaches us any lesson, it is that uncoordinated policy responses are undesirable.”).

<sup>110</sup> EXPLANATORY STATEMENT, *supra* note 7, at 8-9, 13; FINAL REPORT, *supra* note 10, at 13, ¶¶ 358-61, 365.

<sup>111</sup> See ABOUT THE INCLUSIVE FRAMEWORK ON BEPS, <http://www.oecd.org/tax/beps/beps-about.htm> (last visited Sept. 27, 2018).

early in 2018.<sup>112</sup> The G7 followed suit in May 2017, recognizing the need to develop policy options to address digital economy tax challenges.<sup>113</sup> The OECD responded in July 2017 in its OECD Secretary-General Report to G20 Leaders, in which it acknowledged the “growing sense of urgency” to address these issues.<sup>114</sup> The OECD promised an interim report by April 2018 and a final report in 2020, stating: “In a rapidly changing environment, this work will be crucial to ensuring that our tax systems remain fit for purpose so that governments are well-placed to harness the benefits of digitalisation and be prepared for the challenges that such change and disruption can bring.”<sup>115</sup> The G20 reaffirmed its support to working with the OECD on these tax issues, and the G7 confirmed its intention to “work together to seek a consensus-based solution by 2020.”<sup>116</sup>

The EU then re-entered the fray, taking the initiative to discuss the challenges of taxation of the digital economy at a meeting of the Council High Level Working Party in July 2017, followed by technical discussions on the idea of a virtual permanent establishment and an ECOFIN Council meeting in September 2017 in Tallinn.<sup>117</sup> The EU had earlier joined the debate in May 2014 with the issuance of an EC report that agreed with the ultimate Action 1 OECD conclusion in the Final Report that there should not be a special tax regime for digital companies and supported a review of relevant

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<sup>112</sup>G20, Communique: G20 Finance Ministers and Central Bank Governors Meeting, Baden-Baden, Germany, March 17-18, 2017, at ¶ 10, <http://www.g20.utoronto.ca/2017/170318-finance-en.pdf>.

<sup>113</sup>G7, Communique: G7 Finance Ministers and Central Banks' Governors Meeting, Bari, Italy, May 12-13, 2017, at ¶ 16, [http://www.g7italy.it/sites/default/files/documents/G7%20FM%26CBG%20-%20Bari%20Communiqu%C3%A9\\_0.pdf](http://www.g7italy.it/sites/default/files/documents/G7%20FM%26CBG%20-%20Bari%20Communiqu%C3%A9_0.pdf).

<sup>114</sup>OECD, OECD SECRETARY-GENERAL REPORT TO G20 LEADERS, HAMBURG, GERMANY 14 (July, 2017), <http://www.oecd.org/ctp/oecd-secretary-general-tax-report-g20-leaders-july-2017.pdf> [hereinafter 2017 G20 REPORT]. See also OECD, INCLUSIVE FRAMEWORK ON BEPS: PROGRESS REPORT JULY 2016-JUNE 2017 (June, 2017) at 24-25, <http://www.oecd.org/tax/beps/inclusive-framework-on-BEPS-progress-report-july-2016-june-2017.pdf>.

<sup>115</sup>2017 G20 REPORT, *supra* note 114, at 15.

<sup>116</sup>G20, G20 Leaders' Declaration: Shaping an interconnected world, Hamburg, 7/8 July 2017, at ¶ 20, [http://www.consilium.europa.eu/media/23955/g20-hamburg-leaders\\_-communiqu%C3%A9.pdf](http://www.consilium.europa.eu/media/23955/g20-hamburg-leaders_-communiqu%C3%A9.pdf); G7, Communique, The Charlevoix G7 Summit Communique, Charlevoix, Quebec, Canada, June 8-9, 2018, at ¶ 3, <https://g7.gc.ca/en/official-documents/charlevoix-g7-summit-communique/>.

<sup>117</sup>See Council of the European Union, 15175/17, Council conclusions on ‘Responding to the challenges of taxation of profits of the digital economy’ (Nov. 30, 2017), <https://www.consilium.europa.eu/media/31933/st15175en17.pdf>. See also European Union, Press Release, Tax Experts to Discuss Taxation of the Digital Economy in Tallinn (Sept. 6, 2017), <https://www.eu2017.ee/news/press-releases/tax-experts-discuss-taxation-digital-economy-tallinn>.

concepts as applied to business models in the digital economy.<sup>118</sup> Several days after the ECOFIN Council meeting, the EC released a report on September 21, 2017 (the 2017 EC Report), which concludes that an international consensus on tax issues of the digital economy simply cannot be reached.<sup>119</sup> The report set forth its concerns with the “unsustainable situation” of inaction that results in increased tax avoidance, less tax revenues, unfairness, and destabilization of “the level playing field for businesses.”<sup>120</sup> The EC indicated its preference to address digital activity tax issues by expanding its proposed Common Consolidated Corporate Tax Base (CCCTB) to “effectively capture digital activities.”<sup>121</sup> Pending the adoption of the CCCTB, it proposed three potential short-term solutions: an equalization tax on turnover of digitalized companies, a withholding tax on digital transactions, and a levy on revenues generated from the provision of digital services or advertising.<sup>122</sup>

Growing impatient with the lack of concrete action, countries in the EU, led by France, proposed a turnover tax on technology companies.<sup>123</sup> The proposal had the support of ten EU members but apparently not the support of the OECD.<sup>124</sup> As described by the EC, this tax would be imposed “on all untaxed or insufficiently taxed income generated from all internet-based business activities, including business-to-business and business-to-consumer,

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<sup>118</sup>EUROPEAN COMM’N, REPORT OF THE COMMISSION EXPERT GROUP ON TAX’N OF THE DIGITAL ECONOMY 47-49 (May 28, 2014), [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/resources/documents/taxation/gen\\_info/good\\_governance\\_matters/digital/report\\_digital\\_economy.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/good_governance_matters/digital/report_digital_economy.pdf). The European Commission is the executive of the European Union and promotes its general interest. See EUROPEAN COMMISSION, [https://ec.europa.eu/commission/index\\_en](https://ec.europa.eu/commission/index_en) (last visited Sept. 27, 2018).

<sup>119</sup>European Comm’n, *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market* (Sept. 21, 2017), COM(2017) 547, [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/1\\_en\\_act\\_part1\\_v10\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/1_en_act_part1_v10_en.pdf) [hereinafter 2017 EC Report]. See also Fact Sheet, *supra* note 18.

<sup>120</sup>2017 EC Report, *supra* note 119, at 2, 7.

<sup>121</sup>*Id.* at 9, 10. The CCCTB is “a single set of rules to calculate companies’ taxable profits in the EU” that would relieve the burden of companies having to comply with multiple tax systems. See COMMON CONSOLIDATED CORPORATE TAX BASE (CCCTB), [https://ec.europa.eu/taxation\\_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en) (last visited Sept. 27, 2018).

<sup>122</sup>2017 EC Report, *supra* note 119, at 10. See AmChamEU, AmChamEU response to the Commission Consultation on ‘Fair taxation of the digital economy’ (Dec. 5, 2017), [http://www.amchameu.eu/system/files/position\\_papers/amcham\\_eu\\_response\\_to\\_the\\_commission\\_consultation\\_on\\_fair\\_taxation\\_of\\_the\\_digital\\_economy.pdf](http://www.amchameu.eu/system/files/position_papers/amcham_eu_response_to_the_commission_consultation_on_fair_taxation_of_the_digital_economy.pdf) (objecting to a turnover tax as having no relation to either value creation or profits in the country where they would be levied and resulting in administrative burden due to a new system of reporting, collecting, and auditing such taxes. Specifically regarding equalization taxes, the report questions what it is that such taxes “are intended to equalize.”).

<sup>123</sup>Jennifer Rankin, *EU to find ways to make Google, Facebook and Amazon pay more tax*, THE GUARDIAN (Sept. 21, 2017), <http://www.theguardian.com/business/2017/sep/21/tech-firms-tax-eu-turnover-google-amazon-apple>.

<sup>124</sup>*Id.* (noting that Pascal Saint-Amans, the OECD’s tax director, called such a proposal “daft”).

creditable against the corporate income tax or as a separate tax.”<sup>125</sup> The equalization levy would be similar to the equalization levy enacted by India<sup>126</sup> and is viewed as a short-term solution while further work is performed on expanding the concept of PE.<sup>127</sup>

The OECD responded on September 22, 2017, requesting public comments on the issues,<sup>128</sup> and held a public consultation on November 1, 2017, at the University of California, Berkeley,<sup>129</sup> to assist in the preparation of its promised April 2018 report. At the same time, the EC continued to examine possible options for taxing the digital economy, emphasizing that it is essential that the OECD reach “appropriate and realistic conclusions on the way ahead” and identify policy options to move forward.<sup>130</sup> If the OECD does not accomplish this quickly enough, the EU will focus on solutions for itself that result in digital companies paying their fair share of taxes.<sup>131</sup> The EC subsequently launched its own public consultation on October 26, 2017, to obtain input on how it should address digital economy tax issues.<sup>132</sup>

On December 5, 2017, the European Council (Council)<sup>133</sup> adopted conclusions for EU input on responding to the challenges of taxation of profits in the digital economy.<sup>134</sup> The conclusions emphasize the need to keep a level playing field with companies in the digital and traditional sectors of the economy, while ensuring that digital businesses pay their fair share of tax in the correct jurisdictions and that companies pay taxes where value is created.<sup>135</sup> The Council emphasized the work being carried out by the OECD, encouraging continued implementation of the BEPS Actions.<sup>136</sup> The conclu-

<sup>125</sup> 2017 EC Report, *supra* note 119, at 10.

<sup>126</sup> For a discussion of the India equalization tax, *see infra* text accompanying notes 194-98.

<sup>127</sup> 2017 EC Report, *supra* note 119, at 10.

<sup>128</sup> *See* OECD, REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES OF THE DIGITALISED ECONOMY (Sept. 22, 2017), <http://www.oecd.org/tax/tax-policy/tax-challenges-digital-economy-request-for-input.pdf>. Comments were received from more than 50 academics, civil societies, companies, and professional service firms. *See* PUBLIC COMMENTS RECEIVED ON THE TAX CHALLENGES OF DIGITALIZATION, <http://www.oecd.org/tax/beps/public-comments-received-on-the-tax-challenges-of-digitalisation.htm> (last visited Sept. 27, 2018).

