

# Tax Wars: How to End the Conflict Over Taxing Global Digital Commerce

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In the last two years, dozens of governments have proposed or implemented unilateral tax measures to tax foreign-based technology companies. The new tax innovations include special withholding taxes, diverted profit taxes, minimum taxes, and digital services taxes. The rise of these unilateral measures threatens an international tax “war” among governments that could stifle new business models or even the spread of the global digital economy. This Article reviews the failure of international reform efforts to constrain aggressive international tax planning, and how the global digital tax conflict masks a growing dissatisfaction with how to tax value associated with global transactions. The best way to address these global developments is through a coordinated solution that creates an economic presence test (a Quantitative Economic Presence Permanent Establishment) and modifies the division of tax revenues between countries (e.g., the Residual Profit Split by Income proposal).

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DOI: <https://doi.org/10.15779/Z38H70815H>

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In the present day, in the galaxy in which we dwell . . .

#### Tax Wars

Turmoil has engulfed the global economy.

The taxation of digital trade routes is in dispute.<sup>1</sup>

### I. INTRODUCTION

Since the mid-1990s, tax authorities have grappled with the challenges presented by the taxation of cross-border e-commerce, which is now generally described as “digital commerce.” To a considerable extent, reform efforts were coordinated and relied upon traditional income tax laws and principles. All was relatively quiet until the OECD Base Erosion and Profit Shifting (BEPS) initiative of 2013.<sup>2</sup>

By this point, digitalization had a significant impact upon the global economy with global digital commerce representing an ever-growing proportion of overall economic activity. As part of this phenomenon, firm value was increasingly associated with intangible assets (such as brands, goodwill, patents, copyrights, trademarks) as evidenced by the rise of the global tech behemoths known collectively as the FAANGs (Facebook, Apple, Amazon, Netflix and Google).<sup>3</sup>

1. With apologies to George Lucas, we paraphrase the opening screen crawl of *Star Wars: Episode I – The Phantom Menace* (1999), which revealed that the dispute over “the taxation of trade routes” launched the galactic war between the Sith and the Jedi (for Star Wars purists, the war was technically between the Republic and the Trade Federation).

2. The first part of this article draws from Arthur J. Cockfield, *Tax Wars: The Battle of Taxing Global Digital Commerce*, 161 TAX NOTES 1331 (Dec. 2018). We also discuss these developments in ARTHUR COCKFIELD, WALTER HELLERSTEIN & MARIE LEMENSCH, TAXING GLOBAL DIGITAL COMMERCE (2nd ed. 2020)[hereinafter TAXING GLOBAL DIGITAL COMMERCE].

3. For instance, the value of intangibles for firms on the S&P 500 went from 68% of the overall value in 1995 to 84% of overall value in 2015. See OCEAN TOMO, INTANGIBLE ASSET MARKET VALUE STUDY 2–3 (2019) (discussing how the OECD reform process hopes to generate a coordinated solution in

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These multinational firms transact remotely in global goods and services—without the need for any significant physical resources within countries with large consumer markets.<sup>4</sup> In addition, intangible assets are notoriously hard-to-value mobile factors of production and can often, via tax planning, be shifted out of high-tax countries to low or nil jurisdictions.

This digitization, combined with other technology/business developments such as cloud computing, the rise of remotely-provided software as a service (SAAS), and the global monetization of personal data gathered from social media, threatens the ability of large consumer markets to enjoy significant cross-border income tax revenues.<sup>5</sup>

In some cases, the amount of revenue losses appears large, such as the European Union’s assertion that Ireland provided tax benefits of 13 billion Euros (roughly USD \$15 billion) to Apple, which allegedly constitutes illegal state aid.<sup>6</sup> Recent tax haven data leaks, including the Paradise Papers of 2017, show that, in light of media attention and global tax reforms, companies such as Apple and Google restructured their global affairs through ongoing aggressive tax planning, which contributed to revenue losses in high tax countries.<sup>7</sup> For instance, in 2016,

2020). OECD, PUBLIC CONSULTATION DOCUMENT ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY (2019) [hereinafter *OECD 2019 PUBLIC CONSULTATION*]; OECD Secretariat, PROPOSAL FOR A ‘UNIFIED APPROACH’ UNDER PILLAR ONE, 2 (2019) [hereinafter *OECD SECRETARIAT PROPOSAL*]; OECD, PROGRAMME OF WORK TO DEVELOP A CONSENSUS SOLUTION TO THE TAX CHALLENGES ARISING FROM THE DIGITISATION OF THE ECONOMY 6 (2019). The Programme of Work, adopted by the OECD/G20 Inclusive Framework on BEPS at its meeting of May 28-29, 2019, was approved by the G20 Finance Ministers at a meeting in Japan in June 2019. *Id.* at 2. The 136 countries that form the OECD/G20 Inclusive Framework on BEPS subsequently approved aspects of Pillar One. See OECD, STATEMENT BY THE OECD/G20 INCLUSIVE FRAMEWORK ON BEPS ON THE TWO-PILLAR APPROACH TO ADDRESS THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY (2020) [hereinafter *OECD/G20 2020 STATEMENT*].

4. See Arthur J. Cockfield, *The Law and Economics of Digital Taxation: Challenging Traditional Tax Laws and Principles*, 56 BULL. INT’L FISCAL DOCUMENTATION 606, 3, 11 (2002) [hereinafter *Law and Economics of Digital Taxation*] (discussing how taxing the digital economy involves taxing digital goods and services that are ‘information goods,’ considered to be non-rivalrous with near-zero marginal costs of copying and distribution). In an earlier work, I explored how tax planning regarding ‘virtual income’ (defined as income largely derived from the workings of mobile and intangible computer code) could subvert traditional international tax rules. Arthur J. Cockfield, *Transforming the Internet Into a Taxable Forum: A Case Study in E-Commerce Taxation*, 85 MINN. L. REV. 1171, 1176, 1197–1200, and 1230–35 (2001) [hereinafter *Transforming the Internet Into a Taxable Forum*].

5. For an earlier warning regarding the erosion of source state tax jurisdiction, see generally Richard M. Bird, *Shaping a New International Tax Order*, 43 BULL. INT’L FISCAL DOCUMENTATION 292 (1988) (arguing that mechanisms need to be developed to enhance source state tax jurisdiction). See OFFICE OF TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE 23 (1996) (“source-based taxation could lose its rationale and be rendered obsolete by electronic commerce”).

