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NOTE ON COMMENT UPDATE OF ARTICLE 7 ON DIGITAL ACTIVITIES

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This note referrers to the report of 18 April 2019 of the Sub-Committee on Tax Challenges Related to the Digitalisation of the Economy to the Committee on 'Tax Issues related to the Digitalisation of the Economy'[1]. Rationale is presented for a formulary apportionment approach under Article 7 on the basis of a digital nexus interpretation of Article 5 under customary international law rules of interpretation[2].

Update of the UN Model Double Taxation Convention between Developed and Developing Countries – Update Commentary on Article 7 - Profit for a digital nexus.

RELEVANT KEY FINDINGS IN THE SUBCOMMITTEE REPORT OF 18 APRIL 2019 :

- The mission of the Subcommittee was to identify issues related to the digitalised economy and to present solutions that consider the following objectives:
    - avoiding both double taxation and non-taxation,
    - preferring taxation of income on a net basis where practicable and,
    - seeking simplicity and administrability.

- Some of observations that were submitted in return to the Committee suggested the following policy options :

    "., the SEP proposal, while it recognises the role of the demand-side factors, takes under consideration multiple factors as a basis for nexus and not sales alone. A nexus based on multiple factors would not affect small economies engaged in export of raw materials. ***According to this view, there is no suggestion to create nexus on the basis of sales alone, neither is the proposal to change nexus rules for non-digitalized businesses****."*

    A shift in the existing consensus to allocate the rights to tax profits to producing jurisdictions could over time become a general consensus to allocate taxing power to market jurisdictions. That may disadvantage smaller developing countries that are typically supplying and not consuming.

[1] https://www.un.org/esa/ffd/wp-content/uploads/2019/04/18STM_CRP12-Work-on-taxation-issues-digitalization.pdf

[2] See the input provided on 9 August 2020 by the author of this note to the Committee document of a draft of comment update on Article 5. Input also available on the website www.jus-tax.be.

'One risk of the current emphasis on "value creation" as the foundation stone is that if there is no consensus on what it means, then any consensus based on the term will be seen through different lenses, with the consequent possibilities of an uncertain investment environment and double taxation or even double non taxation..'

The methods of MI or UP refer in substance to the concept of value creation.

'*.. Achieving certainty and administrability may well require sacrificing accuracy to some extent, especially in the context of digitalized business taxation, where complete accuracy seems to be an unattainable target.'*

Using complex formulas, such as those that refer to existing or modified transfer-pricing methods, require tax administrations with sufficient knowledge and tools to engage in technical discussions with MNEs. Smaller developing countries would have a hard time mustering such tools for effective taxation purposes.

- A fair balance between developed and developing countries needs to explore the SEP method, requires consensus on :

  - the tax base (to allocate income),
  - factors to divide that tax base (users, sales for market jurisdictions, asset and employment for production jurisdictions).
  - weighting these factors to presume the taxable profit of the permanent establishment.

- Using apportionment for profit since digital companies don't keep books in a territory where they have no presence (digital nexus). This kind of method should use broad formulas for apportionment that strike a balance between accuracy and simplicity in order to achieve the goals of tax certainty and manageability.

  The formulary appointment method is an existing method for profit attribution if no books or accounts are kept by the permanent establishment. This would typically be the case for a digital permanent establishment. It requires :

  (a) definition of the tax base to be divided;
  (b) determination of the factors on the basis of which that tax base is to be divided and;
  (c) the weight of these factors.

  The method of profit attribution under SEP methods is defined by the Subcommittee (§ 15) as considering '*both production and sales as essential for generation of profits, and that neither can be ignored for the purpose of determining the profits that would be taxable in a jurisdiction'* and indicates that for developing countries this approach is the simplest and allows using withholding taxes for efficiency purposes.

RELEVANT KEY FINDINGS IN THE 2017 UN COMMENTS ON ARTICLE 7 :

- (# 21) : Commentary on paragraph 7 of Article 7 of the 2008 OECD Model Convention is applicable to the corresponding paragraph of Article 7 of the United Nations Model Convention :

  59. Although it has not been found necessary in the Convention to define the term "profits", it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD member countries.

- "profits attributable to a permanent establishment": profits being attributed to a permanent establishment even though the enterprise as a whole has never made profits: conversely, that directive may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

- (# 19) : Commentary on paragraph 4 of Article 7 of the 2008 OECD Model Convention is applicable to the corresponding paragraph of Article 7 of the United Nations Model Convention:

  52. It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. (..)
  It is emphasized, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. (..)
  The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. (..)
  [T]he general aim of any method [for apportioning] total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned to use the method which in the light of all the known facts seems most likely to produce that result.(..)
  It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws.(..)

- (#4 & 6) The United Nations Model Convention amplifies this attribution principle by a limited force of attraction rule, which permits the enterprise, once it carries out business through a permanent establishment in the source country, to be taxed on some business profits in that country arising from transactions by the enterprise in the source country, but not through the permanent establishment.

INPUT

1. The cited key findings are taken under consideration for the input provided on the Update on the Comment on Article 7 with regard to profits for a digital nexus under Article 5.

The key element here is that even when a digital permanent establishment can be present under the Customary International Law (CIL) rules of interpretation of treaties[3], there will be no books kept. Accounting information for the digital nexus will be determined by foreign rules.

In that context it is impossible to apply the arm's length criterion or to define by other means an 'independent entity' for profit allocation on an equal base between resident enterprises and permanent establishments that are not only digitally present on the one hand and permanent establishments that are only digitally present on the other hand.

2. It cannot be tolerated for its national tax law that foreign accounting rules determine in part or entirely the tax base in the market jurisdiction. This would be incompatible with equal treatment requirements between resident companies and permanent establishment that are not only digitally present and permanent establishments that are only digitally present.

On the other hand, that same equal treatment requirement between resident enterprises and permanent establishments in general will oblige the market jurisdiction to apply the specific rules for income allocation and tax base for digital nexus also on the other permanent establishments and resident enterprises that reach comparable levels of taxed digital activity.

Under the requirement of equal treatment resident enterprises and permanent establishments that are not only digitally present must be subject to two taxations on income from taxed digital activities. One taxation applies national tax law to determine the tax base and levy the corporate income tax. The other taxation applies the set of separate rules that apply for a digital nexus. In order to avoid double taxation, the digital tax is credited against the tax due resulting from the normal system in as far as that income was a tax base for both taxes.

3. The input provided relates to the question if this dual system can be compliant with the objectives of the Committee, the observations of the Subcommittee and the existing comments on Article 7. Does this system require tax-treaty changes and if so, could the CIL law rules of interpretation of treaties offer a fix trough tax-treaty interpretation of Article 7?

When considered, such an update of the comments on Articles 5 and 7 of the UN Model Double Taxation Convention on digital activities may deal with some urgent matters that spark tensions (for instance DST's) while awaiting consensus on tax treaty-change and the lengthy process of its implementation. It may so help to avoid a looming trade war in 2021 over digital service taxes and temporarily restore both tax and legal certainty in international taxation.

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[3] See the input provided by the author of this note to the Committee document of a draft of comment update on Article 5. Note and input also available on the website www.jus-tax.be.