<sup>129</sup> For a recording of the consultation, *see* BEPS PUBLIC CONSULTATION ON THE TAX CHALLENGES OF DIGITALIZATION, <http://www.oecd.org/tax/beps/public-consultation-on-tax-challenges-of-digitalisation-1-november-2017.htm> (last visited Sept. 27, 2018).

<sup>130</sup> 2017 EC Report, *supra* note 119, at 8.

<sup>131</sup> *Id.*

<sup>132</sup> *See* CONSULTATION: FAIR TAXATION OF THE DIGITAL ECONOMY, [https://ec.europa.eu/info/consultations/fair-taxation-digital-economy\\_en](https://ec.europa.eu/info/consultations/fair-taxation-digital-economy_en) (last visited Sept. 27, 2018).

<sup>133</sup> The Council of the European Union is the “voice of EU member governments, adopting EU laws and coordinating EU policies.” *See* EUROPEAN UNION, COUNCIL OF THE EUROPEAN UNION, [https://europa.eu/european-union/about-eu/institutions-bodies/council-eu\\_en#what\\_does\\_the\\_council\\_do](https://europa.eu/european-union/about-eu/institutions-bodies/council-eu_en#what_does_the_council_do)? (last visited Sept. 27, 2018).

<sup>134</sup> COUNCIL OF THE EUROPEAN UNION, 15445/17, RESPONDING TO THE CHALLENGES OF TAXATION OF PROFITS OF THE DIGITAL ECONOMY (Dec. 5, 2017), <http://data.consilium.europa.eu/doc/document/ST-15445-2017-INIT/en/pdf>.

<sup>135</sup> *Id.* at 3.

<sup>136</sup> *Id.* at 2.

sions take a large step away from clinging to the physical presence standard for creating a PE, stating that a lack of physical presence should not in itself prevent taxation in a jurisdiction if there is an “appropriate nexus reflecting value creation” taking into consideration the arm’s-length principle.<sup>137</sup> More explicitly, the conclusions advocate exploring a virtual PE concept.<sup>138</sup>

#### F. *OECD Interim Report*

To get out in front of a soon-to-be-released EU report, the OECD issued its planned April 2018 report, the Interim Report, one month early on March 16, 2018.<sup>139</sup> At 213 pages, the report is indeed “longwinded.”<sup>140</sup> Touted as a “key milestone,”<sup>141</sup> the OECD once again makes no decision on a solution—either long-term or interim. In fact, almost one-third of the report is spent describing digital markets and value creation<sup>142</sup> and more than 20% discussing the effect of other BEPS Actions on digital economy tax issues.<sup>143</sup>

The Interim Report does, however, venture into a realm that it had sought to exclude from the reach of its BEPS project—allocation of profits and potential changes to nexus rules.<sup>144</sup> The members of the Inclusive Framework agreed to “undertake a coherent and concurrent review” of nexus and profit allocation, with a view to allocating profits to economic activities and value creation. The OECD plans to reach a “consensus-based solution” by 2020 and issue an update in 2019.<sup>145</sup> Recognizing at last the guts of the digital economy tax issues is definitely a step forward in escaping the “inaction” label. That being said, however, many are skeptical that the OECD can accomplish this. Robert Stack’s view as a former insider reflects the view of many government officials and practitioners: “I know, for example, that there are those who want to bring up the big questions of source and residence through the inclusive framework, but I don’t see the OECD as having the tools, the

<sup>137</sup> *Id.* at 4.

<sup>138</sup> *Id.*

<sup>139</sup> INTERIM REPORT, *supra* note 13.

<sup>140</sup> Lee A. Sheppard, *News Analysis: Five Takeaways From the Digital Tax Debate*, 89 TAX NOTES INT’L (TA) 1251 (Mar. 26, 2018).

<sup>141</sup> See OECD, BRIEF ON THE TAX CHALLENGES ARISING FROM DIGITALISATION: INTERIM REPORT 2018 ¶ 24 (2018), <http://www.oecd.org/tax/beps/brief-on-the-tax-challenges-arising-from-digitalisation-interim-report-2018.pdf>.

<sup>142</sup> INTERIM REPORT, *supra* note 13, at Ch. 2.

<sup>143</sup> *Id.* at Ch. 3. The Interim Report states that the implementation of other BEPS Actions “is already having an impact” and “holds much promise” to resolve issues exacerbated by digitalization. *Id.* at ¶¶ 253-54. For direct tax challenges of digitalization, however, the impact is “much less evident” and “to a large extent unaddressed.” *Id.* at ¶ 255.

<sup>144</sup> *Id.* at Ch. 5.

<sup>145</sup> *Id.* at ¶¶ 397-99. The G20 officially committed to this approach. See G20, Communiqué: Finance Ministers and Central Bank Governors Meeting, Buenos Aires, Argentina, March 19-20, 2018, at ¶ 10, [https://g20.org/sites/default/files/media/communique\\_-\\_fmcbg\\_march\\_2018.pdf](https://g20.org/sites/default/files/media/communique_-_fmcbg_march_2018.pdf).

temperament, the technical ability, or the political clout to carry any of that through.”<sup>146</sup>

The Interim Report addresses potential solutions that could be enacted pending a consensus on nexus and profit allocation.<sup>147</sup> Some countries have already enacted interim solutions and others are considering doing so.<sup>148</sup> But, besides there being no consensus on a long-term solution, “[t]here is no consensus on either the merit or need for interim measures and therefore this report does not make a recommendation for their introduction.”<sup>149</sup> Because of the conflict between countries that fear risks and adverse consequences of interim solutions and those that consider the need to impose a tax on certain “e-service” companies,<sup>150</sup> the OECD found it impossible to make a specific recommendation.<sup>151</sup> Although members of the Inclusive Framework could not agree on whether interim solutions were appropriate, the Interim Report provided basic considerations for the design of interim measures: (1) compliance with international obligations, (2) temporary solution until a global solution is reached, (3) targeted to the highest risk companies, and (4) minimization of (a) excess taxation, (b) impact on start-up companies, new businesses, and small companies, and (c) cost and complexity.<sup>152</sup>

The U.S. Secretary of the Treasury, Steven T. Mnuchin, released a statement on the Interim Report immediately after the OECD’s release of the Interim Report:

The U.S. firmly opposes proposals by any country to single out digital companies. Some of these companies are among the greatest contributors to U.S. job creation and economic growth. Imposing new and redundant tax burdens would inhibit growth and ultimately harm workers and consumers. I fully support international cooperation to address broader tax challenges arising from the modern economy and to put the international tax system on a more sustainable footing.<sup>153</sup>

Although the statement appears at first glance to be critical of the Interim Report, in essence, the United States, whether knowingly or not, seems to be in agreement with the OECD’s position.

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<sup>146</sup>Ryan Finley, *Stack Reflects on Turbulent Days at Treasury, Future of the OECD*, 85 TAX NOTES INT’L (TA) 1045 (Mar. 20, 2017).

<sup>147</sup>INTERIM REPORT, *supra* note 13, at Ch. 5

<sup>148</sup>See discussion *infra* Part IV.

<sup>149</sup>INTERIM REPORT, *supra* note 13, at ¶ 404.

<sup>150</sup>*E.g.*, digitalized businesses with significant market presence but insufficient physical presence to create a PE but that “rely heavily on intangible property, data, user-participation and network effects.” *Id.* at ¶ 406.

<sup>151</sup>*Id.* at ¶¶ 404, 406.

<sup>152</sup>*Id.* at ¶¶ 412-63.

<sup>153</sup>U.S. Dep’t of the Treasury, Press Release, Secretary Mnuchin Statement on Digital Economy Taxation Report (Mar. 16, 2018), <https://home.treasury.gov/news/press-releases/sm0316>.

### G. EU Impact Assessment and Proposals

On March 21, 2018, the EU released its own report, the “Impact Assessment,” as well as a proposal for a council directive on an interim “digital services tax” (EC DST Proposal)<sup>154</sup> and a proposal for a council directive for corporate taxation based on significant digital presence (EC SDP Proposal).<sup>155</sup> The Impact Assessment categorically states that the current situation is “clearly unsustainable.”<sup>156</sup> If action is not taken to modernize international tax rules, dire consequences will result: more tax avoidance opportunities, less tax revenues, negative impact on social fairness, and destabilization of level playing fields for businesses.<sup>157</sup> The report asserts that cross-border digital businesses pay an effective average tax rate of 9.5% as compared to a 23.2% rate on cross-border traditional businesses,<sup>158</sup> which not only distorts level playing fields but also contributes to the perception that certain companies are not paying their fair share of taxes.<sup>159</sup> Furthermore, if a comprehensive global solution cannot be found, countries will take unilateral actions to ensure fair taxation, which will make arriving at a global solution all the more unlikely.<sup>160</sup>

The interim tax,<sup>161</sup> which would apply until an international comprehensive solution has been agreed upon, is a three percent tax on turnover<sup>162</sup> of large digital companies (*i.e.*, companies with €750 million of annual global turnover and €50 million of annual EU sales)<sup>163</sup> that provide certain digital services that are “relying strongly on user contributions.”<sup>164</sup> Digital services include online advertising, digital intermediary activities that allow users to interact with each other to facilitate the sale of goods, and the sale of data collected from users generated from users’ activities on digital interfaces.<sup>165</sup> The tax would be levied where the user is located, which would be determined by the location of the device used to access the service.<sup>166</sup>

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<sup>154</sup>European Comm’n, Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM(2018) 148 final (Mar. 21, 2018), [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/proposal\\_common\\_system\\_digital\\_services\\_tax\\_21032018\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf) [hereinafter EC DST Proposal].

<sup>155</sup>European Comm’n, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM(2018) 147 final (Mar. 21, 2018), [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/proposal\\_significant\\_digital\\_presence\\_21032018\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf) [hereinafter EC SDP Proposal].

<sup>156</sup>IMPACT ASSESSMENT, *supra* note 18, at 5.

<sup>157</sup>*Id.* at 5-6.

<sup>158</sup>*Id.* at 18.

<sup>159</sup>*Id.* at 18-19.

<sup>160</sup>*Id.* at 6-7, 21.

<sup>161</sup>*Id.* at 78-79.

<sup>162</sup>EC DST PROPOSAL, *supra* note 154, art. 8.

<sup>163</sup>*Id.* art. 4.

<sup>164</sup>IMPACT ASSESSMENT, *supra* note 18, at 7.

<sup>165</sup>EC DST PROPOSAL, *supra* note 154, art. 3.

<sup>166</sup>*Id.* art. 5.