6. Ruth Mason, *State Aid: Arm’s Length on Appeal*, 158 TAX NOTES 771, 784 (2018).

7. According to the ICIJ, the Paradise Papers findings “expose[ ] tax engineering” of over 100 companies that at times deploy “hidden companies” based in tax havens and demonstrate how high net worth individuals engage in tax avoidance schemes to reduce taxes on yachts, jets, and other big ticket items. See ICIJ, *The Long Twilight Struggle Against Offshore Secrecy* (Dec. 27, 2017), <https://www.icij.org/investigations/paradise-papers/>. See also Omri Y. Marian, *The State Administration of International Tax Avoidance*, 7 HARV. BUS. L. REV. 1, 6–8, 206, 210, 211, 247, 253 (2017) (discussing revelations from LuxLeaks, which revealed the legal and widespread usage of advance tax rulings in

Google reportedly saved \$3.7 billion in taxes through tax planning.<sup>8</sup> Amazon has similarly achieved significant tax savings via planning such that it paid no U.S. federal income taxes despite the doubling of its 2018 profits to \$11.2 billion.<sup>9</sup> Similarly, although Netflix has roughly 6 million Canadian subscribers, Netflix pays no federal income or consumption taxes to the Canadian federal government.<sup>10</sup>

In response, some governments and regional bodies such as the European Union have developed, or are in the process of implementing, economic presence tests, minimum taxes, withholding taxes, and diverted profits taxes. These measures focus on taxing income that is not associated with the physical presence of the businesses engaged in such economic activities.<sup>11</sup> All of these measures involve new tax laws designed to capture greater shares of cross-border profits associated with digital commerce.

The new tax innovations call for a re-evaluation of traditional tax principles to expand the ability of market countries to tax global digital commerce. Whether such a re-evaluation takes place more broadly throughout the world remains to be seen. At its core, these questions address the same dilemmas that have beset international tax long before the advent of the digital economy: who should pay – and who should bear the burden of – a tax, where, and why? The digital economy gives a new urgency to these questions by magnifying the extent of cross-border trade in a manner that makes it increasingly difficult to place profits at any one location.

Luxembourg to reduce global tax liabilities); Arthur J. Cockfield, *Big Data and Tax Haven Secrecy*, 18 FLA. TAX REV. 483, 506 (2016) (discussing findings from tax haven data leaks).

8. Jeremy Kahn, *Google's 'Dutch Sandwich' Shielded 16 Billion Euros from Tax*, BLOOMBERG (Jan. 2, 2018).

9. Matthew Gardner, *Amazon in Its Prime: Doubles Profits, Pays \$0 in Federal Income Taxes*, INST. TAXATION & ECON. POL'Y (Feb. 13, 2019).

10. Because Netflix does not maintain a physical presence within Canada, it is not liable to pay income tax under the Canada-U.S. Tax Treaty. Netflix also does not collect the federal consumption tax—the Goods and Services Tax—although the company has promised to develop more Canadian content. The provinces of Saskatchewan and Quebec impose sales taxes on Netflix subscriptions. See Tony Wong, *Netflix says it would pay Canadian federal sales taxes. But nobody's asked it to*, TORONTO STAR (May 13, 2019), <https://www.thestar.com/politics/federal/2019/05/13/netflix-says-it-will-collect-and-pay-federal-sales-taxes-but-nobodys-asked-it-to.html>.

11. See, e.g., Editorial Board, *France Starts a Digital Tax War*, WALL STREET J. (Aug. 6, 2019), <https://www.wsj.com/articles/france-starts-a-digital-tax-war-11563318469>; Nils Pratley, *U.K. finally takes on arrogant tech giants with new digital services tax*, THE GUARDIAN (Oct. 29, 2018), <https://www.theguardian.com/uk-news/2018/oct/29/uk-digital-services-tax-budget-facebook-google-amazon> (discussing U.K. and other national developments surrounding digital tax measures); Paul Hannon & Nina Trentmann, *U.K. to Roll Out First-of-Its-Kind Digital Tax*, WALL STREET J. (Oct. 29, 2018), <https://www.wsj.com/articles/u-k-to-roll-out-developed-worlds-first-digital-tax-1540831931> (discussing digital tax proposals by the U.K., South Korea, Mexico, Chile, and 'dozens of other countries'). The United States threatened trade sanctions against France for implementing a digital services tax, although the countries later reached a tentative settlement. See Luke Baker, *France, U.S. agree on method for global digital-tax reform*, GLOBE & MAIL (Jan. 24, 2020), at B3. For views on potentially more comprehensive global tax efforts in this direction, see Rifat Azam, *E-commerce Taxation and Cyberspace Law: The Integrative Adaptation Model*, 12 VA. J. L. & TECH. 31 (2007).

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This Article describes the emergence of an international tax “war” of which the scope and ambit remain uncertain at this early stage of the conflict. The analysis shows how a failure to constrain aggressive international tax planning in the digital world has encouraged growing unilateral and uncoordinated income tax measures. In turn, the new tax innovations promote high taxpayer compliance costs and international double taxation, and they discourage international trade and investment. Ultimately, the best hope lies in a coordinated and incremental solution to expand the traditional way that taxable profits are divvied up among nations.<sup>12</sup> Cross-border consumption taxes—value-added taxes (VATs) as well as goods and services taxes (GSTs)—raise similar challenges in the context of global digital taxation but are beyond the scope of this paper.<sup>13</sup>

The Article is organized as follows. Part II provides an overview of global digital taxation reform efforts from the 1990s to ongoing related initiatives, and shows how these reforms have failed to constrain aggressive international tax planning involving global digital commerce. Part III describes how some governments are adopting or developing previously mentioned unilateral solutions.<sup>14</sup> These approaches are contrary to earlier OECD guiding principles for taxing global digital commerce challenges by promoting coordinated solutions based on traditional international tax law and principles. In addition, many new tax innovations impose non-neutral tax treatment between conventional and digital commerce, which distorts economic activity. The global digital tax conflict masks a deeper and growing dissatisfaction with the process of taxing value associated with global transactions. Part IV explores incremental approaches that can be applied neutrally to tax value associated with both digital and conventional commerce. To expand the ability of governments to tax non-resident firms with digital sales and services, governments should adopt a new tax treaty rule called a “Quantitative Economic Presence Permanent Establishment,” or QEPPE, combined with a revised version of the residual profit split method (called the Residual Profit Split by Income reform) to allocate more

12. The analysis relies on a ‘law and technology’ perspective that scrutinizes how technological change can subvert traditional tax laws and policies. See Arthur J. Cockfield, *Tax Law and Technology Change*, in OXFORD HANDBOOK ON THE LAW AND REGULATION OF TECHNOLOGY (Roger Brownsword, Eloise Scotford & Karen Yeung eds., 2017). Building from insights from cyberlaw, academics are developing broader theories of the relationship between law and technology. See Arthur J. Cockfield, *Towards a Law and Technology Theory*, 30 MAN. L.J. 383 (2004).