ARTICLE 7 IS DEFINED BY ARTICLE 5 CIL INTERPRETATION SCOPE

4. The author of the note provided on 9 August 2020 a separate note on the draft of comment update for Article 5 on the nexus for digital activities and how customary international law rules of interpretation of treaties allow to determine a digital nexus without tax treaty change. The input provided on CIL rules of interpretation of treaties on Article 5, lead to the following key findings :

- Value creation is unfit for determining a digital nexus.
- Wealth creation allows to single out business models that create varying sizes of wealth through a digital nexus.
- Relevant criterions of digital presence that creates wealth are users, connections and contracts that must be concluded or executed digitally.
- A digital nexus is triggered by frequent digital activity.
- The frequency of the digital activity is adjusted to the size of the population.
- Income cannot qualify as a criterion of digital activity under CIL interpretation.
- Income can provide a second threshold to be met for a save harbour purpose.

The following levels of digital activity were suggested for a fixed base of digital business:

Criterion/inhabitants	Base : SCOTUS ruling 2018 scale 1 million	Base : EC draft of directive for large Member States = + 20 million inhabitants	cañada approach scale 1 million
USERS		100,000 / 20 = 5,000 per million	5,000
CONNECTIONS			250,000
CONTRACTS	200 / million		200
SAFE HARBOUR	100,000 USD / million		+ 100,000 USD

5. The following criterions were withheld to select business models with such a digital nexus:

Under the object of tax treaties criterion[4] it is to be determined where wealth is created:

- Business to Business to Consumer (B2B-2C) Model: a company operating the platform and business users that are retailers or service providers,

- Business to Consumer to Business (B2C-2B) Model : a company providing free services to build a base of potential consumers for business users, being the ultimate targeted customers of the platform,

- Digital Media Platforms: a company uses personal preferences of the customers to offer personalized choices to the customers,

[4] See Svitlana Buriak, 'A New Taxing Right for the Market Jurisdiction: Where Are the Limits?', *INTERTAX*, Volume 48, Issue 3, p. 301 – 316.

- Business to Customers (B2C) and Business to Business (B2B)[5] E-Commerce Model : Web shops can also use information of users to incite them to buy the goods bought by the company running it, rather than those of the goods of other competing companies that are also put up for sale in that web shop.

  Web shops of companies that produce their own goods or services will typically mainly or only present that group's products on their websites.

  Customers have a role of wealth creation in web shops that mainly offer goods produced by other groups.

There is no need for interpretation rules of treaties for the vast majority of groups that produce services and goods. These groups typically have, if not resident subsidiaries, at least a permanent establishment through an agent that is to follow up on customers' requests in territories with enough customers.

The purpose of tax treaties criterion[6] is next to attributing the right to tax business where it creates wealth to include also the prevention of tax avoidance and evasion[7] :

Tax distortions are more easily organised in a digital economy. They relate to income originating in a State from a digital activity offered in its national territory that is taxed differently if that income is not collected inside but outside the national territory. The tax base of origin is delocalised by allocation of the collection of the income.

Even when all income originating in that State is collected through a company or a permanent establishment set up in the national territory, allocating part of the digital activity outside the national territory can wipe out or substantially reduce the profit tax base formed by the income collected. This erosion of the profit tax base originating in the national territory is triggered by allocating part of the digital activity outside the national territory.

6. Payment not only relates in present times to legal currencies but also to monetised value of tokens that are used to barter. Some digital activities are free, others require payment in legal currencies and still others use tokens bought or bartered with a third party in another nation. How can these new types of payments – bartering digital data (tokens) for digital data (other tokens or access to websites and services) – be included for taxation and assigned a monetary value for that purpose?

For a recent example of such a new payment form: the enterprise that created the Fortnight game decided to allow its 350 million players to upgrade their avatars through the token 'V-bucks' that can be acquired on their website against legal currencies. The game itself is now made available for free in order to avoid the commission Apple claims (30 %) on apps for this game on Apple cell phones.

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[5] The author of the note inserts the B2B E-Commerce model in the selected models by Madam Buriak.
[6] See the input provided to the public consultation of the OECD on Pillar I under participant Verhaeghe.
[7] See the comments on OECD & UN Model Double Tax Conventions (OECD : version 2017, under points 11.2 and 15.6 ; UN : 2017, under points 6, 6.1 and 17.4).

Payment services occur in countless new forms and types and should also be included in scope with specific rules as to the allocated income. That is limited to charged commissions on payment services. Wallets of tokens are a new form of brokering. These business models may have additional income from selling their user data to third parties. They are generally only digitally present and avoid by doing so corporate income taxes. That allows them to charge less for their services than other financial service providers.

In order to address these new important forms of wealth creation, other financial service providers such as banks and brokers must be brought in scope. If not, discriminatory treatment may be invoked when only the newer forms of financial services fall under a separate set of taxation rules. In as far as banks and brokers pay already corporate income taxes they can credit paid taxes against that digital corporate income tax. Fairer competition between older and newer forms of competing financial services is the effect of bringing both in scope.

7. Under the criterion of prevention of tax avoidance and evasion, the groups that produce 'tools of connectivity' (computers, gsm/cellular, television, smart watches or other products that connect to the internet) present high risks of tax avoidance through intellectual property rights that are allocated in jurisdictions that organise 'patent boxes'.

They have also developed significant 'sidelines' of business-models through their tools of connectivity that create additional wealth from data of their users, commissions on sales etc.. and should be anyhow in scope for that type of income. They may as well be subject in the market jurisdiction for their income from the sales of their tools of connectivity. This in order to better prevent tax avoidance through allocation of intellectual property rights.

8. More generally, business models with increased risk of optimisation of allocation of digital activities and/or income outside the market jurisdiction can be defined as :

- Companies that offer free services and both free and paying digital information services to users : they form the first two business models in scope under that criterion.

- Companies that sell goods in the digital economy that typically include high percentages of royalties or patent rights in the price or that mainly offer goods through digital activities form the third business model.

- Companies that mainly offer other services then digital information services through digital activities form the fourth business model. Digital trading and web-based tools of payment activities form a sub category of that business model.

9. In summary[8], the following scope under the criterions of objective and purpose of tax treaties results from the CIL rules of interpretation of treaties when applied on Article 5 OECD, UN or US Model Double Tax Conventions :

[8] For more rationale, see the submission to the OECD public consultation for input on Pillar I of Verhaeghe.

BUSINESS MODELS IN SCOPE	WEALTH CREATION	PREVENTION OF TAX AVOIDANCE
(1) personalised services other than non-personalised information or standardised communication, (2) as an intermediary or directly, (3) through digital interfaces, (4) and in exchange for payment	B2B-2C Model B2B-2C sub-Model for transactional services provided for operations between users	Paying for personalized services **(AIRBNB, UBER, DELIVEROO..)** Web-payments / traders / token-platforms **(PAY-PAL, STRIPE.. / E-BAY.., /digital traders../wallets..)**
(A) goods sold in the national territory, (a1) at prices including substantial rights, or (a2) at payment of rights calculated on the profits made by selling these goods, (a3) which are payable to companies of the group by the permanent establishment or the resident company, and (B) goods of third companies, (b1) sold in the national territory, (b2) by orders received through internet or call centers,	B2C E-Commerce Model & B2B E-Commerce Model	tools of connectivity **(APPLE, SAMSUNG, HUAWEI..)** sales of goods by the internet that are not produced by that group **(ALIBABA, AMAZON..)**
(1) all access offered through digital interfaces, (2) of non-personalised or standardised information or communications, (3) that require payment	Digital Media Platforms Model	Paying services for information or standardized communication (**Netflix, HBO, news sites..)**
(1) all forms of free access, (2) through digital interfaces, (3) to digital information or communication, (4) with a commercial intent for the provider.	B2C-2B Model	Free Users or Free services (**Google, Facebook, Twitter, Skype.. / free news sites..)**

These results of business models for a digital nexus under Article 5 are those in scope for Article 7. They are in the author's view in a large extent compliant with the following findings in the report of April 2019 of the Subcommittee :

- nexus rules for non-digital business are not to be affected ;
- nexus is not determined on the basis of sales (CONTRACTS) alone.