As a permanent solution, the EC proposes expanding the scope of PEs to companies with a significant digital presence,<sup>167</sup> which would exist if a company has either revenues from digital services in excess of €7 million, more than 100,000 users, or more than 3,000 online business contracts.<sup>168</sup> Countries would be encouraged to amend their tax treaties with non-EU countries to change the PE provisions.<sup>169</sup>

The EC considered and discarded other options—a destination-based cash-flow tax (DBCFT), a unitary tax, and a residence tax base with destination tax rate.<sup>170</sup> The DBCFT would allow taxation by the country where a company's customers are located, with the presence of a company in a country irrelevant. The unitary tax would allocate worldwide profits among countries based on turnover in each country, with new rules for digital tax nexus. The residence tax base with destination tax rate would keep taxing rights and profit allocations with the country of tax residence but would apply a weighted average tax rate based on where turnover is generated. Although any of these reforms would “fundamentally challenge the international tax system,” they also would “address the problems at their roots.”<sup>171</sup> In spite of this potential for solving the problems of taxation of the digital economy, the member states of the EU preferred to adapt the present system, apparently finding these discarded reforms too radical.

Despite choosing a less extreme option, the EC's proposal generally has not been met with praise.<sup>172</sup> Member countries in the EU themselves—Ireland, Luxembourg, the Netherlands, Denmark, Finland, and Sweden—do not favor the proposal.<sup>173</sup> Four countries—the Netherlands, Ireland, Denmark, and Malta—submitted formal objections to the EC.<sup>174</sup> The American

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<sup>167</sup>IMPACT ASSESSMENT, *supra* note 18, at 49-53. See Tom O'Shea, *The EU's Proposed "Significant Digital Presence" Framework*, 90 TAX NOTES INT'L (TA) 1295 (June 11, 2018).

<sup>168</sup>EC SDP Proposal, *supra* note 155, art. 4(3).

<sup>169</sup>IMPACT ASSESSMENT, *supra* note 18, at 51.

<sup>170</sup>*Id.* at 28-30.

<sup>171</sup>*Id.* at 34.

<sup>172</sup>See Jeremy Cape, *Is the European Commission's Digital Economy Proposal the Work of Daft Punks?*, 90 TAX NOTES INT'L (TA) 863 (May 14, 2018).

<sup>173</sup>Patrick Smyth, *Netherlands and Luxembourg join Ireland as wary of digital tax*, THE IRISH TIMES (Mar. 23, 2018), <https://www.irishtimes.com/news/world/europe/netherlands-and-luxembourg-join-ireland-as-wary-of-digital-tax-1.3437129>; Francesco Guarascio, *Nordic countries oppose EU plans for digital tax on firms' turnover*, REUTERS (May 31, 2018), <https://uk.reuters.com/article/uk-eu-digital-tax/nordic-countries-oppose-eu-plans-for-digital-tax-on-firms-turnover-idUKKCN1IW333>. According to Pierre Moscovici, the European Taxation Commissioner, 20 of 28 member countries support the proposal. See Isabel Gottlieb, *EU Digital Tax Proposal Has "Reasonable Chance," Moscovici Says*, DAILY TAX REP. (BNA), Apr. 20, 2018.

<sup>174</sup>Stephanie Soong Johnston, *Lawmakers Try Showing "Yellow Card" for EU Digital Taxation Plan*, 90 TAX NOTES INT'L (TA) 974 (May 18, 2018). For the reasoned opinion of the Netherlands, see EUROPEAN PARLIAMENT, NATIONAL PARLIAMENT REASONED OPINION ON SUBSIDIARITY (May 29, 2018), [http://www.europarl.europa.eu/RegData/docs\\_autres\\_institutions/parlements\\_nationaux/com/2018/0147/NL\\_CHAMBER\\_AVIS-COM\(2018\)0147\\_EN.pdf](http://www.europarl.europa.eu/RegData/docs_autres_institutions/parlements_nationaux/com/2018/0147/NL_CHAMBER_AVIS-COM(2018)0147_EN.pdf).

Chamber of Commerce to the European Union expressed its concern that the EC short-term measures “may make it more difficult for [the OECD] process to succeed.”<sup>175</sup> And, the European Centre for International Political Economy (ECIPE) harshly criticizes the report, challenging the very justification for imposing a tax on digital companies—that these companies are not paying their fair share of taxes.<sup>176</sup>

Notwithstanding the thousands of hours spent on the writing of OECD and EC reports on tax issues of the digital economy, and the many more hours spent by others critiquing and discussing the recommendations and lack thereof, there is still no consensus solution. In the wake of continued inaction, countries have been left to their own devices and many have felt compelled to act.

#### IV. Unilateral Solutions

As of the beginning of 2018, a solution to the digital economy tax issues remains out of reach. The OECD has not been able to come to the point of recommending an overall solution that necessarily would address the allocation of taxing rights. The Inclusive Framework has agreed to find a consensus solution on the issues of nexus and profit allocation by 2020. Doubting that a solution will ever be agreed upon, however, countries and the EU have taken matters into their own hands through enactment of uncoordinated and unilateral solutions into their laws or proposals for interim taxes that would remain in effect until a comprehensive solution is adopted. In fact, the OECD encouraged countries to enact their own solutions to address the issues in the Final Report.<sup>177</sup> Leaving this important area unresolved was completely at odds with what the OECD set out to do in its BEPS project:

Failure to collaborate in addressing BEPS issues could result in unilateral actions that would risk undermining the consensus-based framework for establishing jurisdiction to tax and addressing double taxation which exists today. The consequences could be damaging in terms of increased possibilities for mismatches, additional disputes, increased uncertainty for business, a battle to be the first to grab taxable income through purported anti-avoidance measures, or a race to the bottom with respect to corporate income taxes. In contrast, collaboration to address BEPS concerns will enhance and

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<sup>175</sup>AmCham EU, Press Release, US business concerned over EU digital tax proposal (Mar. 21, 2018), <http://www.amchameu.eu/news/us-business-concerned-over-eu-digital-tax-proposal>.

<sup>176</sup>Matthias Bauer, European Centre for Int'l Political Economy, *Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions* (Mar. 2018), <http://ecipe.org/publications/digital-companies-and-their-fair-share-of-taxes/>. “The European Centre for International Political Economy (ECIPE) is an independent and non-profit policy research think tank dedicated to trade policy and other international economic policy issues of importance to Europe.” EUROPEAN CENTRE FOR INTERNATIONAL POLITICAL ECONOMY, ABOUT US, <http://ecipe.org/about-us> (last visited Sept. 27, 2018).

<sup>177</sup>FINAL REPORT, *supra* note 10, at ¶ 357.

support individual governments' domestic policy efforts to protect their tax base while protecting multinationals from uncertainty or double taxation.<sup>178</sup>

The OECD admits that different solutions adopted by countries create uncertainty and compliance costs,<sup>179</sup> and the EU cautions that unilateral methods "threaten to create new obstacles and loopholes."<sup>180</sup>

Despite these warnings, the OECD in its Interim Report was again unsuccessful in recommending a global solution or advocating for, or opposing, interim measures pending such a solution.<sup>181</sup> Not being satisfied to wait for a solution that many feel will never come, countries have independently and unilaterally gone down their own paths to require companies to pay their fair share of taxes in their jurisdictions. Some of the laws that have been enacted to address the problems are described below.<sup>182</sup>

**United Kingdom.** The U.K. was the first country to enact a diverted profits tax (DPT).<sup>183</sup> The DPT applies to profits beginning April 1, 2015, and focuses on "contrived arrangements designed to erode the U.K. tax base."<sup>184</sup> The tax has two prongs: (1) avoiding the creation of a U.K. PE and (2) using arrangements or transactions that lack economic substance to exploit tax mismatches through expenditures or income diversion within a group.<sup>185</sup> The rate for the DPT is generally 25%, which is higher than the current corporate income tax rate of 19%, to encourage businesses to change their arrangements and pay corporate income tax.<sup>186</sup> The tax applies to all corporations, except for small and medium-size enterprises (*i.e.*, enterprises with less than 250 employees and either an annual turnover of not more than €50 million or total assets of not more than €43 million).<sup>187</sup> Notwithstanding that a DPT was not among any recommendations for any BEPS Actions, the

<sup>178</sup> 2013 REPORT, *supra* note 3, at 48.

<sup>179</sup> Annex I: Inclusive Framework on BEPS, at 24-22, in 2017 G20 REPORT, *supra* note 114.

<sup>180</sup> European Comm'n, Press Release, Taxation: Commission sets out path towards fair taxation of the Digital Economy (Sept. 21, 2017), [http://europa.eu/rapid/press-release\\_IP-17-3305\\_en.htm](http://europa.eu/rapid/press-release_IP-17-3305_en.htm).

<sup>181</sup> See *supra* text accompanying notes 139-53.

<sup>182</sup> For summaries of legislation enacted by countries to tax digital companies or transactions, see IMPACT ASSESSMENT, *supra* note 18, at 53-55; INTERIM REPORT, *supra* note 13, Ch. 4; U.N., COMM. OF EXPERTS ON INT'L COOPERATION IN TAX MATTERS, THE DIGITALIZED ECONOMY: SELECTED ISSUES OF POTENTIAL RELEVANCE TO DEVELOPING COUNTRIES TAX MATTERS, U.N. Doc. E/C.18/2017/6 (Aug. 8, 2017); U.N., COMM. OF EXPERTS ON INT'L COOPERATION IN TAX MATTERS, TAX CHALLENGES IN THE DIGITALIZED ECONOMY: SELECTED ISSUES FOR POSSIBLE COMMITTEE CONSIDERATION, U.N. Doc. E/C.18/2017/CPR.22 (Oct. 11, 2017).

<sup>183</sup> Finance Act 2015, Part 3 (Eng.). For a detailed description of the U.K. DPT, see Shinasa Wasimi, Jai Nario & Kathryn Bertram, *Diverted Profits Tax: U.K., Australian, and New Zealand Approaches*, 87 TAX NOTES INT'L (TA) 349 (July 24, 2017).

<sup>184</sup> See HM REVENUE & CUSTOMS, DIVERTED PROFITS TAX: GUIDANCE (Nov. 30, 2015), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/480318/Diverted\\_Profits\\_Tax.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf).

<sup>185</sup> *Id.* at 4.

<sup>186</sup> *Id.* at 4, 5.