13. See Walter Hellerstein, *State Taxation of Electronic Commerce*, 52 TAX L. REV. 425 4 (1997); Marie Lemensch, *The Treatment of “Digital products” and Other “E-Services” Under VAT*, in VAT/GST IN A GLOBAL DIGITAL ECONOMY (M. Lang & I. Lejeune eds., 2015). OECD countries are encouraged to follow guidelines that were endorsed by over a hundred countries at the 2015 Global Forum on VAT. See OECD, INTERNATIONAL VAT/GST GUIDELINES (2017).

14. In particular, the minimum tax imposed by the new Global Intangible Low Taxed Income (GILTI) offers an entirely new approach to taxing cross-border income generated by intangibles like copyright and patents. Proposed regulations under section 951A of the Internal Revenue Code provide guidance for U.S. shareholders to determine the amount of GILTI to include in gross income. See DEPT. OF TREASURY, 26 CFR Part 1, REG-104390-18 (Sept. 2018).

taxable profits to source countries. These steps would call for a cease fire in the developing tax war.

## II. A BRIEF HISTORY OF GLOBAL DIGITAL TAX REFORMS

### A. Earlier Reform Efforts

Tax rules, primarily put in place to deal with cross-border transactions involving physical goods in the post-World War I environment, have a more difficult time in guarding against aggressive planning techniques.<sup>15</sup> Since that time, the world has changed. In particular, global investments and transactions increasingly rely on value-creation associated with highly mobile intangible assets such as brands, goodwill, copyright, and patents. In other words, where firm value was once associated with physical things (such as the number of plants or retail centers), this value is more and more associated with the more ethereal world of intangible assets.

The digital world also exacerbates a number of the already-existing soft spots in the international tax regime. Global digital transactions involving digital goods and services as well as intangible assets are characterized in part by their intangible nature and the ease with which they cross national borders. Moreover, the digital world facilitates cross-border collaboration, production, and sales of these intangible goods and services. All digital goods and services are “information” goods that have potentially high fixed costs of production, but near zero marginal costs of reproduction and distribution.<sup>16</sup> Consider a new song by Kendrick Lamar. It might take significant resources to produce the song (e.g., Mr. Lamar’s time and effort, studio time, musicians and music producers). But once the song has been created and digitized, it can be copied and transferred across borders for sale at virtually no cost. Moreover, information goods are non-rivalrous, meaning the purchase of the digital rap song does not impinge in any way on the next purchase of a digital song by another consumer.<sup>17</sup> International tax laws and policies, initially put in place to govern a world where it was costly to reproduce and transfer physical goods across borders, appear ill-suited to this new world of widespread production, usage, and consumption of information goods.

Prior to the ensuing discussion of reform efforts, a brief segue is needed to sketch out how law currently apportions cross-border profits between two (or

15. See PROFESSOR BRUINS, ET AL., REPORT ON DOUBLE TAXATION SUBMITTED TO THE FINANCIAL COMMITTEE (1923) (discussing different alternatives to the taxation of cross-border business profits and recommending exclusive residence-based taxation); TECHNICAL EXPERTS TO THE FINANCIAL COMMITTEE OF THE LEAGUE OF NATIONS, DOUBLE TAXATION AND TAX EVASION: REPORT AND RESOLUTIONS (1925) (advocating adoption of the residence-based taxation of business profits along with foreign tax credits for taxes paid to source countries).

16. See CARL SHAPIRO & HAL R. VARIAN, INFORMATION RULES 3 (1999). For a discussion of the tax implications of this theory, see Cockfield, *Law and Economics of Digital Taxation*, *supra* note 4.

17. *Id.*

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more) countries. The main rule found within the 3,000+ bilateral tax treaties throughout the world allocates profits to activities generated by “permanent establishments.”<sup>18</sup> Permanent establishments in turn are generally defined within tax treaties as fixed places of businesses through which business is conducted.<sup>19</sup> Profits are then attributed to the permanent establishments based on the arm’s length standard so that transfer prices, at least in theory, are supposed to reflect fair market values.<sup>20</sup> In this way, value is assigned to transactions for cross-border income tax purposes.

There are two main sources of dissatisfaction with this traditional arm’s length approach to identifying value within global digital commerce.<sup>21</sup> First, in the digital world, companies have an easier time selling goods and services across borders without the need to set up a traditional permanent establishment like a retail outlet. Relatedly, the digital world allows companies to generate advertisement revenues in foreign markets via the sale of an Internet user’s personal data in exchange for the “free” provision of online services, again diluting market countries’ tax jurisdiction.

Second, tax planning strives to shift intangibles (like the copyright to a Kendrick Lamar song) and related profits out of high tax countries—while ostensibly still complying with the arm’s length standard. For instance, companies sometimes co-develop intangibles with partners in low tax jurisdictions so that a portion of any subsequent stream of cross-border royalty income will be taxed within the lower taxed country (see the discussion of cost contribution arrangements in Part II.C). Under this approach, a Lamar song could be refined and improved by an individual living in a tax haven so that a portion of the royalties would flow to and be taxed in this zero-tax jurisdiction.

In the mid-1990s, international tax reform efforts strove to address these concerns. While OECD reform efforts began in earnest at a 1996 conference in Turku, Finland, the watershed moment took place two years later at the OECD Ministerial Conference on Electronic Commerce held in Ottawa in October 1998. I attended this conference as an official Observer and wrote a related report for the OECD’s Committee on Fiscal Affairs.<sup>22</sup> The most important outcome of the conference was an agreement by participating OECD and non-OECD countries on the Ottawa Taxation Framework Conditions, which set out a series

18. See, e.g., CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL [hereinafter Canada-U.S. Tax Treaty], Canada-U.S., Sept. 26, 1980, E102370 - CTS 1984 No. 15.