In addition, business models in scope that pass the digital activity threshold may still be exonerated under the income threshold. In that way small innovative enterprises are not obstructed in their growth towards medium-sized companies that can be reasonably considered to be able to support the cost of assistance from professionals in complying with the filing obligations under digital activities taxation rules of various market jurisdictions.

ALLOCATING INCOME UNDER ARTICLE 7 TO THE BUSINESS MODELS IN SCOPE

1) Free of charge users and free services:

10. This 'free of charge' business model can best be sized by the number of CONNECTIONS or the number of USERS. When it comes to merchandising the user data, CONTRACTS will hardly give a good image for locating that digital activity, since companies all over the world can pay for data on potential clients in a given jurisdiction and invoices can be sent to them from anywhere on the planet. Hence the use of worldwide turnover.

Three steps seem logical to determine a realistic assumption of income created by worldwide commercialising of the number of users or the data collected on them within a national territory:

- determine the number of users or connections in the national territory for a given period as a proportion of the number of users or connections worldwide of a commercial group that reports worldwide income from that digital activity to its shareholders and whose income is substantially obtained from merchandising users and data collected from users,

- that percentage is multiplied by the worldwide cash flow for that type of digital activity and gives the gross income that can be allocated,

- that amount is adjusted by multiplying it with the product of the per capita GDP of that country divided by the average of per capita GDP of all countries with similar or higher sizes of activity for that type of digital activity; the comparative result is the gross income allocated to the digital nexus.

This gross income tax base is clearly oversized since it does not consider worldwide expenses and will lead to excessive taxation if not adjusted by means of a margin to reduce that tax base. That margin will be addressed in the next section. The groups in scope must be allowed to proof their actual income that can be allocated to their digital activities in that market jurisdiction.

2) Paid information or communication services for standardised data:

11. This business model is taxed on the fees collected from paying users in the market jurisdiction. But allocation tools for collecting income outside the national territory can hamper that profit tax base for the State where these paying users reside.

Paying users, like free users, also give rise to data mining and advertising all over the world. Soo the cash flow that is obtained from advertising, or data mining related to users, should be determined in the overall group income. Free of charge business models could be tempted to avoid taxes by charging rather symbolic subscription fees. Some business models mix both free of charge and paying users.

12. This business model can best be sized up by the criterions of CONTRACTS and USERS.

The first allocation problem is the allocation of fees collected. Delocalisation of income collected can be addressed by recipient reports of fee payments or destination-based invoices under GST, VAT or sales taxes to USERS.

The second allocation problem is the allocation of the digital service itself outside the national territory, in order to reduce or annul the profit tax base consisting of fees collected in the national territory. This problem relates to BEPS and CFC regulation for those providers who have a permanent establishment.

If no permanent establishment is present, direct income taxation is thus avoided in the market jurisdiction. Through a digital nexus one can address better that second allocation problem.

3) Digitally sold goods and material digital interfaces:

13. This type of business model will generally give the highest yield under the criterion of CONTRACTS. This is the most important criterion for countries with smaller populations since it does not relate to worldwide sales.

4) Paying digital services other than standardised data / information transfer:

14. This type of business model will generally give the highest yield under the criterion of CONTRACTS. This is the most important criterion for countries with smaller populations since it does not relate to worldwide sales.

15. A digital business model in scope may reach the size of activity for multiple presence criterions (USERS, CONNECTIONS or CONTRACTS). In order to avoid over-taxation, only the highest yielding criterion applies.

In that way, smaller countries can always fall back on the minimum turnover through contracts relating to that business model and larger countries may claim higher income if their user or connection criterion that is based on worldwide turnover exceeds the income from contracts.

Income can so be allocated through the following formula's :

Data & Formula / Criteria	example for a country with 5 million inhabitants
USERS: 25,000 yearly	GROUP data: WORLDWIDE CASHFLOW FOR THAT TYPE OF DIGITAL ACTIVITY (WCF) – NATIONAL USERS (NU) – WORLDWIDE USERS (WU) PUBLIC data: GROSS DOMESTIC PRODUCT PER CAPITA (GDPc) – AVERAGE GROSS DOMESTIC PRODUCT PER CAPITA (AGDPc) - CORPORATE TAX RATE (CTR) - MARGIN PER TYPE OF DIGITAL ACTIVITY (MDA) NATIONAL TURNOVER = WCF x NU / WU x GDPc / AGDPc PROFIT = NATIONAL TURNOVER x MDA digital CIT = PROFIT x CTR

CONNECTIONS: 1.25 million	GROUP data: WORLDWIDE CASHFLOW FOR THAT TYPE OF DIGITAL ACTIVITY – NATIONAL CONNECTIONS - WORLDWIDE CONNECTIONS PUBLIC data: GROSS DOMESTIC PRODUCT PER CAPITA – AVERAGE GROSS DOMESTIC PRODUCT PER CAPITA – CORPORATE TAX RATE - MARGIN PER TYPE OF DIGITAL ACTIVITY NATIONAL TURNOVER = WCF x NC / WC x GDPc / AGDPc PROFIT = NATIONAL TURNOVER x MDA digital CIT = PROFIT x CTR
CONTRACTS: 1,000+	GROUP data: CONTRACTS FOR DIGITAL BUSINESS IN THE NATIONAL TERRITORY – ALL INVOICES – ALL CONTESTED OR CREDITED INVOICES PUBLIC data: CORPORATE TAX RATE - MARGIN PER TYPE OF DIGITAL ACTIVITY THAT COMPANY MAINLY OFFERS IN CONTRACTS INCOME = INVOICES – CONTESTED OR CREDITED INVOICES PROFIT = INCOME x MDA digital CIT = PROFIT x CTR
SAFE HARBOUR: 500,000 USD	TURNOVER REPORTED FOR ALL DIGITAL ACTIVITIES MEETING SIZE IF LESS THAN 500,000 USD = EXONERATION PER DIGITAL ACTIVITY MEETING SIZE OF PRESENCE: ONLY ONE CRITERION OF PRESENCE APPLIES = TAX FOR THAT CRITERION OF SIZE MULTIPLE CRITERIA APPLY = COMPARE TAXES => ONLY 1 CRITERION WITH HIGHEST TAX YIELD PREVAILS FOR THAT TYPE OF DIGITAL ACTIVITY

16. Rationale for other corrections for avoiding over-taxation on a world-level are provided in the author's submission to the OECD public consultation on Pillar I. The following procedure can be considered for determining a digital nexus and allocating income to it :

Step 1: Determine if a business (line) model exceeds the size of digital activity set for that market jurisdiction to be considered a digital permanent establishment. All activities in that market jurisdiction of all controlled enterprises worldwide must be considered. A controlled enterprise is an enterprise that is part of reported consolidated results.

Step 2: Gather information on the level of the group on worldwide reported income for that business (line) model, the number of worldwide connections, users and the number of connections, users and contracts that relate to that market jurisdiction.

Step 3: Report these data to the market jurisdiction with a list of all jurisdictions where the size of activity as determined by that market jurisdiction are exceeded. The group must also provide a list of the invoices that relate to that type of digital activity in the market jurisdiction and indicate the total of those invoices that are contested or credited.