<sup>187</sup> *Id.*

U.K. government maintains its DPT is consistent with the purpose of the BEPS project—“to ensure that the profits taxed in the U.K. fully reflect the economic activity here.”<sup>188</sup> It is estimated that the DPT will generate £1.35 billion in revenue by 2019.<sup>189</sup>

Australia. Following the example of the U.K., Australia enacted a Multinational Anti-Avoidance Law (MAAL),<sup>190</sup> effective January 1, 2016, and a DPT, effective July 1, 2017.<sup>191</sup> MAAL is similar to the U.K.’s PE avoidance prong of the DPT and Australia’s DPT is similar to the U.K.’s DPT diverted profits prong. The law imposes a tax of 40% for the DPT and 30% for MAAL, compared to the regular corporate income tax rate of 30%, with the aim of ensuring that tax paid by a “significant global entity” properly reflects the economic substance of its activities in Australia and preventing profit diversion offshore through related party arrangements.<sup>192</sup> In 2018, draft legislation was introduced to extend the application of MAAL to prevent companies getting around the MAAL through the use of passthrough entities.<sup>193</sup>

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<sup>188</sup> *Id.* at 4.

<sup>189</sup> HM TREASURY, CORPORATE TAX AND THE DIGITAL ECONOMY: POSITION PAPER 2 (Nov. 2017), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/661458/corporate\\_tax\\_and\\_the\\_digital\\_economy\\_position\\_paper.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661458/corporate_tax_and_the_digital_economy_position_paper.pdf).

<sup>190</sup> TAX LAWS AMENDMENT (COMBATING MULTINATIONAL TAX AVOIDANCE) ACT 2015, [https://www.aph.gov.au/Parliamentary\\_Business/Bills\\_Legislation/Bills\\_Search\\_Results/Result?bId=r5549](https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r5549). France also enacted a DPT in 2016 that added storage facilities and websites intended to reach French customers to the activities that create PEs. The rate for the DPT was set at five percentage points higher than the regular tax rate. The law was to take effect on January 1, 2018, but the constitutional court struck down the DPT because tax authorities would have had the decision-making authority as to which companies were subject to the tax. See Conseil Constitutionnel, Communiqué de presse, Decision No. 2016-744 DC (Dec. 29, 2016).

<sup>191</sup> TREASURY LAWS AMENDMENT (COMBATING MULTINATIONAL TAX AVOIDANCE) ACT 2017, [https://www.aph.gov.au/Parliamentary\\_Business/Bills\\_Legislation/Bills\\_Search\\_Results/Result?bId=r5805](https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r5805) (last visited Sept. 27, 2018). For a detailed description of the Australian MAAL and DPT, see Wasimi et al., *supra* note 183. See also Antony Ting, Tommasco Faccio & Jeffery M. Kadet, *Effects of Australia’s MAAL and DPT on Internet-Based Businesses*, 83 TAX NOTES INT’L (TA) 145 (July 11, 2016).

<sup>192</sup> TAX LAWS AMENDMENT (COMBATING MULTINATIONAL TAX AVOIDANCE) ACT 2015, *supra* note 190. A “significant global entity” is either a global parent entity with an annual global income of at least AUD 1 billion or a member of a group of entities that are consolidated for accounting purposes if the global parent entity has an annual global income of at least AUD 1 billion. AUSTRALIAN TAXATION OFFICE, DIVERTED PROFITS TAX, <https://www.ato.gov.au/general/new-legislation/in-detail/direct-taxes/income-tax-for-businesses/diverted-profits-tax/?=redirected> (last visited Sept. 27, 2018).

<sup>193</sup> TREASURY LAWS AMENDMENT (TAX INTEGRITY AND OTHER MEASURES) BILL 2018, [https://www.aph.gov.au/Parliamentary\\_Business/Bills\\_Legislation/Bills\\_Search\\_Results/Result?bId=r6092](https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r6092).

**India.** India imposed a gross receipts tax on digital companies through an equalization levy that is outside the reach of its income tax.<sup>194</sup> Effective June 1, 2016, the six percent tax is imposed on gross payments between businesses, is enforced through withholding, and currently applies only to online advertisements and sales of online advertising space.<sup>195</sup> Income subject to the equalization levy is not subject to the corporate income tax and does not apply if a nonresident company has a PE in India.<sup>196</sup> India is additionally looking to expand its nexus rules so that a nonresident company would be subject to the corporate income tax if it has a significant economic presence, regardless of whether the company has a physical presence in India, subject to minimum revenue or user thresholds.<sup>197</sup> Significant economic presence would encompass transactions in goods, services, or property in India, including download of data or software, or continuous soliciting of business activities or interacting with users through digital means.<sup>198</sup>

**Israel.** In 2016, Israel clarified that, for countries with which Israel does not have a tax treaty, online services provided out of the country can create sufficient nexus if the activities constitute a significant economic presence evidenced by “digital presence.”<sup>199</sup> Factors that indicate digital presence for a company include conclusion of contracts online, use of online services or products by a significant number of customers in Israel, locally targeted websites, and significant revenue generated from online activities of users in Israel.<sup>200</sup>

**Italy.** Italy adopted a Levy on Digital Transactions in 2017, to be effective beginning in 2019.<sup>201</sup> Collected through withholding, a three percent tax will be imposed on amounts paid for digital services that are provided electronically and will apply only to customers in Italy and only on business-to-business transactions.<sup>202</sup> The tax is an equalization levy, designed to equalize the

<sup>194</sup>Ch. VIII of Finance Act 2016, No. 28. See CENTRAL BOARD OF DIRECT TAXES, DEP'T OF REVENUE, MINISTRY OF FINANCE, GOV'T OF INDIA, PROPOSAL FOR EQUALIZATION LEVY ON SPECIFIED TRANSACTIONS, REPORT OF THE COMM. ON TAX'N OF E-COMMERCE (Feb. 2016), <https://www.incometaxindia.gov.in/Lists/Latest%20News/Attachments/26/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf>.

<sup>195</sup>Ch. VIII of Finance Act 2016, No. 28.

<sup>196</sup>*Id.*

<sup>197</sup>India Ministry of Finance, Finance Bill, 2018, Chapter 3 (Direct Taxes), Clause 4 (Amendment of Section 9), Explanation 2A, at 7.

<sup>198</sup>*Id.* See Tirathesh Bagadia, *India: New Nexus-based Concept of Significant Economic Presence*, 45 TAX PLAN. INT'L REV. (BNA) 24 (Apr. 30, 2018).

<sup>199</sup>Administrative Circular No. 04/2016 (Apr. 11, 2016).

<sup>200</sup>*Id.*

<sup>201</sup>Law 205/2017, at ¶¶ 1011-19.

<sup>202</sup>*Id.* See William Hoke, *Italian Budget Panel Halves Proposed Web Tax Rate, Drops Tax Credit*, 2017 WTD 245-1 (Dec. 22, 2017). See also Francesca Gastaldi & Alberto Zanardi, *Taxation of the Digital Economy: The Case of Online Advertising in Italy* (June 10, 2017), [https://editorialexpress.com/cgi-bin/conference/download.cgi%3Fdb\\_name%3DSIEP2017%26paper\\_id%3D149+%&cd=1&hl=en&ct=clnk&gl=us](https://editorialexpress.com/cgi-bin/conference/download.cgi%3Fdb_name%3DSIEP2017%26paper_id%3D149+%&cd=1&hl=en&ct=clnk&gl=us).

treatment between companies supplying digital services and those providing services in a traditional manner.

United States. The United States got in on the unilateral legislation push, enacting its own BEPS reforms as part of its “Tax Cuts and Jobs Act,” including the Base Erosion and Anti-abuse Tax (BEAT) and income inclusion for Global Intangible Low-Taxed Income (GILTI), both effective for tax years beginning after 2017.<sup>203</sup> The BEAT applies to all types of companies, not just digital companies, but only if average annual gross receipts of a corporation over a period of three years exceed \$500 million and the corporation has a “base erosion percentage” of at least three percent.<sup>204</sup> The BEAT is essentially an alternative minimum tax on U.S. corporations (or foreign corporations with U.S. trades or businesses) that make payments to foreign related parties, generally even if the payments are at an arm’s-length price.<sup>205</sup> Examples of such payments are royalties, interest, and certain services.<sup>206</sup> In very basic terms, taxable income of a corporation is recalculated after adding back the related party payments and applying a 5 to 13.5% tax rate, instead of the standard 21% corporate tax rate.<sup>207</sup> If the BEAT is higher, the corporation pays that higher amount as its corporate income tax.<sup>208</sup>

GILTI requires that a U.S. shareholder of a controlled foreign corporation include in the shareholder’s income its “global intangible low-taxed income.”<sup>209</sup> In general terms, this income inclusion is the shareholder’s share of the amount that the corporation’s income (with certain exclusions) exceeds a deemed ten percent return on the corporation’s tangible assets.<sup>210</sup> A U.S. shareholder that is a U.S. corporation can deduct 50% of this GILTI inclusion.<sup>211</sup>

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<sup>203</sup> Pub. L. No. 115-97, §§ 14201(a), 14401, 131 Stat. 2054 (2017).

<sup>204</sup> I.R.C. § 59A(e)(1). The “base erosion percentage” for a tax year is the ratio of base erosion payments to all allowable deductions. I.R.C. § 59A(c)(4). See Jasper L. Cummings, Jr., *Selective Analysis: The BEAT*, 158 TAX NOTES (TA) 1757 (Mar. 26, 2018); Bret Wells, *Get With the BEAT*, 158 TAX NOTES (TA) 1023 (Feb. 19, 2018).

<sup>205</sup> The provisions for the BEAT are contained in I.R.C. § 59A.

<sup>206</sup> I.R.C. § 59A(d).

<sup>207</sup> I.R.C. § 59A(b).

<sup>208</sup> I.R.C. § 59A(a).

<sup>209</sup> I.R.C. § 951A(a).

<sup>210</sup> I.R.C. § 951A(b). Controlled foreign corporations are foreign corporations in which U.S. shareholders (U.S. persons that own at least ten percent of the corporation’s stock, by vote or value) own directly, indirectly, or constructively more than 50% of the corporation’s stock, by vote or value. I.R.C. §§ 951(b), 957(a). See Ken Brewer & Nicolaus F. McBee, *U.S. International Tax Reform: The Good, the Bad, and the GILTI*, 159 TAX NOTES (TA) 839 (May 7, 2018); Ken Brewer & Nicolaus F. McBee, *The Good, the Bad, and the GILTI: Part 2, the Basket Question*, 159 TAX NOTES (TA) 1297 (May 28, 2018); Jasper L. Cummings, Jr., *GILTI Puts Territoriality in Doubt*, 159 TAX NOTES (TA) 161 (Apr. 9, 2018).