19. *Id.* at art. V.

20. Under the arm’s length standard, transfer prices—the prices paid for cross-border goods and services between related companies—should reflect prices that were negotiated between unrelated parties, that is, the fair market value. See Article 9 OECD Model Tax Treaty.

21. Jinyan Li, *Slicing the Digital Pie with A Traditional Knife: Effectiveness of the Arm’s-Length Principle in the Age of Electronic Commerce*, TAX NOTES INT’L 775 (Nov. 19, 2001).

22. I revised the report into a law review article; see Arthur J. Cockfield, *Balancing National Interests in the Taxation of Cross-border E-Commerce*, 74 TUL. L. REV. 343 (1999) (reviewing OECD reform processes and tax proposals).

of guiding principles for reform efforts.<sup>23</sup> Under these principles, any new rules should be coordinated to reflect consensus political views in order to avoid destabilizing the international tax regime. Moreover, any new laws should be clear and simple, and be imposed neutrally to avoid distortions between e-commerce and conventional commerce. Ultimately, the rules must strike a balance: “Governments must provide a fiscal climate within which electronic commerce can flourish, weighed against an obligation to operate a fair and predictable taxation system that provides the revenue required to meet the legitimate expectations of citizens for publicly provided services.”<sup>24</sup>

The OECD’s cooperative processes in this area generated a series of ‘firsts,’ including the first time that non-OECD governments were given a major role in the deliberation of reforms; the development of the first Technical Advisory Groups with members of the academy, industry, and governments to guide policy formulation; and the first efforts to generate international consensus surrounding cross-border value-added taxes.<sup>25</sup>

A review of government reactions to these processes showed that until 2013, governments generally agreed to abide by the Ottawa Taxation Framework Conditions and generally did not develop their own tax solutions for global digital commerce.<sup>26</sup> This approach echoed the mid-1990s views espoused by Tillinghast and others that traditional international tax laws and policies would suffice to confront the challenges.<sup>27</sup> A possible explanation for this cautious approach lies in the then-view that the taxation of cross-border ecommerce would not lead to undue revenue losses for high tax countries.

23. See OECD, OTTAWA TAXATION FRAMEWORK CONDITIONS 4 (1998).

24. The traditional principles bear repeating at greater length. Under the principle of neutrality, ‘business decisions should be motivated by economic rather than tax considerations.’ Under the principle of efficiency, ‘[c]ompliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.’ Under the principle of fairness and effectiveness, ‘[t]he potential for tax evasion and avoidance should be minimized while keeping counter-acting measures proportionate to the risks involved.’ Under the principle of certainty and simplicity, ‘[t]he tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction.’ Under the principle of flexibility, ‘[t]he systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.’ *Id.* at 6–11. These principles are directed at the new tax innovations in Part III.E, *infra*.

25. See Arthur J. Cockfield, *The Rise of the OECD as Informal ‘World Tax Organization’ through the Shaping of National Responses to E-commerce Taxation*, 8 YALE J. LAW & TECH. 136, 149–61 (2006) [hereinafter *Rise of the OECD as World Tax Organization*].

26. See HELLERSTEIN & LEMENSCH, TAXING GLOBAL DIGITAL COMMERCE, *supra* note 2, at chapter 4. The only clear area of disagreement surrounded the new server/permanent establishment rule that became part of the Commentaries to the OECD model tax treaty in 2003. The new rule was largely a response to the worry that the US dominated e-commerce and hence would enjoy resulting tax revenues from its residence-based tax system. According to one estimate, the United States accounted for roughly 80 percent of the global total of e-commerce in 1998. See OECD, THE ECONOMIC AND SOCIAL IMPACTS OF ELECTRONIC COMMERCE: PRELIMINARY FINDINGS AND RESEARCH AGENDA 29 (1999).

27. David Tillinghast, *The Impact of the Internet on the Taxation of International Transactions*, 50 BULL. INT’L FISCAL DOCUMENTATION 524 (1996).

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### *B. The OECD Digital Tax Base Erosion and Profit Shifting (BEPS) Initiative*

All appeared relatively tranquil in the digital tax world until the last few years. In hindsight, grey clouds could be seen forming on the horizon. They can be traced back to the 2008 global financial crisis that wreaked havoc on the global economy, diminished tax revenues, and left many countries facing distressing fiscal problems.

The dire fiscal situation of so many countries focused renewed attention on aggressive international tax planning due to the worry that this planning was contributing to further revenue losses.<sup>28</sup> The OECD stepped into the fray with its 2013 Base Erosion and Profit Shifting (BEPS) initiative.<sup>29</sup> In 2013, the OECD launched its BEPS project to develop cooperative efforts among governments in this area, which was subsequently endorsed by the G20.<sup>30</sup> “Base erosion and profit shifting” refers to the many tax plans used by multinational firms to reduce their global tax liabilities, mainly by ‘shifting’ paper profits to tax havens. The OECD approach includes fifteen studies called “Actions.” Several Actions target specific problem areas such as interest deductions, hybrid mismatch arrangements, and various aspects of transfer pricing, including intangibles and the allocation of risk within multinational groups.<sup>31</sup>

The challenge, as set out by the G-20 in the Tax Annex to the St. Petersburg Declaration of 2013, is to design and implement tax rules to ensure that “profits are taxed where economic activities occur and where value is created.”<sup>32</sup> According to the OECD, “[t]he BEPS package of measures represents the first substantial renovation of the international tax rules in almost a century. . . . BEPS planning strategies that rely on outdated rules or on poorly co-ordinated domestic measures will be rendered ineffective.”<sup>33</sup>

In addition, the OECD developed an Inclusive Framework whereby participating countries (currently 127 nations) commit to the BEPS package along with minimum standards.<sup>34</sup> The OECD’s ongoing outreach efforts are

28. See also Arthur J. Cockfield, *BEPS and Global Digital Taxation*, 75 TAX NOTES INT’L 933 (2014).

29. See OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING 74–76 (2013) [hereinafter ADDRESSING BEPS]. See also OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY (2014).