Step 4: Following that report, the market jurisdiction has access to public information on the most recently published Gross Domestic Products and size of population of itself and all other jurisdictions on that reported list.

Step 5: After calculating the allocated income to the market jurisdiction for all reported types of digital activities by that group, the market jurisdiction exonerates that allocated income if a certain threshold is not reached on the level of that group.

If that group does not comply in these steps with providing information, the tax administration is in its right to sanction and fix through presumptions the allocated income on the base of the information at its disposal. This will relate to most recent published group results, detected activity or other general information, as would have been the case for a permanent establishment that is not only digital or for a resident enterprise when not complying.

17. This procedure of allocating income can be considered in the authors' view as compliant with the objectives of the Committee :

- avoiding both double taxation and non-taxation,
- preferring taxation of income on a net basis where practicable and,
- seeking simplicity and administrability.

And of the following requirement under the SEP approach in the 18 April 2019 report of the Subcommittee:

- definition of the tax base to be divided & allocating income;
- avoid in doing so complex formulas for tax administrations of developing countries.

FORMULARY APPORTIONMENT OF ALLOCATED INCOME

18. After determining the allocated income, a tax base must be determined in that income to apply the national corporate tax rate on. A major problem over method arises in this stage when no books nor tangible factors in the market jurisdiction exist. In the report of 18 April 2019, the Subcommittee recommended a SEP approach that observes these requirements:

- determination of the factors on the basis of which that tax base is to be divided and;
- balance the weight of these factors,
- and consider in doing so both production and sales factors.

Furthermore, as already mentioned in the input on Article 5, even when books are available for a digital nexus, classic accounting standards are unfit to express the part of wealth that is created in a market jurisdiction.

19. There is no legal base under the existing Article 7 OECD MTC to justify the European Commission's approach (however cautious) recommended in March 2018 that suggested in a draft directive to the European Council that profit must be determined 'as if a separate and

independent enterprise' is present, using criteria such as functions, assets used or risks assumed.

First of all, under article 7 OECD MTC, this method requires 'dealings with other parts of the enterprise' before it can be applied. But:

1° As dealings will occur on the same server of the non-resident enterprise, a digital permanent establishment in most cases has no dealings with separate parts of that enterprise by definition.

2° Even when applying such a method, in the absence of any physical presence, there is no asset used, no risk assumed and no function on the national territory.

Allocating inside the market jurisdiction parts of the non-resident enterprise that are located physically outside the national territory cannot be considered as an interpretation in good faith of article 7 OECD MTC that may have been part of the original intent of the contracting parties when they stipulated these definitions.

This being said, this kind of method may be practicable after formal changes to tax treaties come into effect. However, the calculations required for splitting activities may prove to be at odds with the requirement of simplicity for tax administrations of developing countries. The same problem can be identified for the OECD's Unified Approach under Pillar I.

20. In their paper published on 22 October 2019 on the website of CEPS[9], L. Carpentieri, S. Miscossi and P. Parasancdolo invite their readers to further reflections on new corporate income taxes needed for the digital and immaterial economy.

Traditional profit determination has become inapt to capture the goal of taxing 'return to capital'. Intangible assets are very difficult to allocate and determine. Something has value in a digital age when used and for as long as it is used. Although one can determine how much the model is used, nobody knows how long that digital business (line) model will endure, making yearly depreciation often meaningless.

Internet and digital platforms have created an 'above territories' territory, inaccessible to national tax authorities, allowing such stateless income not to contribute to public expenditure in the countries where multinational companies sell their goods and services.

That paper also mentions the effect of corporate income tax changes under the Trump administration, that has changed from a 'worldwide' system to a 'territorial' system, thus significantly enlarging the 'above territories' territory for major U.S. enterprises. It implies rethinking corporate income taxes on domestic earnings only and excluding profits that are gained abroad. This will increase tax competition among jurisdictions.

[9] L. Carpentieri, S. Miscossi and P. Parasancdolo, *Overhauling corporate taxation in the digital economy*, paper published on CEPS website October 22nd 2019

L. Carpentieri, S. Miscossi and P. Parasancdolo suggest as a solution for updating the international corporate tax system, to only consider profit or loss as a tax base when maintaining the existing corporate income tax rules. For taxing these new business models, corporate income tax should be determined on destination-based turnover and presumptive taxes. Company activity indicators trigger presumptions of the tax base in that jurisdiction without further need to consolidate results across jurisdictions.

21. The author of this note observes also that profit on the group level cannot be a fair basis for dividing taxing rights over digital activities. First of all, the accounting rules and corporate income tax rules on the group level are in general not those of the market jurisdictions. Unequal treatment is triggered between resident companies and permanent establishments that are not only digitally present and permanent establishments that are only digitally present.

Secondly, it is possible that the bulk of investments of the group are located in one jurisdiction. All market jurisdictions see their income tax base reduced on the group level by the reduced over-all profit while they have no possible return of these investments for their national economy. Where a high level of digital activity is observed, there is an obvious mismatch.

Third, some business models set their profit margin on sales of goods or services very low or even with loss, in order to gain larger parts of the market and user data. The income retrieved of user date makes then up for the lost income on sales. It is not for that market jurisdiction to subsidize these aggressive commercial policies. A minimal profit margin on sales that occurred in their jurisdiction should be always be taxable to address such practices. Also, this aggressive commercial policy lowers the tax base for indirect taxes such as VAT, GST or sales taxes on digital activities.

22. Rulings of both the Supreme Court of the United States (SCOTUS) and the Court of Justice of the European Union (CJEU) confirmed there is no rule that obliges to tax on the basis of the accounted profit. Taxes can be levied on the basis of gross receipts when found appropriate for national tax policy objectives. These rulings are :

1) CJEU, 3 March 2020 [10].

23. The CJEU ruled on a progressive corporate income tax levied on gross income from telecommunication services in Hungary :

> *"44. In this case, the law on the special tax on certain sectors makes no distinction between undertakings according to where they have their registered office. All the undertakings operating in Hungary in the telecommunications sector are subject to that tax, and the tax rates that are, respectively, applicable to the various bands of turnover defined by that law apply to all those undertakings. That law does not, therefore, establish any direct discrimination*."
> *(..)*
> *50. In that context, and contrary to what is maintained by the Commission, progressive taxation may be based on turnover, since, on the one hand, the amount of turnover constitutes a criterion*

[10] CJEU, 3 March 2020, case C-75/18, Vodafone Magyarország Mobil Távközlési Zrt. v. Nemzeti Adó- és Vámhivatal Fellebbviteli Igazgatósága, ECLI:EU:C:2020:139

of differentiation that is neutral and, on the other, turnover constitutes a relevant indicator of a taxable person's ability to pay."

2) CJEU, 3 March 2020 [11].

24. The CJEU ruled on a progressive corporate income tax levied on gross income from retailers in Hungary and found similar considerations as in the other case but considered also :

"71. In this case, it is apparent from the material available to the Court, in particular from the passage in the preamble of the law on the special tax on certain sectors quoted in paragraph 3 of the present judgment, that, by means of the application of a steeply progressive scale based on turnover, the aim of that law is to impose a tax on taxable persons who have an ability to pay 'that exceeds the general obligation to pay tax'."

3) CJEU, 27 June 2019[12].

25. Reasons that can be identified as considerations on horizontal and vertical equity (cited from §§ 87, 89, 103 and 104, 122) are :

A consideration that relates to horizontal equity (cited from §§ 87 and 103):

- *..the progressive structure of a tax rate cannot as such be contrary to the objective of collecting budgetary revenue.* ***Similarly, the objective of promoting public burden sharing is very general and could be put forward for most taxes****...(..).. it cannot be excluded that a redistributive purpose may also justify the progressivity of a turnover tax, as the Government of Hungary rightly maintains in the present case*.