<sup>211</sup> I.R.C. § 250(a)(1)(B). See Chris William Sanchirico, *The New US Tax Preference for “Foreign-Derived Intangible Income*, 71 TAX LAW REV. \_\_ (2018) (forthcoming).

The above is not a complete list, and even where a country has not enacted legislation, it may be considering taking action or additional action.<sup>212</sup> The U.K. is one country that has studied the issues extensively and, despite enacting a DPT, is preparing to take further unilateral action because of the lack of progress in developing an international consensus. In November 2017, it released a position paper on “Corporate Tax and the Digital Economy,” emphasizing that it must receive corporate tax that is commensurate with the value generated from the U.K. market and specifically from participation by users in the U.K., even if an enterprise does not have a traditional PE in the country.<sup>213</sup> If progress is not made on reforming the international tax framework, the U.K. will take further unilateral action and go beyond “traditional and well understood concepts,” even if it is difficult to do so.<sup>214</sup> As an interim solution, the paper proposes extending the withholding tax on royalties paid to no- or low-tax jurisdictions for sales to U.K. customers.<sup>215</sup>

Based on feedback from its initial position paper, the U.K. published an updated paper in March 2018, stating in emphatic terms: “The current misalignment between where digital businesses are taxed and where they create value threatens to undermine the fairness, sustainability and public acceptability of the corporate tax system.”<sup>216</sup> The paper sets forth an approach to incorporate user-created value into international tax rules by allowing user jurisdictions the right to tax digital companies that realize value from users and attributing profits through a profit split method that utilizes “pre-determined parameters.”<sup>217</sup> Acknowledging the difficulty of obtaining international consensus and details of such a new system, the paper underlines the importance of taking interim measures and emphasizes again its readiness to act unilaterally,<sup>218</sup> a position universally growing stronger by many countries the more time passes with inaction.

Considering the aggressive approach taken by countries in Europe in going after digital companies with legislative changes and tax assessments, coupled with impatience with the inaction of Action 1, more countries will likely enact measures in their laws to ensure they receive their fair share of profits

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<sup>212</sup> See INTERIM REPORT, *supra* note 13, Ch. 4, n.5 (discussing proposals in Turkey, Thailand, and Indonesia).

<sup>213</sup> HM Treasury, *supra* note 189, at 2.

<sup>214</sup> *Id.* at 2, 11.

<sup>215</sup> *Id.* at 13. See also HM Treasury, ROYALTIES WITHHOLDING TAX: CONSULTATION DOCUMENT (Dec. 1, 2017); Tommaso Faccio & Jeffery M. Kadet, *Will Bringing Sales Onshore in the U.K. Lead to Higher Taxes?*, 82 TAX NOTES INT’L (TA) 679 (May 16, 2016).

<sup>216</sup> HM Treasury, CORPORATE TAX AND THE DIGITAL ECONOMY: POSITION PAPER UPDATE (Mar. 2018) at 3.

<sup>217</sup> *Id.* at 7-23.

<sup>218</sup> *Id.* at 24-25.

of digital companies.<sup>219</sup> As more and more individual measures are enacted, however, it becomes less and less likely that an international consensus can be reached.

## V. Nexus in a Digital Economy

Those who continue to maintain that there is no need to change international tax rules of nexus are refusing to accept that times have changed. Although sales have been made via mail order catalogs for more than a century,<sup>220</sup> the ability to transact sales and services electronically has expanded exponentially the ability of a company to reach customers without ever being physically present in the country where the customer is located. Domestic laws of most countries, as well as most treaties, require some type of physical presence either directly or through an agent for a country to assert taxing jurisdiction over business profits of a nonresident company.<sup>221</sup> Continuing to cling to this physical presence standard makes no sense in the current economy. A discussion of the OECD and EU's positions on physical presence nexus follows, as well as an examination of nexus issues confronting states in the United States.

### A. OECD/EU

The OECD considered several options in its 2014 Deliverable to address tax issues of the digital economy—a withholding tax, a bit tax, and two options as alternative forms of nexus—significant digital presence and significant presence.<sup>222</sup> The Final Report modified the options to include a withholding tax, equalization levy, or significant economic presence that considers digital factors.<sup>223</sup> The nexus options are designed to address the realities of a digital economy business model, in which a nonresident company sells products or services through a website, mobile application, or other digital method, without having a physical presence in the country.<sup>224</sup> The OECD describes the nexus issue as

[t]he continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business, combined with the increasing role of network effects generated

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<sup>219</sup> See INTERIM REPORT, *supra* note 13, at ¶ 368 (“Until such time as a global consensus can be achieved on how to address the broader direct tax challenges raised by digitalisation, it is likely that more countries will follow suit and adapt their tax system through a series of uncoordinated measures.”).

<sup>220</sup> For a history of Sears mail-order catalog, which began catalog sales in 1894 and continued with its general merchandise catalog until 1993, see HISTORY OF THE SEARS CATALOG, <http://www.searsarchives.com/catalogs/history.htm> (last visited Sept. 28, 2018).

<sup>221</sup> FINAL REPORT, *supra* note 10, at ¶¶ 184-85, 271. For a discussion of the physical presence requirement, see *supra* text accompanying notes 20-24.

<sup>222</sup> 2014 DELIVERABLE, *supra* note 58. See *supra* text accompanying notes 57-78.

<sup>223</sup> FINAL REPORT, *supra* note 10, at ¶¶ 277-308.

<sup>224</sup> *Id.* at ¶¶ 184-85.

by customer interactions, can raise questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate.<sup>225</sup>

The OECD recognizes that, although sales did occur in the pre-digital economy without a nonresident company having a physical presence in a country (such as through catalog sales), “[i]ncreasing reliance on automated processes may further decrease reliance on local physical presence.”<sup>226</sup> Under current rules, a dependent agent can create a physical presence by concluding contracts, but this route to having a PE is rendered irrelevant where contracts are concluded remotely.<sup>227</sup> The EU takes a stronger position, emphatically recognizing that “companies operate in a fundamentally different manner today” than when international tax rules were written, when “no physical presence is required to sell goods and services into a market.”<sup>228</sup> In essence, international tax rules are “no longer fit for purpose.”<sup>229</sup>

The ability of a company to have customers in a country without a taxable presence is not unique to digital business, but “it is available at a greater scale in the digital economy than was previously the case.”<sup>230</sup> The number of potential customers has expanded “because distance forms less of a barrier to trade.”<sup>231</sup> Work previously performed by personnel in the customer’s country can be performed outside the country, including by automated equipment, with the result that less local personnel and infrastructure are needed in the country where customers are located.<sup>232</sup> The OECD notes in the Final Report that despite these changes large MNEs still may need to have a physical presence in a country, cautioning that it is “therefore important not to overstate the issues of nexus.”<sup>233</sup> Taking the opposite stand in the very next sentence of the Final Report, however, is the OECD’s admonition not to understate this point either, because a large amount of sales can be generated without an enterprise having a taxable presence—thus raising questions about whether the current tax rules are “appropriate in the digital economy.”<sup>234</sup>

The intent of a significant economic presence option for addressing digital economy tax issues is “to reflect situations where an enterprise leverages digital technology to participate in the economic life of a country in a regular and sustained manner without having a physical presence in that country.”<sup>235</sup> A taxable presence would be found based on “a purposeful and sustained interaction with the economy of [a] country via technology and other automated

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<sup>225</sup> *Id.* at ¶ 248.

<sup>226</sup> *Id.* at ¶ 184.

<sup>227</sup> *Id.* at ¶ 256.

<sup>228</sup> 2017 EC Report, *supra* note 119, at 3.

<sup>229</sup> *Id.* at 6.

<sup>230</sup> FINAL REPORT, *supra* note 10, at ¶ 185.

<sup>231</sup> *Id.* at ¶ 253.

<sup>232</sup> *Id.*

<sup>233</sup> *Id.* at ¶ 255.

<sup>234</sup> *Id.*

<sup>235</sup> *Id.* at ¶ 276.

tools.”<sup>236</sup> In addition to economic interaction, revenue generated from remote transactions into the country would need to be considered to ensure that the economic presence is in fact “significant.”<sup>237</sup> Although revenue is “one of the clearest potential indicators” of significant economic presence, the OECD would not find revenue in itself to be sufficient to create nexus, and revenue would need to be combined with other factors.<sup>238</sup>

Another option initially considered by the OECD as an option separate from significant economic presence was the expansion of the PE concept to enterprises having a significant digital presence. The EC supports this PE extension as a long-term solution.<sup>239</sup> Under the EC’s proposal, income taxation would be triggered if certain digital activity thresholds are exceeded—revenues in excess of €7 million, more than 100,000 users, or more than 3,000 online business contracts.<sup>240</sup> By adopting such a standard, however, companies with digital activities would be taxed differently than companies without, a fundamental violation of the OECD’s ring-fence prohibition.<sup>241</sup>

### B. *States of the United States*

States in the United States and the District of Columbia impose their own taxes, which are in addition to taxes of the U.S. federal government. The method for dividing taxes among 51 different taxing jurisdictions in the United States provides useful guidance regarding potential splitting of taxing jurisdiction in an international context, particularly with respect to a physical presence nexus standard.

Sales and use taxes are commonly imposed by states on the retail sale of goods and services, and sellers generally are required to collect and remit the taxes. The U.S. Supreme Court expressly limited the ability of states to require mail-order vendors with no physical presence in the state to collect state use tax in a 1967 case, *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*.<sup>242</sup> In this case, the Court held that the state of Illinois had no power to impose a use tax collection obligation on out-of-state companies, because it was a violation of the Due Process Clause of the U.S. Constitution and an unconstitutional burden on interstate commerce under the dormant Commerce Clause.<sup>243</sup> Ten years later, the Supreme Court provided further guidance, establishing a “substantial nexus” requirement for sales taxes on

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<sup>236</sup> *Id.* at ¶ 277.

<sup>237</sup> *Id.*

<sup>238</sup> *Id.* at ¶ 278.

<sup>239</sup> IMPACT ASSESSMENT, *supra* note 18, at 49-53. See *supra* text accompanying notes 167-69.

<sup>240</sup> EC SDP Proposal, *supra* note 155, art. 4(3).

<sup>241</sup> See *supra* text accompanying note 87.