30. OECD, ADDRESSING BEPS, *supra* note 29.

31. Later in that same year, the OECD launched an action plan to implement the BEPS project. See OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013) [hereinafter BEPS ACTION PLAN]. See also OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY (2014).

32. GROUP OF TWENTY (G20), TAX ANNEX TO THE ST. PETERSBURG G20 LEADERS’ DECLARATION (2013).

33. OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1: FINAL REPORT 3 (2015) [hereinafter ACTION 1 FINAL REPORT].

34. The OECD countries agreed to adopt four ‘minimum standards’ of preventing treaty shopping, Country-by-Country Reporting (whereby tax authorities deploy a common template for multinational firms to disclose their tax payments in foreign countries for transfer pricing purposes), fighting harmful tax practices, and improving dispute resolution. In some cases, however, countries have not fully agreed to implement all of these minimum standards.

meant to legitimize its international tax reform agenda.<sup>35</sup> The addition of the G20 to the OECD BEPS project was another important outreach step, resulting in non-OECD countries with large economies, including Brazil, Russia, India, China and South Africa, to now formally endorse the project.<sup>36</sup>

Action 1 required the OECD to identify the main challenges that the digital economy poses for the application of current international tax rules and to develop detailed alternatives to address these challenges.<sup>37</sup> Action 1 noted that the digital economy presented the following tax challenges:

[M]obility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. The digital economy has also accelerated and changed the spread of global value chains in which MNEs [multinational enterprises] integrate their worldwide operations.<sup>38</sup>

Other tax challenges arising from the digital world include the usage of new payment systems such as cryptocurrencies and the enhanced trading of personal information for ‘free’ services in the cross-border business-to-consumer social media context. For example, companies such as Facebook and Google earn revenues largely by selling user data to third party marketing companies.<sup>39</sup> The growth of the global digital economy, coupled with its interrelationship with the daily lives of so many consumers and businesses, led to renewed worries of reduced tax revenues for countries where consumers are based (market countries), and more revenues for countries where the digital goods and services are produced (residence countries). However, if taxable profits can be shifted away from high tax residence countries to zero tax offshore jurisdictions (sometimes referred to as tax havens), it also led to increased double non-taxation.<sup>40</sup>

Action 1 presented its Final Report in 2015 and recommended a few modest reforms, leaving more substantive reform efforts to other Actions. Some of the 2017 changes to the OECD model tax treaty are meant to enable source countries

35. See Richard M. Bird, *Reforming International Taxation: Is the Process the Real Product?* (10 Ga. St. Univ. Int’l Ctr. for Pub. Pol’y, Working Paper No. 15-03, 2015), <http://icepp.gsu.edu/files/2015/07/ispwp1503.pdf>.

36. Reuven S. Avi-Yonah & Haiyan Xu, *Evaluating BEPS*, 10 ERASMUS L. REV. 3, 8–9 (2017).

37. See OECD, BEPS ACTION PLAN, *supra* note 31, at 14–15. Thirteen Action final reports, including Action 1, were presented to the G20 leaders at their summit in Antalya, Turkey on 15 November 2015.

38. See OECD, ACTION 1 FINAL REPORT, *supra* note 33, at 11. These views of digitization are broader than the earlier views of e-commerce that focused on the cross-border trade of goods and services related to the Internet. Under another view, the digital economy is characterized by the geographical mobility of (a) intangibles as value creators; (b) business functions, including reliance on data; and (c) its product and users. See Joachim Englisch, *BEPS Action 1: Digital Economy – EU Law Implications*, 3 BRITISH TAX REV. 280, 281–82 (2015).

39. Facebook, for instance, generates roughly 98% of its revenues by monetizing user data. *How Facebook Makes Money*, INVESTOPEDIA, (Jan. 12, 2020), <https://www.investopedia.com/ask/answers/120114/how-does-facebook-fb-make-money.asp>.

40. For discussion on the ways that cloud technologies challenge traditional transfer pricing principles, see Orly Mazur, *Transfer Pricing Challenges in the Cloud*, 57 B.C. L. REV. 643 (2016).

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to exert more taxing jurisdiction over non-resident digital companies, including: (a) the reform to prevent companies from fragmenting their activities in a market country into supposedly preparatory or auxiliary activities that are exempt from permanent establishment status;<sup>41</sup> (b) the broadening of the dependent agent/permanent establishment concept to include situations where an agent concludes a contract and the principal does not materially modify the contract;<sup>42</sup> and (c) the narrowing of the independent agent exemption to permanent establishment status.<sup>43</sup> The permanent establishment principle was modified to encourage more market state taxation in circumstances where a non-resident company manages to generate significant profits from market state consumers.

While these developments were helpful, OECD and participating non-OECD countries failed to obtain consensus on any significant coordinated response to global digital taxation. Action 1's Final Report notes, "Countries could, however, introduce any of the options [to create a significant economic presence test, withholding tax or equalisation levy] in their domestic laws as a further safeguard against BEPS, providing they respect current treaty obligations, or in their bilateral tax treaties."<sup>44</sup> The provisos are meant to remind governments to consider how their legal obligations under tax treaties and trade agreements might interact with any new digital tax measures.

41. Under the traditional tax treaty definition, a permanent establishment is a fixed base through which business is conducted. A firm that conducts mere preparatory or auxiliary activities, however, is excepted from this main definition and hence does not constitute a permanent establishment. The most important development to arise from Action 1 is a modification of the permanent establishment definition in Article 5(4) of the OECD Model Tax Treaty. The reform arose from the view that multinational firms were entering into artificial arrangements to divert profits away from high tax countries. The Task Force on the Digital Economy noted that some activities that were previously preparatory or auxiliary in the context of conventional business models may have become core functions for some businesses engaged in global digital commerce. OECD, PREVENTING THE ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT STATUS, ACTION 7 – 2015 FINAL REPORT (2015).

42. In addition, the definition of a permanent establishment in Article 5(5) and 5(6) was modified to address artificial arrangements that seek to shift profits to a jurisdiction where a contract has been concluded (e.g., by simply providing for a clause of the contract that stipulates that the contract has been concluded in this jurisdiction). It was thought that global digital activities, which often deploy website contracting for both business-to-consumer and business-to-business transactions, have greater latitude to engage in this sort of aggressive international tax planning. According to the Final Report of Action 7: "As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business. The changes to Article 5(5) and 5(6) and the detailed Commentary that appear [in this report] will address *commissionnaire* arrangements and similar strategies [to] better reflect this policy." *Id.*

43. This same Final Report recommends that Article 5(6) be amended to provide that a person will not be considered an independent agent if the person acts 'exclusively or almost exclusively on behalf of one or more enterprises to which [they are] closely related.' *Id.*

44. OECD, ACTION 1 FINAL REPORT, *supra* note 33, at 148. The OECD hopes to produce another report on tax and the digital economy in 2020. *Id.* at 149.