Considerations that relate to the ability to pay, progressive tax rates / exemptions and safe harbour (cited from §§ 89, 122 and 103-104):

- *It may reasonably be presumed that an undertaking which achieves a high turnover may, because of various economies of scale, have proportionately lower costs than an undertaking with a smaller turnover — because fixed unit costs (buildings, property taxes, plant, staff costs for example) and variable unit costs (raw material supplies for example) decrease with levels of activity — and that it may, therefore, have proportionately greater disposable revenue which makes it capable of paying proportionately more in terms of turnover tax*.

- *The distinguishing criterion chosen by the Hungarian authorities of not having generated profits in 2013 is objective. It is whether the undertakings concerned met that criterion which is random. Lastly, in the light of the Hungarian legislature's objective of introducing sectoral taxation with a redistributive purpose, that criterion, which is intended to ensure in the first year of the advertisement tax's introduction a moderate tax burden for taxable persons in an unfavourable situation, establishes a difference in treatment between undertakings not in a similar situation: the profit-making undertakings in 2013 and undertakings not having made profits that year.*

[11] CJEU, 3 March 2020, case C-323/18, Tesco-Global Áruházak Zrt. v. Nemzeti Adó- és Vámhivatal Fellebbviteli Igazgatósága, ECLI:EU:C:2020:140

[12] CJEU, 27 June 2019, case T-20/2017, European Commission v. Hungary, ECLI:EU:T:2019:448

- *A redistributive purpose may indeed even justify a total exemption for some undertakings (..) Consequently, as regards a turnover tax, a variation criterion taking the form of progressive taxation above a certain threshold — even if that threshold is a high one — which may reflect the wish to tax an undertaking's activity only when that activity reaches a certain level, does not in itself imply the existence of a selective advantage*.

4) SCOTUS, 21 June 2018 in the case *South Dakota v. Wayfair*[13].

26. This ruling applies horizontal equity by considering that:

- only resident companies still pay taxes, which disturbs the even playing field among competitors and among states that can no longer meet their financial obligations,
- consumers who buy local products pay taxes that other consumers avoid by ordering from another State,

and vertical equity:

- the requirement of a threshold of activity or income before a digital activity can be taxed (safe harbour).

Only when the activity of a non-resident company is deemed to have a relevant size, does it become fair under this ruling to tax gross income in the market jurisdiction, so that this competitor contributes also to the general budget.

The ruling also specifically states that fairness dictates that major loss of public finances must be addressed in an economy where up to 10 % of commercial transactions have become digital and considers on fairness (p. 17 ruling):

> *"**But there is nothing unfair about requiring companies that avail themselves of the States' benefits to bear an equal share of the burden of tax collection**. **Fairness dictates quite the opposite result**. Helping respondents' customers evade a lawful tax **unfairly shifts to those consumers** who buy from their competitors with a physical presence that satisfies Quill—even one warehouse or one salesperson—**an increased share of the taxes**. It is essential to public confidence in the tax system that the Court avoid creating inequitable exceptions. (..) In the name of federalism and free markets, Quill does harm to both. The physical presence rule it defines has limited States' ability to seek long-term prosperity and has prevented market participants **from competing on an even playing field**."*

5) SCOTUS, 18 May 2015 in the case *Comptroller of the Treasury of Maryland v. Wynne*[14].

27. This ruling pointed out that corporations benefit from general services when conducting their business in that territory (p. 13):

> *"Attempting to explain why the dormant Commerce Clause should provide less protection for natural persons than for corporations, petitioner and the Solicitor General argue that States should have a free hand to tax their residents' out of state income because States provide their residents with many services. As the Solicitor General puts it, individuals "reap the benefits of local roads,*

[13] https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf
[14] http://www.supremecourt.gov/opinions/14pdf/13-485_o7jp.pdf

local police and fire protection, local public schools, [and] local health and welfare benefits." Brief for United States as Amicus Curiae 30.

*This argument **fails because corporations also benefit heavily from state and local services**. Trucks hauling a corporation's supplies and goods, and vehicles transporting its employees, use local roads. Corporations call upon local police and fire departments to protect their facilities. Corporations rely on local schools to educate prospective employees, and the availability of good schools and other government services are features that may aid a corporation in attracting and retaining employees. Thus, disparate treatment of corporate and personal income cannot be justified based on the state services enjoyed by these two groups of taxpayers."*

Gross receipts can be a tax base between States of the United States (p. 11 and 12 of the ruling):

" ... *The discarded distinction between taxes on gross receipts and net income was based on the notion, endorsed in some early cases, that a tax on gross receipts is an impermissible "direct and immediate burden" on interstate commerce, whereas a tax on net income is merely an "indirect and incidental" burden*. (..) *And we have now squarely rejected the argument that the Commerce Clause distinguishes between taxes on net and gross income."*

When applying this ruling, under the criterion of horizontal equity non-resident companies can be asked to participate in costs of several public services in the source country to which they do not contribute.

28. Some of these rulings consider that the ability-to-pay theory is a rationale to contribute more from a general redistributive perspective. To put so to speak more weight on the strongest shoulders. And so even for general public spending they did not necessarily benefitted from directly or indirectly for their digital activities in that jurisdiction. Abusive taxation can be avoided through equal treatment requirements: resident enterprises are subject to similar taxation when complying with the criterions of taxation.

On that basis, the author of the note considers a factor to determine the profit margin that relates to the effects on public spending that is *caused* by digital activities. Digital activities provoke various types of enterprises to stop their non-digital activities, to adjust these activities by laying off workers. Sometimes new algorithms allow to increase profits by supplanting workforce in the wealth creation in response to competing enterprises. It is then for the general budget to provide for income and reschooling of those affected by such digital activity.

Could a part of the tax base be determined on that basis of that factor of *caused* public spending that not benefited to that enterprise without treaty override? Resident enterprises can also cause this type of public spending through their digital activities in the market jurisdiction. It could be considered fair to subject them under national tax policy on a minimum level of corporate income taxation through the digital corporate income tax in order to redistribute and improve more equal sharing among taxpayers of public spending caused in part by their activities. When also applying the set of rules for digital nexus on resident companies that reach the same levels and types of digital activity as for digital nexus, the rule of equal treatment imposes to do so also for permanent establishments that have only a digital presence.

29. The benefit theory and the ability-to-pay theory relate way back in ordering international taxation on income as pointed out in October 2018 by the Belgian Professor Debelva[15]. His findings point out that debates on fairness in international taxation occurred over time on two levels: horizontal equity (benefits justify taxes) and vertical equity (taxpayers with different amounts of income should pay different amounts of tax, or ability to pay).

This author subsequently found '*…The exemption method appears to not be compliant with horizontal equity requirements in any situation in which the states involved apply different tax rates. In such cases, the taxpayer obtaining cross-border income will pay more or less than his domestic counterpart. (..) The ordinary tax credit method (CEN) also cannot fully attain horizontal equity, which can be explained by the fact that in practice, a full tax credit is never provided*. '

Applied to digital activities, these new technologies allow providers of digital goods and services to remain untaxed, which creates an inter-nation horizontal equity problem according to Debelva. Tax bases are not adequately shared between the States and this may provoke tax migration. This also creates an inter-personal vertical equity problem. Multinational enterprises can best use these new technologies to pay less tax than domestic taxpayers.