<sup>242</sup> 386 U.S. 753 (1967).

<sup>243</sup> *Id.*

interstate activities<sup>244</sup> in *Complete Auto Transit, Inc. v. Brady*.<sup>244</sup> In 1991, the North Dakota Supreme Court refused to follow *Bellas Hess* in *North Dakota v. Quill Corporation*, finding the holding in *Bellas Hess* to be obsolete, considering “the tremendous social, economic, commercial, and legal innovations” that had occurred since 1967.<sup>245</sup> The U.S. Supreme Court reversed this decision in 1992, in *Quill Corporation v. North Dakota*,<sup>246</sup> overruling *Bellas Hess* with respect to its due process holding but upholding the case under the dormant Commerce Clause of the U.S. Constitution.<sup>247</sup>

*Quill* specifically noted that Congress could overturn its decision through legislative action.<sup>248</sup> In fact, Congress tried and failed over a seven-year period to pass legislation that would allow state sales and use tax to be levied on companies that do not have a physical presence in the state. The Marketplace Fairness Act (the “MFA”) was first introduced under the 112th Congress in 2011<sup>249</sup> and again in the U.S. Senate in 2013, 2015, and 2017.<sup>250</sup> The MFA would allow states to tax remote sellers for state and local sales and use taxes, subject to a minimum threshold of \$1 million remote sales per year. In 2015 and 2017, the Remote Transactions Parity Act (RTPA)<sup>251</sup> was introduced, with provisions similar to the Marketplace Fairness Act but with thresholds reduced over a three-year period.<sup>252</sup> With no change to legislation and *Bellas Hess* not being overruled, the physical presence rule for state sales and use tax remained in effect since 1992.

The *Bellas Hess* physical presence requirement was never expressly extended to taxes other than sales and use tax. Federal law in fact prohibits a state from imposing a tax on net income if the only activity in the state is solicitation of orders for sales of tangible personal property and the orders are sent outside

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<sup>244</sup> 430 U.S. 274 (1977). The Court held that to sustain the validity of a state tax, the tax must (1) apply to an activity with a substantial nexus to the state, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly related to the services the state provides. *Id.* at 279.

<sup>245</sup> 470 N.W.2d 203, 208 (1991).

<sup>246</sup> 504 U.S. 298 (1992).

<sup>247</sup> *Id.* The dormant Commerce Clause is a judicial doctrine that prohibits states from interfering with interstate commerce unless authorized by Congress. See Brian Galle, *Kill Quill, Keep the Dormant Commerce Clause: History's Lessons on Congressional Control of State Taxation*, 70 STANFORD L. REV. ONLINE 158 (Mar. 2018); Hayes R. Holderness, *Questioning Quill*, 37 VA. TAX REV. 313 (2018); Eric S. Smith, *Due Process Implications Related to State Notice and Economic Nexus Laws*, 70 TAX LAW. 833 (2017); Matthew T. Szudajski, *The Rising Trend of Sales Tax Nexus Expansion*, 70 TAX LAW. 907 (2017); Adam B. Thimmesch, *A Unifying Approach to Nexus Under the Dormant Commerce Cause*, 116 MICH. L. REV. ONLINE 101 (2018).

<sup>248</sup> *Quill*, 504 U.S. at 318-19.

<sup>249</sup> S. 1832, 112th Cong. (2011).

<sup>250</sup> S. 743, 113th Cong. (2013); S. 698, 114th Cong. (2015); S. 976, 115th Cong. (2017). See Adam B. Thimmesch, *State Taxing Power after Direct Marketing Association v. Brohl*, 80 ST. TAX NOTES (TA) 299 (Apr. 25, 2016).

<sup>251</sup> H.R. 2775, 114th Cong. (2015); H.R. 2193, 115th Cong. (2017).

<sup>252</sup> The threshold is \$10 million of sales in the first year, decreasing to \$5 million and then \$1 million, and zero after three years.

the state for approval and fulfillment.<sup>253</sup> States have other types of taxes, however, such as gross receipts tax, minimum tax, or capital tax, to which this law does not apply. In the absence of a Supreme Court explicit requirement that physical presence is a prerequisite to the imposition of other types of taxes, states have interpreted this silence to mean that they can impose direct taxes on companies that have no physical presence in the state.<sup>254</sup> The Supreme Court did, however, state in *Quill* that even though it had not “articulated the same physical-presence requirement” for taxes other than sales and use taxes, “that silence does not imply repudiation of the . . . rule.”<sup>255</sup>

The U.S. Supreme Court agreed in 2018 to revisit *Quill* and hear *South Dakota v. Wayfair, Inc.*<sup>256</sup> to address the physical presence issue in a digital economy. In 2015, Justice Kennedy had, in a concurring opinion in *Direct Marketing Association v. Brohl*,<sup>257</sup> encouraged states to enact laws that did not comply with the physical presence standard to give the Supreme Court an opportunity to reevaluate *Quill* “in view of the dramatic technological and social changes that had taken place in our increasingly interconnected economy.”<sup>258</sup> Justice Kennedy elaborated, stating:

There is a powerful case to be made that a retailer doing extensive business within a State has a sufficiently “substantial nexus” to justify imposing some minor tax-collection duty, even if that business is done through mail or the Internet. . . . This argument has grown stronger, and the cause more urgent, with time. When the Court decided *Quill*, mail-order sales in the United States totaled \$180 billion. . . . But in 1992, the Internet was in its infancy. By 2008, e-commerce sales alone totaled \$3.16 trillion per year in the United States. . . . The Internet has caused far-reaching systemic and structural changes in the economy, and, indeed, in many other societal dimensions. Although online businesses may not have a physical presence in some States, the Web has, in many ways, brought the average American closer to most major retailers. A connection to a shopper’s favorite store is a click away—regardless of how close or far the nearest storefront. . . . As a result, a business may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term.<sup>259</sup>

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<sup>253</sup>Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified in 15 U.S.C. §§ 381-84). Public Law 86-272 prevents a state from imposing its income tax if the only business activities in the state are the solicitation of orders for sales of tangible personal property, with approval of orders and fulfillment of orders outside of the state.

<sup>254</sup>*See, e.g.,* *Geoffrey v. South Carolina Tax Comm’n*, 437 S.E.2d 13 (S.C. 1993) (income tax on royalty payments for use of trademarks within the state satisfies substantial nexus requirement under Commerce Clause due to presence of intangible property); *Crutchfield Corp. v. Testa*, 88 N.E.3d 900 (Ohio 2016) (commercial activity tax on revenue earned by out-of-state seller for sales shipped into Ohio upheld; Commerce Clause does not require physical presence for a business-privilege tax).

<sup>255</sup>*Quill*, 504 U.S. at 314.

<sup>256</sup>138 S. Ct. 2080 (2018).

<sup>257</sup>135 S. Ct. 1124 (2015).

<sup>258</sup>*Id.* at 1135 (Kennedy, J., concurring).

<sup>259</sup>*Id.*

After this opinion was issued, South Dakota enacted a law that applies an economic nexus standard for tax on sales to South Dakota purchasers by out-of-state retailers, requiring collection of the tax if the seller's gross revenues from sales of tangible personal property, electronic products, or services delivered into South Dakota either exceed \$100,000 or consist of at least 200 separate transactions.<sup>260</sup> *Wayfair* challenged this statute and gave Justice Kennedy the opportunity he sought for a Supreme Court review of *Quill*.

On June 21, 2018, the Supreme Court overruled *Quill* and *Bellas Hess* by a vote of 5-4.<sup>261</sup> The Court held that states can require remote sellers to collect and remit sales and use taxes for customers in the state—regardless of whether the seller has a physical presence in the state—provided that the states do not discriminate against or impose undue burdens on interstate commerce. The Court did not mince words, finding the physical presence standard to be “removed from economic reality,” “artificial in its entirety,” and “unsound and incorrect.”<sup>262</sup> Further, the requirement is a “judicially created tax shelter” for sellers that limit their physical presence in a state, which “has become easier and more prevalent as technology has advanced.”<sup>263</sup> The ability of a business to avoid taxation by not having a physical presence in the state creates an artificial competitive advantage for out-of-state sellers over in-state brick-and-mortar companies. It also results in an unfair system where a remote seller avails itself of a state's benefits but does not pay its fair share of taxes.

Specifically regarding advancements in technology, the Court recognized that it “should not maintain a rule that ignores substantial virtual connections to the State” and disregards the reality that “[m]odern e-commerce does not align analytically with a test that relies on . . . physical presence.”<sup>264</sup> Noting that the internet has made the Court's holding in *Quill* “all the more egregious and harmful,” the Court emphasized that the internet has “changed the dynamics of the national economy” and made the physical presence rule “no longer a clear or easily applicable standard.”<sup>265</sup> The opinion notes that in 1992 less than two percent of Americans had access to the internet and that mail-order business totaled \$180 billion.<sup>266</sup> This statistic compares with 89% internet access today and e-commerce retail sales of \$453.5 billion, and the strong likelihood of continued growth in the future.<sup>267</sup>

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<sup>260</sup>S.B. 106, codified as S.D. CODIFIED LAWS § 10-64 (2016). Under the statute, all sellers of tangible personal property, electronically delivered products, or services are deemed to have a physical presence in South Dakota if their South Dakota gross revenue is greater than \$100,000 or 200 total South Dakota sales.

<sup>261</sup>*Wayfair*, 138 S. Ct. at 2080.

<sup>262</sup>*Id.* at 2092, 2095, 2099.

<sup>263</sup>*Id.* at 2094.

<sup>264</sup>*Id.* at 2095.

<sup>265</sup>*Id.* at 2097, 2098.

<sup>266</sup>*Id.* at 2097.

<sup>267</sup>*Id.*

Besides strongly impacting the ability of states to tax, the *Wayfair* decision is important in the international context because it recognizes that tax standards have to be changed to reflect the realities of a changed economy and the ability to do business remotely. Acknowledgement by the Court of the tax advantages that remote sellers have over local businesses when a physical presence standard is used and the resulting unfairness are common complaints of countries where such sellers are accessing their marketplaces. Labeling such a standard a “tax shelter” is equally applicable in the international arena. The acknowledgment by the highest court in the United States should lend substantial support to a recognition that methods of doing business have changed and that action needs to be taken to address new business models in which a physical presence is meaningless.