*C. The Failure to Constrain Aggressive Tax Avoidance*

In an earlier assessment, I noted that the main difficulty with the BEPS project is that it does not address a fundamental incentive within the international tax regime: multinational corporations should rationally engage in tax plans in which the transaction costs they face are lower than the global tax savings they derive via tax planning.<sup>45</sup> The BEPS project does nothing to alter this environment.<sup>46</sup> While the project may result in new anti-avoidance rules, multinational firms should embrace this added technical complexity even though complex rules raise the risk of, among other things, international double taxation. These firms can take advantage of the system's complexity to generate new tax avoidance strategies that offset the raised transaction costs.

In fact, the BEPS project can be portrayed largely as an assemblage of past efforts to inhibit aggressive planning, particularly previous efforts in the 1960s such as efforts to tax cross-border passive business income on an accrual basis via controlled foreign corporation rules as well as (at the time secret) deliberations concerning the abusive use of tax treaties.<sup>47</sup> The BEPS Actions led to innovations in the area of global administrative tax agreements (that is, the Common Reporting Standard,<sup>48</sup> Country by Country Reporting<sup>49</sup> and the

45. See Arthur J. Cockfield, *The Limits of the International Tax Regime as a Commitment Projector*, 33 VA. TAX REV. 59, 88–93 (2013) [hereinafter *Tax as a Commitment Projector*]. See also Cockfield, *supra* note 28, at 936. Part of the problem surrounding the BEPS project is that it involves many disparate elements without a coherent intellectual framework to guide specific reforms. See Adam H. Rosenzweig, *Building a Framework for a Post-BEPS World*, 74 TAX NOTES INT'L 1077 (2014) (developing guiding principles for international tax cooperation).

46. Christians and Shay are also correct when they point out that it is too soon to render any final judgments about the BEPS project. See ALLISON CHRISTIANS & STEPHEN SHAY, GENERAL REPORT, 102A CAHIER DE DROIT FISCAL INTERNATIONAL: ADDRESSING BEPS: ORIGINS, STANDARDS, AND RESPONSES 17, 13, 52 (2017).

47. Secret OECD meetings held in Denmark began because of a confidential note from US representatives. They addressed the issues of treaty abuse and revenue losses. See Note by the United States Delegation on Tax Avoidance through the Improper use or Abuse of Tax Conventions (TFD/FC/135) (Nov. 14, 1961), <http://www.taxtreatieshistory.org>.

48. See OECD, CRS MULTILATERAL COMPETENT AUTHORITY AGREEMENT (2014) (providing for the adoption of CRS standards). The OECD agreement is based on Article 6 of an earlier multilateral agreement. See OECD, CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS (1998) (providing for cooperation surrounding tax administration). In contrast to tax avoidance, tax evasion involves a criminal intent to purposefully hide income or assets from tax authorities. As of November 2018, 153 countries were committed to the new CRS regime under this approach. See OECD, *AEIO: Status of Commitments*, <http://www.oecd.org/tax/automatic-exchange/commitment-and-monitoring-process/AEOI-commitments.pdf>. For discussion, see DAVID KERZNER & DAVID W. CHODIKOFF, INTERNATIONAL TAX EVASION IN THE GLOBAL INFORMATION AGE 344 (2016) (concluding in part that automatic information exchanges are superior to 'exchanges upon request'). The United States has so far refused to sign on, preferring to focus on its domestic anti-tax haven initiatives. In particular, U.S. domestic legislation known as the Foreign Account Tax Compliance Act (FATCA), 26 U.S.C. §§ 1471–1474, § 6038D, operates in a similar manner to the CRS. Most governments have negotiated an agreement to implement FATCA whereby they agree to deliver bulk taxpayer information to the Internal Revenue Service.

49. See Arthur J. Cockfield & Carl MacArthur, *Country-by-Country Reporting and Commercial Confidentiality*, 63 CANADIAN TAX J. 627 (2015). For a discussion of how CBCR works, see generally OECD, COUNTRY-BY-COUNTRY REPORTING: HANDBOOK ON EFFECTIVE TAX RISK ASSESSMENT (2017); OECD, HANDBOOK ON EFFECTIVE IMPLEMENTATION (2017). The United States and other governments

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Multilateral Instrument).<sup>50</sup> In terms of possible substantive tax law changes, the reform efforts generally focus on bolstering the current environment through specific anti-avoidance rules (SAARs), general anti-avoidance rules (GAARs), and other traditional mechanisms.

To demonstrate how the BEPS reforms will not significantly constrain tax planning within the global digital economy, we will consider a hypothetical business.<sup>51</sup> In its initial report on BEPS, the OECD reviewed a “two-tiered” cross-border e-commerce structure using a cost contribution arrangement (CCA) to transfer intangibles among related foreign members of a corporate group.<sup>52</sup> A CCA is an agreement whereby members of a multinational group agree to share costs and risks of developing, producing, or selling goods and services where each participant’s proportional share of the overall contributions to the arrangement will be consistent with the resulting income each party enjoys.<sup>53</sup>

The structure involved a group of related companies developing search and advertising technology, as follows. Soon after it begins operation, Company A, a corporation, transfers rights to technology (that it developed in Country A) to Company C. Company C is an unlimited liability company registered under the laws of Country B, but managed in Country C (and is thus a tax resident of Country C).

Under the CCA, Company A receives a ‘buy in’ payment for the technology and agrees to share the cost of future technology development. The buy-in payment is fully taxable in Country A. Company C then licenses the technology to Company D based in Country D. Company D then sub-licenses the technology to Company B.