30. From the vertical equity point of view, it would be fair to single out business models that use means of allocation of payment for digital services that can avoid or reduce taxation. If the profits made through such business models are considerable, from the vertical equity point of view also, these business models should contribute more.

The effects of digital activities relate to far more than avoiding taxation. Other disturbing effects of digital activities may require measures to partially compensate the costs both resident and non-resident enterprises using digital activities bear less than a fair share of the general costs they induce of (horizontal equity point of view):

- job loss due to replacing human functions with algorithms,
- reduced social welfare contributions through creating contractors that mainly depend on executing decisions of algorithms,
- increased pollution from individualized package deliveries and massive returns,
- costs of carbon-free production and storage of electricity to constantly supply these activities on the national territory and costs for reinforcing electricity networks both upstream and downstream from the various points of carbon-free production of electricity (solar panels on buildings, windmills etc.,
- cost for supervising telecommunication networks and electronic payments.

31. Digital activities are also unique in their production process; both the countries of the location of the server and the connection to that server have a share of the wealth created in their territories. This production process is described as prosumption; the users produces in part what he consumes by providing his data, choices etc..

[15] Prof. F. DEBELVA, 'Fairness and International Taxation: Star-Crossed Lovers?', World Tax Journal, 2018, (volume 10) N° 4, published on 9 October 2018

A large part of the allocated income should be reserved for taxation by the country of residence of the provider of the digital activity, since expenses are deducted from that tax base (servers, office space, programmers, administration) in that country.

A share of 50 % can be considered to compensate the deductible costs in the country of residence that reports to its tax authorities the turnover allocated to the digital dixus by the market jurisdiction. This means 50 % of the tax base derived from turnover allocated to the digital nexus cannot be taxed by the market jurisdiction.

The remaining allocated turnover is then considered profit to be divided through a profit margin between the market jurisdiction and the jurisdiction that must exempt or allow credit on national CIT on reported income for the digital CIT levied by the market jurisdiction.

By not exceeding a profit margin of 25 %, the market jurisdiction can be considered to leave an equitable share of the presumed profit allocated in its territory to serve as either further deduction of costs or taxable profit in that other jurisdiction. In theory, profit is thus divided equally between both countries where these 'prosumption' digital activities occur.

32. For the market jurisdiction, that profit margin can be set in comparison to profit margins resident companies report on similar digital activities, while not exceeding that suggested 25 % margin. Others margins may be considered by the Committee for specific sectors, the 25 % is randomly determined for the purpose of formulary apportionment. Provided there is a rationale for treating comparable economic sectors differently.

But, existing sectoral profit margins registered in the national economy may be low in that sector and incite to exclude the profit factor in the weighing of factors. But caution must be observed when these domestic sectoral profit margins may be too low because of the pressure of tax distortion by the non-resident competing enterprises. Given the suffered pressure over the past years on profits through location savings and lower taxes by non-resident enterprises on the whole of that sector. The accounted profit margin for local enterprises does also not reflect the ability to pay nor the costs avoided by the non-resident enterprise and when considered may reward the pressure exerted on overall profitably through outsourced digital activities. The proposed cure would then worsen the disease it seeks to fight when considering national accounted profits as an indicator for a maximum profit margin for the digital nexus.

33. Given these considerations, horizontal equity can be said to mean for determining profit margins in the allocated income that:

(1) comparable sizes or types of digital activities in the national territory contribute on similar shares of their national turnover since they 'consume' comparable quantities of public services, such as roads, electricity produced and distributed, regulations on telecommunication providers and networks, safety of payments...

(2) wealth is created by user input in the production process of digital activity,

and vertical equity can be considered to mean that:

(3) higher profits justify higher taxes (ability-to-pay principle),

(4) businesses models with effects that entail higher costs to the nation, contribute a larger share of their income (a 'cost principle' for supplanting other businesses or human functions with effects on national budgets). Such costs include loss of tax income, job losses, idle buildings, costs of educating the unemployed, use of skilled employees...

(5) larger businesses must be prevented from exploiting their size to elude taxation (BEPS),

(6) and smaller businesses should be exempted (safe harbour).

Under these 6 criteria, both resident and non-resident enterprises with business (line) models that relate to digital activities can be estimated to have profit margins (MDA) between 10 % and 25 %. Resident enterprises and physical permanent establishment already pay CIT and so contribute effectively to the general budget. They must be allowed to deduct the CIT that relates to income that is also taxed for digital CIT purposes from the digital CIT that is due.

34. The other criteria that can then be applied to these various business models pertain to profits (ability to pay), user input of data and avoidance of costs caused under that business model such as the electricity and telecommunication required by users that are regulated and/or publicly provided for in their jurisdiction and avoided local costs of functioning (location savings).

Avoiding payment of taxes as the taxes that are paid by resident companies that not seek to avoid these costs is but a way of making profit for non-resident and resident companies that enjoy comparable benefits of services financed by the general budget of authorities. This warrants the presumption of profits made through avoided costs considerations.

35. The tax base in the allocated turnover can be determined through weighted margins per type of digital activity (MDA) that express horizontal and vertical equity by counting in the weighed profit margin each one of these factors :

- the risk of avoiding tax costs (T),
- the high profit margin for that type of business (P),
- the value of user input in production (U),
- avoiding payment for costs generated such as provoking high use of electricity by users in the market jurisdiction (C),
- location savings that refer to the ability to set prices targeting resident competitors and thus causing job losses or the ability to substitute workers by independent contractors (S).

36. The cañada approach implies in total 7 steps, of which step 1 to 5 relate to determining a digital nexus and allocating income to that jurisdiction for that business model in scope. Enterprises can prove that another amount of income was collected.

Steps 6 and 7 relate to the profit margin that is presumed per business model in scope and that is a fixed margin in the allocated income for that business model. Enterprises cannot prove that

less profit is accounted in their books from that digital activity. This ensures a minimum level of effective taxation that is equal for all competing enterprises in that market jurisdiction. Steps 6 an 7 are :

Step 6: When the allocated income is so determined as a whole; the market jurisdiction has to check if it can determine in the group's report if part of that allocated income is also taxed by resident enterprises (subsidiaries) or physical permanent establishments. That part of allocated income will then be considered a separate tax base outside the tax base for the digital nexus. The remaining allocated income is then attributed to the digital nexus of the reporting enterprise of that group.

Step 7: On the allocated income per digital nexus, the market jurisdiction applies a presumed profit margin (Margin of that Digital Activity) and multiplies this with the corporate tax rate. The result is the digital corporate income tax.

The allocated income that was split under step 6 will then be only taxed under normal corporate income taxes unless that other resident enterprise or physical permanent establishment of the group satisfy themselves to the sizes of digital activity and income for a digital nexus. In that case they suffer both systems and can credit the second tax against the normal corporate income tax is as far as that tax relates to that income.

37. When giving for the ease of an example an equal 5 % margin to each factor, the following formula can be applied for a weighed profit margin in the allocated income to business models that have create wealth through digital activities in the market jurisdiction :

type of digital activity	Criterion (expected highest yield for tax base)	margin
Paid services for information or communication of standardised data.	USERS / CONTRACTS	10 % T & C
Free of charge users or free services.	CONNECTIONS / USERS	15 % T & U & P
Sale of goods that include substantial intellectual property rights in the price than can be used as connection tools.	CONTRACTS	15% T & P & C
Online sale of goods that are not produced by the seller.	CONTRACTS	20 % T & U & P & S
Paying services for personalised data or services / web-payments / traders / token-platforms.. (except professions that cannot legally sell their clients' data to third parties and must generally meet clients in person).	ALL THREE CRITERIA	25 % T & U & P & C & S

1) Paid services for information or communication of standardised data.