## VI. Proposal: Factor Presence Nexus

A proven means of applying income taxation based on significant economic presence is “factor presence nexus,” which was adopted by the U.S. Multistate Tax Commission (MTC) as a model statute for states on October 17, 2002 (the Model).<sup>268</sup> The MTC is “an intergovernmental state tax agency working on behalf of states and taxpayers to facilitate the equitable and efficient administration of state tax laws that apply to multistate and multinational enterprises.”<sup>269</sup> The Model is intended to be a “simple, certain and equitable standard for the collection of state business activity taxes” that states can adopt as is or with modifications.<sup>270</sup> Under the Model, a company has a taxable presence for purposes of certain specified business activity taxes, such as the income tax, if the property, payroll, or sales exceed specified thresholds,<sup>271</sup> which are listed in the model as \$50,000 of property, \$50,000 of payroll, or \$500,000 of sales in the state, or 25% of the company’s total property, total payroll, or total sales.<sup>272</sup> The Model has been followed, with some variations, in ten states—Alabama, California, Colorado, Connecticut, Michigan, New York, Ohio, Tennessee, Virginia, and Washington.<sup>273</sup> This type of nexus offers a

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<sup>268</sup>Multistate Tax Comm’n, Factor Presence Nexus Standard for Business Activity Taxes (Oct. 17, 2002), [http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf).

<sup>269</sup>See MULTISTATE TAX COMMISSION, <http://www.mtc.gov/The-Commission> (last visited Sept. 28, 2018).

<sup>270</sup>Multistate Tax Comm’n, *supra* note 268, at 1.

<sup>271</sup>*Id.* at ¶ A(2).

<sup>272</sup>*Id.* at ¶ B(1).

<sup>273</sup>ALA. CODE § 40-18-31.2(b); CAL. REV. & TAX. CODE § 23101(b)-(d); COLO. CODE REGS. § 39-22-301.1; CONN. GEN. STAT. § 12-216a; MI COMP. LAWS §§ 208.1201-208.1203; N.Y. TAX LAW § 209.1(b); OHIO REV. CODE ANN. § 5751.01(H)-(I); TENN. CODE ANN. § 67-4-2004(49); and VA. CODE ANN. § 58.1-408. California law also contains a catchall provision, such that even if one of the factors is not present, a person still may be subject to income tax if it was “actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.” CAL. REV. & TAX. CODE § 23101(a).

bright-line test, providing the advantage of tax certainty instead of a more amorphous “economic nexus” standard that is determined based on facts and circumstances.

The Model is similar to a proposal for finding nexus based solely on the location of customers. Professor Avi-Yonah was an early proponent of such a proposal, under which sales in excess of a certain amount, e.g., \$500,000 in a year, would deem a company to have a PE, following the example of the MFA.<sup>274</sup> Revenues are an important factor in apportioning income, and “the sheer fact of potential customers being available is in itself a valuable resource for suppliers of remote digital services.”<sup>275</sup>

A test that looks only to sales is not, however, enough. Even if a company does not have sufficient sales to justify finding nexus, nexus could still be established based on property or payroll. The OECD agrees that revenues should be a factor in establishing nexus but are not “sufficient in isolation.”<sup>276</sup> Although a tax that establishes nexus based on a company’s property or payroll in a jurisdiction could provide “an incentive for a company to move assets and employees out of that state,”<sup>277</sup> disregarding assets and employees goes against the basic justification for taxing rights over a company—*i.e.*, does a company have sufficient contact with a jurisdiction to be subject to its tax laws? Unlike concluding contracts remotely in an Irish company by the company’s sole employee, for example, having personnel or a plant and equipment in a locale is not easily subject to manipulation from one jurisdiction to another. Further, it would seem incongruous that a company that has, for example, 800,000 employees or a manufacturing plant in Country X would not pay any tax in Country X if it had no customers there. Considered as a “common-sense notion[,] . . . nexus exists where (and only where) significant amounts of the (apportioned) tax base exists or could exist . . . in other words, where the corporation has significant amounts of the economic activities that are factors in the apportionment formula.”<sup>278</sup>

#### A. *What Would a Factor Presence Nexus Cover?*

A factor presence nexus in the international context would cover all transactions, not just those effected by digital means. The OECD considered this

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<sup>274</sup>Reuven Avi-Yonah, *A Virtual PE: International Tax and the Marketplace Fairness Act* (Apr. 30, 2013), <http://ssrn.com/abstract=2259127>. For others advocating this position, see Jeff Ferry, *Revenue Gains From Sales Factor Apportionment Corp Income Tax*, 157 TAX NOTES (TA) 1313, 1315 (Nov. 27, 2017); Bill Parks, *Why Objections to Sales Factor Apportionment Are Bogus*, 157 TAX NOTES (TA) 1155, 1161 (Nov. 20, 2017) (“SFA offers the fairness our corporate tax system lacks and could greatly increase its efficiency.”).

<sup>275</sup>Frans Vanistendael, *Digital Disruption in International Taxation*, 89 TAX NOTES INT’L (TA) 175 (Jan. 8, 2018).

<sup>276</sup>FINAL REPORT, *supra* note 10, at ¶ 278. Compare the European’s Commission DBCFT proposal, discussed *supra* text accompanying notes 170-71.

<sup>277</sup>Ferry, *supra* note 274, at 1315.

<sup>278</sup>Charles E. McLure, *Implementing State Corporate Income Taxes in the Digital Age*, LIII NAT’L TAX J. 1287, 1297 (2000).

issue in the Final Report—why should digitally concluded transactions be treated differently from transactions concluded by mail or telephone?—taking the conservative position that “it may be preferable” to include all such transactions in determining nexus.<sup>279</sup> In keeping with the BEPS principle of not “ring-fencing” the digital economy,<sup>280</sup> it would be more than merely preferable, and would be essential, that all transactions be considered in establishing nexus.

Just as under the Model, there should be a minimum threshold of sales, property, or employees before an enterprise would be subject to tax in a jurisdiction, which should not be too high when compared to a country’s potential revenue gain.<sup>281</sup> A minimum threshold would prevent, for example, a company selling goods on the internet primarily to countries in South America from being subject to tax in Iceland on one sale for a relatively small amount. A minimum threshold would establish a bright-line test to give certainty to an enterprise doing business in a country. In addition, compliance costs and administrative burdens would be lessened by appropriately establishing the amount of the minimum threshold. As noted by the OECD, artificial fragmentation of revenue would need to be addressed by applying the threshold in the aggregate to all affiliated companies.<sup>282</sup>

#### B. *How Would a Digital Presence be Measured and Determined?*

For purposes of establishing the required presence under a three-factor formula of sales, property, or payroll, there is no need to have a “digital factor” in addition to revenue. The OECD in the Final Report suggests factors, such as digital or user-based factors, be used to show “regular and sustained participation in the economic life of a country.”<sup>283</sup> Potential digital factors are a local domain name, a local digital platform, and local payment options as factors that enable an enterprise to have “sustained interaction” with customers.<sup>284</sup> These factors, however, provide no additional measure of economic presence and could lead to manipulation. For example, if a minimum level of revenue, plus a local domain name, is required to have a significant digital presence, a company could just not have a local name, and taxable presence would be avoided even though the economic presence has not in reality changed.

User-based factors would result in unnecessary complexity. The Final Report posits that factors based on users could indicate how much a company participates in the economic life of a country.<sup>285</sup> Examples listed are “monthly active users” (*i.e.*, registered users who visited a company’s digital platform), contracts concluded through a digital platform, and value of

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<sup>279</sup> FINAL REPORT, *supra* note 10, at ¶ 278.

<sup>280</sup> *Id.* at ¶¶ 115, 291, 364, 368.

<sup>281</sup> *See id.* at ¶ 278.

<sup>282</sup> *Id.* at ¶ 278.

<sup>283</sup> *Id.* at ¶ 282.

<sup>284</sup> *Id.* at ¶ 279.

<sup>285</sup> *Id.* at ¶ 280.

digital content collected through a digital platform.<sup>286</sup> These factors provide no more evidence of economic presence than does revenue generated by sales to customers in a country. Such factors also would treat nondigital transactions differently than digital transactions—a ring-fence violation.

The OECD would determine which additional factors should be combined with revenue based on “the unique features and economic attributes of each market,” such as size, local language, currency restrictions, and banking system.<sup>287</sup> It would not, however, be practically workable for each company, or even the OECD or other international body, to analyze these factors for each country and continually monitor to determine if any changes are warranted. The Final Report compares a nonresident enterprise that concludes transactions with customers through a local digital platform that has local payment options with a nonresident company that generates sales through negotiation outside of the customer’s country and only a “passive website” that provides information on products but does not allow transactions or collect data.<sup>288</sup> If the revenue threshold is met, the OECD considers that the first situation might warrant a finding of taxable nexus but not the second situation.<sup>289</sup> Policing based on a distinction of whether a website can process transactions or a local payment system is used would seem to be impossible to enforce and would return to the current common practice of the artificial conclusion of contracts in a no-tax jurisdiction.

The BEPS Monitoring Group (BMG)<sup>290</sup> proposes that a significant economic presence “should reflect the contribution to value added resulting from the closer and interactive relationships with customers” including: (1) relationships with customers or users over six months, plus a physical presence directly or through a dependent agent; (2) sales of goods or services involving a close relationship with customers in the country, including a website in local language, delivery from suppliers in the country, using banking and other facilities from suppliers in the country, or offering goods or services sourced from suppliers in the country; or (3) supplying goods or services to customers in the country resulting from or involving systematic data-gathering or contributions of content from persons in the country.<sup>291</sup> This approach involves unnecessary complications, and it would be

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<sup>286</sup> *Id.*

<sup>287</sup> *Id.*

<sup>288</sup> *Id.* at ¶ 283.

<sup>289</sup> *Id.*

<sup>290</sup> “The BEPS Monitoring Group is a global network of independent researchers on international taxation, sponsored by tax justice organizations, concerned especially with the effects of international taxation on development. Its aim is to produce reports relating to the reform of the international system for the taxation of transnational corporations, with a special focus on the Tax Declaration of the G20 world leaders and the OECD’s BEPS Action Plan.” See THE BEPS MONITORING GROUP, <https://bepsmonitoringgroup.wordpress.com/what-is-the-beps-monitoring-group/> (last visited Sept. 28, 2018).