Company B is where most of the thousands of the group’s employees work, and it is based in Country B, which maintains a high corporate income tax rate. However, in calculating its income in Country B, Company B deducts the amount of the royalty it pays to Company D, thereby reducing its taxable profits to less than 1% of its gross revenues. Country B has a tax treaty with Country D that eliminates withholding for cross-border royalties.

were able to agree on CBCR because they would not have to make any substantive changes to their tax laws. Rather, they merely need to alter their administrative practices to share more tax and financial information. Accordingly, there did not exist the traditional political concern that an international tax agreement would undermine each country’s own tax sovereignty. *See* Cockfield & MacArthur, *supra*, at 631, 645–46.

50. Over one hundred countries have agreed to participate in the Multilateral Convention to Implement the Tax Treaty Measures to Prevent Base Erosion and Profit Shifting, whereby they agree to modify their bilateral tax treaties to implement BEPS treaty reforms. OECD, MULTILATERAL CONVENTION TO IMPLEMENT TAX TREATY RELATED MEASURES TO PREVENT BEPS (2016).

51. A more detailed discussion of this matter is set out in Arthur J. Cockfield, *Taxing Global Digital Commerce in a Post-BEPS World*, in *TRIBUTAÇÃO DA ECONOMIA DIGITAL – DESAFIOS NO BRASIL, EXPERIÊNCIA INTERNACIONAL E NOVAS PERSPECTIVAS* (Ricardo Maitto da Silveira, Alexandre Luiz Moraes do Rêgo Monteiro & Renato Vilela Faria eds., 2018).

52. *See* OECD, ADDRESSING BEPS, *supra* note 29, at 74–76.

53. *See* Chapter VI of the OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (2017) [hereinafter OECD TRANSFER PRICING GUIDELINES].

The structure can be designed to: (a) ensure royalty income is not taxed by any high tax country; (b) eliminate withholding taxes on cross-border royalties; and (c) avoid the application of controlled foreign corporation rules. The cross-border structure discussed by the OECD incorporates two traditional international tax planning efforts.

First, related business entities are placed in foreign tax havens to ensure that as many cross-border royalties as possible are taxed in these zero tax rate countries. Moreover, the offshore jurisdictions are “shopped”<sup>54</sup> to ensure they have bilateral tax treaties with the economies where the technology is either designed or purchased to reduce withholding taxes on these royalties and to generate other tax benefits such as the tax-free repatriation of after-tax profits “generated” within the tax havens. The structure is also designed to comply with the controlled foreign corporation rules of Country B so that foreign source income is not deemed to be passive income subject to these rules.<sup>55</sup>

Second, the business entities used are so-called hybrid entities (such as an unlimited liability company) that, under the laws of one country, are treated as a taxable person and, under the laws of the other country, are treated as a flow-through entity where only the owners of the entity are subject to tax. This international tax arbitrage strategy is also designed to promote global tax savings by ensuring that cross-border royalties remain largely untaxed in high tax countries.

As mentioned, the most important recommendations coming out of Action 1 surround proposed changes to the definition of permanent establishments.<sup>56</sup> These reforms do not come into play with respect to the above-noted structure as it does not rely on any permanent establishments.

As illustrated by the hypothetical, the value of firms engaged in global digital transactions is significantly invested in intangible assets such as brand, goodwill, copyright, trademark, or patents; payments for this intellectual property may give rise to cross-border royalty payments. An important concern is to tamp down on the ability of firms to shift intangible rights to low tax jurisdictions, such as the cross-border payment from Company B to Company D that reduces taxable income in high tax Country B (that is, Company B makes a tax deductible payment in Country B, reducing its taxable profits in this country and allocating more income to Country D, which will be selected for lower or nil income taxes). Multinational firms sometimes claim that because of contractual allocations and legal ownership of intangibles, significant profits should be shifted to these jurisdictions even if the related company performs very few to no business activities.

54. Treaty shopping involves an attempt by a taxpayer to identify a treaty partner country with favorable terms, then locating an intermediary such as a corporation within this country to attract the tax benefits.

55. See OECD, ADDRESSING BEPS, *supra* note 29, at 76.

56. See the discussion accompanying notes 40 and 41.

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The BEPS work surrounding transfer pricing revised the guidelines for intangibles to clarify that legal ownership alone does not necessarily generate a right to tax all (or even any) of the cross-border royalties generated by the intangible.<sup>57</sup> Rather, countries where the companies that perform important functions, contribute assets, and sustain economically-significant risks will be entitled to tax returns from intangibles.

Under this approach, related parties within a multinational firm should be compensated based on the value they create through functions performed, assets used, and risks assumed in the development, maintenance, protection, and exploitation of intangibles. For instance, the structure envisions related party payments by Companies A, B, C, and D, despite the fact that the bulk of the economic activities occur in Country B. Tax authorities could challenge the transfer prices paid to jurisdictions where less activities are taking place.

Specific rules have been additionally developed to inhibit the use of CCAs that seek to divert profits to low tax jurisdictions on the basis that the intangible was co-developed (or paid for) by a related company based in these jurisdictions. For instance, the reforms try to ensure that contributions, including intangibles, to a CCA should not be measured at cost (e.g., the cost of contributed labor and parts) where this does not provide a reliable basis to determine the value contributed by participants (e.g., the real value-adding activities could take place in a country with the skilled labor needed to develop the intangible asset). This reform, if implemented by governments, could affect the buy-in payment to Company A within the hypothetical.

Efforts have also been directed at inhibiting perceived abuses associated with the application of the transactional profit split methods (see also Part IV.C). At times, firms deploy a version of this profit split method to allocate residual profits from intangibles to companies based in low tax jurisdictions. This tax planning strategy is at-times conducted by firms with global value chains. For hard-to-value intangibles, the OECD reforms in this area suggest that the post-transfer profitability of an intangible can be taken into account to determine the appropriate transfer prices. Again, this reform could affect the value of the compensation paid to Company A.

In addition to transfer pricing rules, controlled foreign corporation (CFC) rules are expected to be modified as a result of the work of Action 3.<sup>58</sup> This is important because income generated from intangibles or the sale of digital goods and services is considered highly mobile. CFC rules generally try to tax foreign source passive income, including returns on intangibles, on a current or accrual basis even if this income has not been repatriated from a foreign country. The main way that the suggested CFC reforms will address digital economy matters

57. See OECD, ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION 63–115 (2015).

58. See OECD, DESIGNING EFFECTIVE CONTROLLED FOREIGN COMPANY RULES, ACTION 3 – 2015 FINAL REPORT (2015).

is via new definitions to capture income so that it is included as foreign source passive income (called “Subpart F” income under U.S. tax law).<sup>59</sup> For instance, the OECD notes that new definitions may be needed to include profits generated by license fees as well as certain types of income from sales of digital goods and services.<sup>60</sup> By broadening the definition of passive income subject to CFC rules, the reforms attempt to subject greater amounts of activities associated with the global digital economy to current taxation. The gist of the proposed reforms is to identify whether the CFC is engaged in substantial economic activities or whether it is really supporting profit shifting of passive income that ought to be subjected to current taxation by a residence country.