38. The impact of this business model on national job losses (S) seems low (loss of video shops and movie theaters) ; the value of user input (U) is minimal and profits (P) do not seem to be particularity high.

There is a high risk for tax distortion (T) for collecting income outside the market jurisdiction since they can commercialise their user data and invoice outside the national territory the publicity they serve to national users.

These business models rely heavily on connection tools and large amounts of electricity to send images, and wireless connections to operate them, provided by their users and by regulated telecommunications networks that are sometimes physically maintained by government entities. This general cost factor (C) for provided services requires a higher contribution in this business model.

2) Free of charge users or free services.

39. The effect of risks for tax distortion and avoidance is high (T). They commercialise the data of their users worldwide as a business model and can invoice from any given jurisdiction to any given jurisdiction that is not the market jurisdiction. Their profits are typically high (P) because they do not pay their users for their input. User have an important share in wealth creation trough their choices and other data they provide (U).

These enterprises provoke major shifts in other business models by communicating commercial information to their users, which results in both winners and losers in other enterprises in and outside the national territory. This is but an indirect effect on employment, that is not provoked by direct competition. So factor (S) is not withheld. As to factor (C), these business model allows sharing messages and images. Cost factor (C) is considered to be less present.

3) Digitally sold goods and material digital interfaces:

40. The criterion of ordering goods through digital interfaces is far too wide to constitute a relevant digital activity that presents typically high risks for tax distortion. Often agents are present in the market jurisdictions with enough customers for these goods.

As far as the sale of tools of connectivity are concerned, user input is not required (U). The effects on job loss in other business models (S) can sometimes be positive in the national territory : they create new shops and jobs. Their profit margin (P) can be assumed to be high as can be their ability to tax engineer (T). The third effect taken in consideration is the need for transportation and delivery of their material goods (C).

The sale of goods exclusively through internet by companies with a model similar to ALIBABA, AMAZON etc.. are highly disturbing for other existing business models with great job losses as a result in traditional activities such as retail sales (S). They do not contribute to these costs. They can also avoid tax cost easily by allocating payment or digital activity outside the territory

(T). They also cause increased traffic (through various contractors) and pollution (C). Profits on the sold goods is often low (P. because prices are set to acquire market-shares. They can in turn market increased volumes of user data intragroup and to third parties (U). So (P) and (U) are here combined into the factor (U).

4) Paying digital services other than standardised data / information transfer:

41. This business model aims at call centers, traders or web-based paying services that can be set up all over the globe without requiring physical contact with clients. Risks of relocating income collection or parts of the digital service are high here (T). Location saving also allows presumption of high profits through avoided costs (P). User participation is essential in the wealth creation of personalized services (U) ; that user date provides another source of income when marketed.

As this type of business model has the highest potential of supplanting national employment by international relocation or substitute workers functions by algorithms, a factor (S) is present. As to the other general costs (C) ; this type of activity can be considered to have an intensive use of telecommunication in order to conclude, monitor and control operations in the market jurisdiction. This especially when related to transportation services of goods or persons by (semi) independent contractors.

42. Please note that under this approach multiple business models can apply for a group :

- For a group like Apple, income out of the sales of tools of connectivity (15 % margin) is treated differently than income from commissions on applications (paying services) (25 % margin). This are two separate taxable business models under this approach.
- For a group like Amazon, Alibaba or Zalando, income out of sales of their own products on their websites (20 % margin) is treated differently that income from commissions on sales of other enterprises using their platform (25 % margin).
- For a group like Google (Alphabet) or Facebook, income out of marketing data from free users (15 % margin) is treated differently then payments collected for having access to standardised information (10 % margin) or payments collected from various paying individualized services (upgrade visibility of a website in the search criterions) (25 % margin). On their sales of tools of connectivity, a 15 % margin applies, on other goods of third parties they sell a 20 % margin applies.

43. This approach meets the following objectives :

- Rationale for the determination of the factors on the basis of which the tax base is to be divided for a business model in scope. That rationale relates to existing principles of benefit and ability-to-pay and recent case-law.
- use of broad formulas for apportionment that strike a balance between accuracy and simplicity in order to achieve the goals of tax certainty and manageability,
- existing or modified transfer-pricing methods are not considered, nor is value,

The provided input leaves open for discussion what weight each factor should have in a business model in scope and what total margin all factors combined should better not exceed.

Result of CIL rules of interpretation of treaties applied on Article 7 under this approach.

44. In his input provided on Article 5, the author of the note cited extensively the rationale for the customary international law rules of interpretation as acknowledged in two resolutions of 20 December 2018 by the General Assembly of the United Nations.

These rules require in substance :

- To apply the criterions of interpretation laid down in the Articles 31 and 32 VCLT[16] in one single combined interpretation, in good faith, in the present context.

- When confronted with an outcome that is unclear, ambiguous, manifestly unequitable or absurd when applied in present times, to give an interpretation that is consistent with the purpose of tax treaties and the original objective of the parties.

- These rules can fully apply when no specific definition is given to a notion in the treaty. In that case it is presumed this notion can evolve over time in the intent of the parties.

An ambulatory interpretation under Article 3(2) OECD MTC is no treaty override to the extent that the application of the new national definition does not exceed the limits established by the treaty context[17].

45. These rules of interpretation, as customary international law, apply immediately and universally on all existing treaties, as was also laid down in these resolutions that were adopted on 20 December 2018 by the General Assembly of the United Nations. There is no rationale to exclude tax treaties from these rules.

The hard law base for that effect is provided by Article 38, paragraph 1 (b) of the Statute of the International Court of Justice that recognizes customary international law as a source of law to settle disputes between countries.

In the Common law tradition, the most recent rule prevails. That is customary international law by definition. In the Continental law tradition, the Statute of the International Court of Justice obliges to customary international law above national laws and treaties.

46. There is no general conflict of the cañada approach with Article 7 under CIL rules of interpretation, since the term 'profit' in tax treaties relate to gross income from business conducted in the market jurisdiction, and 'expected to make' or 'attributed to' allows the use of formulary apportionment. As pointed out in the existing comments on Article 7 when faced with the absence of books.

The factor (S), that relates to costs *caused* by the digital activity in the digital nexus, other than general costs for publicly provided services that benefited to that digital activity, may require a test under CIL rules of interpretation.

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[16] Vienna Convention on the Law of Treaties of 23 May 1969 *(United Nations Treaty Series, vol. 1155, p. 331)*

[17] C. Di Pietro, 'Tax Treaty Override and the Need for Coordination between Legal Systems: Safeguarding the Effectiveness of International Law', *World Tax Journal*, 2015, February 2015, p. *73.*

But, as pointed out before, recent case-law allows countries to tax on the base of gross receipts with the following objectives: fairer spreading of budgetary costs and requesting higher contributions from stronger shoulders. It is clear that this can be requested from resident enterprises by their tax authorities.

When the special rules for a digital nexus are also applied to resident companies, it becomes then under equal treatment requirements in tax treaties mandatory to tax in a similar way a permanent establishment that meet equal sizes of digital activity in that market jurisdiction.

A similar logic applies for the factors T and C. But avoided costs (both tax and general budget costs) are but a way to preserve a larger share of the gross income. They are so more relevant to determine the income that is expected to result from the wealth creation of a business model in scope.