<sup>291</sup> The BEPS Monitoring Group, *Submission on Tax Challenges of the Digital Economy 9* (Oct. 2017), <https://bepsmonitoringgroup.files.wordpress.com/2017/10/digital-economy.pdf>.

difficult to monitor compliance. The BMG recognizes that factor presence nexus, “a more radical approach,” would be “easier to apply,” but has concerns that factor presence nexus would perhaps also be easier to avoid.<sup>292</sup> The EU’s permanent proposal for a new PE also would tax based on digital presence, but with minimum thresholds to three categories that should be relatively easy to determine. Nexus would exist under the EU proposal if a company has either revenues from digital services in excess of €7 million, more than 100,000 users, or more than 3,000 online business contracts.<sup>293</sup> Although this proposal is simpler than digital factors suggested by the OECD in the Final Report, it nonetheless ring-fences digital transactions.

### C. *How Could Income be Attributed to Factor Presence Nexus?*

The Final Report correctly points out that the existing rules for allocation of profits to a PE would result in “no meaningful income” being allocated to a company that has a significant economic presence but no physical presence.<sup>294</sup> Under the OECD Model, profits are allocated to a PE as if the PE were a separate and independent enterprise based on transfer pricing rules that examine assets, functions, and risks.<sup>295</sup> Where no physical presence is required, there would be little if any assets, functions, and risks that would allow an allocation of profits to a virtual presence.

The Final Report discusses adjustments that would be required to the existing profit allocation rules that consider functions and risks, including an analysis “based on game theory that would allocate profits by analogy with a bargaining process within a joint venture,”<sup>296</sup> a proposal seemingly taking complexity to an extreme. It would be necessary for purposes of certainty to have a set formula and not a variable formula determined case by case.<sup>297</sup> The Final Report also considers using a modified deemed profit method as a solution to the attribution of profits, for example, by applying a ratio of presumed expenses to revenue from in-country customers.<sup>298</sup> How the ratio would be determined, however, would have to consider the particular industry, degree of integration of the particular company, and type of product or service.<sup>299</sup> Industry-specific ratios could be determined or the ratios could be further refined by considering such factors as capital equipment, turnover, and employees.<sup>300</sup> Unfortunately, such refinements would, once again, venture into a world of hyper complexity. The Final Report notes deemed

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<sup>292</sup> *Id.*

<sup>293</sup> EC SDP Proposal, *supra* note 155, art. 4(3). See *supra* text accompanying notes 167-69.

<sup>294</sup> FINAL REPORT, *supra* note 10, at ¶ 285.

<sup>295</sup> OECD MODEL TREATY, *supra* note 20, art. 7. See OECD, ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS: BEPS ACTION 7 (Mar. 2018).

<sup>296</sup> FINAL REPORT, *supra* note 10, at ¶ 286.

<sup>297</sup> *Id.* at ¶ 287.

<sup>298</sup> *Id.* at ¶ 290.

<sup>299</sup> *Id.*

<sup>300</sup> *Id.*

profit methods are “generally perceived as relatively easy to administer and raise revenue”<sup>301</sup> but then continues with a recitation of problems with such an approach, including the hesitation once again of departing from current international standards.<sup>302</sup>

Looking to the model of states in the United States and tying into a factor presence nexus, profits could be attributed to a company based on a three-factor formula that parallels factor presence nexus—sales, property, and personnel.<sup>303</sup> Although formulary apportionment certainly would be a “departure from current international standards,”<sup>304</sup> it would be a clear and certain means of allocating profits. Professors Hongler and Pistone in their IBFD report assert that formulary apportionment is “unfeasible from a political perspective (at least at the moment),” perhaps because of a general feeling that formulary apportionment is against the arm’s-length standard.<sup>305</sup> They instead propose that the OECD Transfer Pricing Guidelines<sup>306</sup> be amended to provide for allocation of income based on digital presence by use of the profit split method, plus an upfront allocation of one-third of the profits to the market jurisdiction.<sup>307</sup>

#### D. *Objections to Factor Presence Nexus*

The main objection to a factor presence standard is that it is too major a change to make. The EC maintains that “there is little appetite for fundamental reform options,”<sup>308</sup> which flies in the face of the grand notion of the BEPS project to work together to make necessary changes to international tax rules at this “turning point in the history of international co-operation on taxation.”<sup>309</sup> The OECD’s inability to reach a solution on Action 1 clearly shows that divergent interests of countries have prevented any change to the foundation of an outdated system of international taxation. Methods of doing business changed without an international consensus, however. To continue

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<sup>301</sup> *Id.* at ¶ 291.

<sup>302</sup> *Id.*

<sup>303</sup> See UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT, 7A pt. 1 U.L.A. 365 (1957), <http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf>. See also Reuven Avi-Yonah & Kimberly Clausing, *Reforming the Corporate Taxation in the Global Economy: A Proposal to Adopt Formulary Apportionment*, in PATH TO PROSPERITY: HAMILTON PROJECT IDEAS ON INCOME SECURITY, EDUCATION AND TAXES 319-44 (Jason Furman & Jason E. Bordorff eds., 2008); Monica Gianni, *Transfer Pricing and Formulary Apportionment*, 7 TAXES 169 (1996); Paul A. Blay, *Reviving Transfer Pricing Enforcement Through Formulary Apportionment*, 7 TAX DEV. J. 28 (2017).

<sup>304</sup> FINAL REPORT, *supra* note 10, at ¶ 288.

<sup>305</sup> Hongler & Pistone, *supra* note 68, at § 4.8.1.

<sup>306</sup> OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (July 2017).

<sup>307</sup> Hongler & Pistone, *supra* note 68, at § 4.8.

<sup>308</sup> IMPACT ASSESSMENT, *supra* note 18, at 50.

<sup>309</sup> ACTION PLAN, *supra* note 6, at 25.

to apply rules that were made to deal with an entirely different form of doing business ignores the realities of the present economy.

Objections to fundamental changes are also made based on the difficulties of implementing reforms. Adopting a nexus standard that is not based on physical presence to one of economic presence would certainly require changes in the domestic laws of countries, as well as to treaty obligations. Change, however, is inevitable. Laws will have to be revised at some point as the digital economy is only going to continue to grow.

Professor Hellerstein raises the oft-neglected point that if a PE based on factors other than physical presence is instituted, how is collection of the tax enforced?<sup>310</sup> In particular he notes that “[t]he ability to enforce a tax based on a virtual PE is likely to depend in substantial part on the political will to use the means that are available, reinforced by significant penalties for non-compliance [such as blocking a company’s virtual presence], to ensure effective enforcement based on the virtual PE.”<sup>311</sup> While this issue should be recognized and addressed when countries enact laws to change nexus rules, it is not any more of an impediment to tax collection than, for example, a nexus found based on the conclusion of a contract in a country by one person where the company has no assets other than perhaps rented office space and some equipment.

The largest complaint next to a general aversion to fundamental reforms is the continually echoed refrain of “Value Creation.” The OECD included the “attribution of value created from the generation of marketable location-relevant data through the use of digital products and services” in its statement of Action 1.<sup>312</sup> From there, value creation in the digital economy took on a life of its own. Professors Olbert and Spengel find that the lack of a “common and concise” definition of value creation is a “major pitfall” to a discussion of the tax challenges of the digital economy.<sup>313</sup> But, what it has become is more than a pitfall but an apparent excuse not to move forward with reform. The United Nations perhaps puts it the best—“where value is created, by whom and what that created value is, can all be subject to considerable differences of opinion.”<sup>314</sup> The EC states that value is created “from a combination of algorithms, user data, sales functions and knowledge.”<sup>315</sup> The OECD recognizes that there is no consensus “on whether, and the extent to which [data and user participation] should be considered as contributing to a firm’s value creation,

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<sup>310</sup>Walter Hellerstein, *Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments*, 68 BULL. FOR INT’L TAX’N 346 (June/July 2014). See also Hongler & Pistone, *supra* note 68, at § 5.1.

<sup>311</sup>Hellerstein, *supra* note 310, at 348.

<sup>312</sup>ACTION PLAN, *supra* note 6, at 14-15.

<sup>313</sup>Olbert & Spengel, *supra* note 98, at 21.

<sup>314</sup>U.N., COMM. OF EXPERTS ON INT’L COOPERATION IN TAX MATTERS, 15TH SESS., TAX CHALLENGES IN THE DIGITALIZED ECONOMY: SELECTED ISSUES FOR POSSIBLE COMMITTEE CONSIDERATION, E/C.18/2017/CRP.22 (Oct. 11, 2017).

<sup>315</sup>Fact Sheet, *supra* note 18.

and therefore, any impact they may have on the international tax rules.”<sup>316</sup> Arguments could go on endlessly as to what creates value, depending on the value an activity has to a particular taxpayer.<sup>317</sup> In effect, holding up international tax reforms because of a lack of definition of “value creation,” and the strong likelihood of no agreement ever being reached on what creates value, is simply a means of preventing reforms from moving forward.

## VII. Conclusion

The reform of international tax rules is at a standstill. Despite heroic efforts by the OECD, its Action 1 has become its Inaction 1. Countries with differing interests have refused to come to a common accord to the point that countries and the EU have despaired of ever finding a common global solution and have moved forward with their own plans. As more countries enact their own provisions to tax the digital economy, the less likely it is that a consensus will ever be reached.

A factor presence nexus presents a straightforward, relatively simple solution to solve the issues of allocating taxing jurisdiction in an economy that has evolved considerably since the physical presence standard was put in place. Carving up the international tax pie based on a company’s sales, payroll, and assets would be administrable with compliance costs that are not excessive. Changing the physical presence standard is a paradigm shift from current rules that rightfully will concern tax administrations and legislatures. The advantages of moving forward with such a system, however, outweigh the disadvantages of a tax system that has not advanced with the economy and results in unfair taxation. While such a reform is seen by some as radical, it is imperative that the realities of the present economy be faced and changes made. Maintenance of the status quo is unacceptable. In the absence of confronting the challenge, countries will continue to enact a patchwork of uncoordinated laws that will create a system even more onerous and unfair than the existing, outdated system and could lead to double taxation.

The Inclusive Framework has its job cut out for it as it works against a 2020 deadline to find a consensus solution. It should seriously consider and examine the impact that a system for factor presence nexus would offer and the certainty and fairness it would bring to multinational enterprises and their countries’ tax administrations.

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<sup>316</sup>INTERIM REPORT, *supra* note 13, at ¶ 372.

<sup>317</sup>*See, e.g.,* Alison Christians & Laurens van Apeldoorn, *Taxing Income Where Value is Created*, 21 FLA. TAX REV. \_\_\_\_ (2018) (forthcoming), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3132538](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3132538) (allocating revenues to countries so as not to inappropriately benefit richer countries at the expense of poorer ones).