47. The cañada approach so basically seeks to obtain through the selected factors a minimal contribution to costs of used services that are provided for at the expense of the general budget of authorities (benefit theory : factors U and C) and a fairer share in supporting that same general budget (ability-to pay : factors T, P, S) of that market jurisdiction.

There is no apparent conflict in the author's view under the CIL rules of interpretation of Article 7 OECD, UN or US Model Double Taxation Conventions :

1. *Textual method:*

48. The word 'profit' in tax treaties has been given the general meaning of all gross income that can be obtained from a business nexus. The words 'expected to make' or 'attributed to' allow the contracting parties to allocate that income and determine a tax base in that allocated income.

This article allows to presume allocated income by lack of books or other accurate documentation. As long as the requirement of equal treatment are observed between resident companies and permanent establishments, contracting parties can exert in turn their sovereign powers to fix a tax base that is compliant with the national tax policy objectives.

There is no text base to exclude in good faith any of the five factors that fix a tax base.

2. *Historical method:*

49. Presumptive allocation of income to a nexus is generally accepted. The arms' length and transfer-pricing concepts are applications of the principle that contracting parties have the right under the treaty to overrule booked income when in conflict with a normal wealth creation through the business activity of the nexus. There is no reason why digital business activity should be treated otherwise. In absence of books, presumptive allocation of income can be used in good faith.

The ability-to-pay theory and the benefit theory are historically accepted criterions for dividing taxing rights over income allocated to a nexus. All five factors that fix the tax base relate back to either one of these two principles. Their combined effect cannot exceed a certain level for the jurisdiction of the digital nexus. The other part of the allocated income can only be taxed in the jurisdiction where the enterprise declared the income that is allocated to the digital nexus in the market jurisdiction.

3. Teleological method:

50. The main purpose of tax treaties is to tax wealth where it is created and to the extent that is was created in that market jurisdiction.

The OECD has inserted the following purpose of tax treaties into the OECD Model Double Taxation Convention, version 2017, under points 11.2 and 15.6:

> *"11.2 Since the publication of the first ambulatory version in 1992, the Model Convention was updated 10 times (in 1994, 1995, 1997, 2000, 2002, 2008, 2010, 2014 and 2017). The last such update, which was adopted in 2017, included a large number of changes resulting from the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and, in particular, from the final reports on Actions 2, 6, 7 and 14 produced as part of that project (..)*
>
> *15.6 An important objective of tax treaties being the prevention of tax avoidance and evasion, (..)"*

Since 2017, prevention of tax avoidance and evasion is a recognized purpose of tax treaties for the OECD. Similar objectives can be noted in the UN Model Double Taxation Convention of 2017, under points 6, 6.1 and 17.4:

> *"6. Broadly, the general objectives of bilateral tax treaties therefore include (..) They also aim to prevent certain types of discrimination as between foreign investors and local taxpayers, and to provide a reasonable element of legal and fiscal certainty as a framework within which international operations can confidently be carried on. (..) In addition, the treaties seek to improve cooperation (..) with a view to preventing avoidance or evasion of taxes and by assistance in the collection of taxes.*
>
> *6.1 Finally, it has become clear as a result of international focus on base erosion and profit shifting that treaties are not intended to facilitate treaty shopping and other treaty abuses.*
>
> *17.3 In particular, the Committee noted that the Manual provides the following useful checklist of the benefits and costs commonly associated with tax treaties :*
>
> - *Avoidance of fiscal evasion."*

The 2017 UN Model Double Taxation convention also cites point 15.6 of the OECD Model Double Taxation Convention.

The use of presumed allocated income to a nexus is compliant with both these purposes, as is using five factors in order the achieve a minimal level of taxation that applies equally on all competing enterprises in that market jurisdiction, regardless of where these enterprises are established. In all business models the 'T' factor is present as the factor that responds to the

increased risk of tax avoidance through that business model that has use of digital activities in that market jurisdiction.

4. Ambulatory method:

51. The term 'profit' was not defined. Nor how to 'attribute' nor how to 'expect' it. It's meaning can so evolve in present times where digital activities require other factors.

The five factors make use of recent case-law and are compliant with general tax policy objectives in present times that relate to a more equal sharing of the tax burden among all enterprises that create wealth in the jurisdiction of the contracting party through their digital activities.

5. Good faith test:

52. This combined interpretation of these four methods is in line with good faith, since they seek to address tax distortion between competing enterprises in the same jurisdiction by imposing on all enterprises involved in similar digital activities a minimal equal share in tax burden. In doing so, wealth creation nexus and equal treatment are observed.

6. Unclear, ambiguous, manifestly unreasonable or absurd test:

53. This combined interpretation that presumes income by factors of both high income and risks for avoiding fiscal costs and general costs does not lead to a meaning of 'profits they can be expected to make' or 'attributed to' that is unclear, ambiguous, manifestly unreasonable or absurd.

The presumed allocation of income to a digital nexus can be rebuked by proving the actual income obtained through the activities of that digital nexus.

The rationale for the five factors relates back to generally accepted objectives and purposes of tax treaties. They must be applied in present times on business activities that are unfit for applying the usual factors for determining profit on the base of books or records.

54. Four of the five factors that fix the tax base relate to either presumed net income (U & P) or avoiding expenditures of that gross income that resident companies with similar activities are subject to (T & C). They all four presume more income that can be taxed.

Excluding the factor 'social costs' (S) because it relates not to more income for the enterprise, but to the expenditure for the contracting party that is provoked by the taxed digital activity, would be in present times manifestly unreasonable. Recent case-law accepts that enterprises can be requested – in as far as equal treatment is observed - to contribute more to the general budget of a contracting party when more successful.

Factor S is only applied on business models that already have the factor P of high presumed profits or when the factor (U) has a similar effect of presumed net income.

55. In a digital economy, various human functions are already, or will be, supplanted by digital activities, as algorithm performances increase every year. The companies that apply this often argue that they have no choice because their competitors have started or will start doing so. One job out of five existing in Europe in 2016 is estimated to be supplanted by 2030 by algorithms[18] and it is fairly uncertain whether job creation by digital activities will compensate this lack of national income from a personal income tax perspective.

On the other hand, the nation is very certainly exposed to the loss of revenue from income tax on the supplanted human functions, to the need to provide social welfare and to the costs of education that might allow these workers to acquire new digital skills for their next job.

56. From the point of view of both horizontal equity and vertical equity, it would therefore be fair to single out both resident and non-resident business models that are typically reviewing their ways of doing business by replacing human functions with algorithms, or that use contractors who for the most part are actually mere executioners of decision-making algorithms of that enterprise.

These enterprises could be subject to higher taxes in order to contribute to the higher costs they induce for the general budget of the market jurisdiction where they obtain their income. True, this increase in taxation may in turn accelerate the process of supplanting human functions in order to maintain profits. But that would happen in any case over time, as technology progresses. This is what history learns on prior industrial revolutions. At least in the meantime the nation would recover income to face these costs caused by digital activities.

CLOSING REMARKS

57. The input provided in this note builds further on the digital nexus input provided for the comment update on Article 5 on 9 August 2020.

The cañada method achieves most of the policy objectives the Committee and the suggestions of the Subcommittee. It may therefore be taken under consideration when organising taxing rights in the digital economy that can be applied by both developing and developed countries.

The author hopes that the provided input may inspire the Committee in its ongoing efforts to that end.

Brussels, 17 August 2020,

P. Verhaeghe

[18] McKinsey & Company, *Digitally-enabled automation and artificial intelligence: Shaping the future of work in Europe's digital front-runners*, October 2017, p. 72