As touched on above, the hypothetical cross-border structure also deployed a hybrid entity via Company C. These hybrid entities, which take advantage of different national laws that promote dissimilar and often-conflicting tax outcomes, may be deployed to a greater extent in the digital world. Similarly, enhanced global activity in the digital world leads to more treaty shopping to take advantage of treaties with countries that have low or no income taxes.

The OECD BEPS project targets hybrid entities and treaty shopping through two separate Actions.<sup>61</sup> To the extent governments modify their domestic tax rules or tax treaties to inhibit planning through these devices, it may restrict certain cross-border structures for firms engaged in global digital sales and services.<sup>62</sup>

The OECD BEPS reforms increase the technical complexity of the international tax regime in an effort to tamp down on aggressive international tax planning. To the extent the reforms are implemented by governments, the reforms will require a re-evaluation by tax advisors of existing and planned cross-border structures. On the other hand, the reforms in the digital tax arena do not significantly change the existing global tax landscape for tax planners because the reforms mainly attempt to tweak the current international tax system.

59. Under I.R.C. § 951(a) (2018), a U.S. shareholder is currently required to include its pro rata share of the CFC’s passive income as well as other specified income sources in its income.

60. OECD, ACTION 1 FINAL REPORT, *supra* note 33, at 146.

61. *See also* OECD, HYBRID MISMATCH ARRANGEMENTS: TAX POLICY AND COMPLIANCE ISSUES (2012); OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS (2015).

62. Finally, reforms efforts have been directed to intellectual property regimes, including patent boxes, under Action 5. *See* OECD, COUNTERING HARMFUL TAX PRACTICES MORE EFFECTIVELY, TAKING INTO ACCOUNT TRANSPARENCY AND SUBSTANCE, ACTION 5 – 2015 FINAL REPORT (2015). For transactions that seek to shift intellectual property rights, the OECD has proposed a new “nexus approach” which looks to firm expenditures as a proxy for substantial activity. The effort tries to ensure that countries where significant monies are spent on actual research and development activities get to tax the related returns generated by intangibles. This effort may inhibit the ability of some multinational firms engaged in global digital economic activities to deploy “patent boxes” or otherwise shift income associated with the development of intangibles for tax planning purposes. In the hypothetical, the firm does not deploy any intellectual property protections, hence these reforms will not apply. This work follows up on the OECD’s earlier efforts to inhibit the use of “harmful preferential tax regimes.” *See* OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998) [hereinafter HARMFUL TAX COMPETITION].

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In terms of a tentative conclusion, the reforms should not restrict aggressive international tax planning, and corresponding revenue losses, in significant ways.

### *D. Summary*

By the mid-1990s, academics and policy makers warned that global e-commerce would hurt the ability of market countries—countries where sales take place—to tax cross-border transactions. Internet-based companies sold physical and digital goods and services to consumer countries without the need to set up a physical presence within these countries. As a result of this new commercial environment, governments cooperated through OECD processes to ensure they developed coordinated solutions. Governments agreed on the 1998 Ottawa Taxation Framework conditions that espoused the need to apply traditional international tax laws and principles to cross-border e-commerce and to ensure that tax rules applied neutrally to both digital and conventional commerce. As a result of this political cooperation, governments were generally content to abide by the consensus view to develop modest tax reforms.

By 2013, however, the global environment had changed. Many governments were still suffering from revenue losses associated with the 2008 global financial crisis. The digital economy had grown to a much larger portion of overall commerce with firm value being increasingly associated with intangible assets such as brands, goodwill, copyright, and patents. Despite this changing environment, governments were unable to attain consensus on coordinated rules to confront the tax challenges of the global digital economy. Instead, OECD reforms were directed at modest changes to the OECD model tax treaty. In many cases, these changes did not provide market countries with the ability to tax profits associated with sales of digital goods and services to their consumers. Nor did the changes significantly inhibit aggressive international tax planning that leads to reduced tax revenues for high tax countries.

Without agreement on these important issues, many governments felt the need to rebel and launch a tax war, a topic to which we now turn.

### III. THE REBEL FORCES FIGHT BACK

This Part discusses how certain governments and regional bodies have or are developing significant economic presence tests, withholding taxes, transaction taxes (e.g., equalization levies and digital services taxes), and minimum taxes (e.g., diverted profits taxes).<sup>63</sup> Governments may be pursuing “go it alone” digital tax reforms as a result of broader political trends, such as nationalism and anti-globalization, that discourage political cooperation. This development is not

63. The governments are trying to come up with new rules to align their procedural enforcement with their substantive enforcement. See Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GA. L. REV. 1 (2003).

necessarily a result of dissatisfaction with the OECD and G20 BEPS reform processes.<sup>64</sup>

*A. Significant Economic Presence Tests*

The permanent establishment concept, discussed in Part II.A, helps to show how international tax rules historically emphasized the need for physical presences within market countries for such countries to tax cross-border profits. Skaar traces how this need for a physical presence has been diluted by legal developments that reflect changing global economic developments (see also the discussion in IV.B).<sup>65</sup>

Beginning in the late 1990s, academics explored how the permanent establishment concept could be further diluted to make way for the new world of global digital commerce. For instance, Hinnekens studied how a ‘virtual’ permanent establishment could be created via a qualitative test such as one that inquires into the facts and circumstances surrounding non-resident sales.<sup>66</sup> Others discussed how a more straightforward quantitative test (e.g., focusing on above threshold sales such as US \$10 million) could be used to trigger permanent establishment status.<sup>67</sup> More recently, a French report advocated the need to tax profits generated by social media consumers—even if the non-resident firm maintained no physical presence within the market country.<sup>68</sup>

A 2018 report by the OECD Inclusive Framework on BEPS reviewed efforts by national governments that dilute the traditional permanent establishment principle. For instance, the Slovak Republic expanded the definition of a “fixed place of business” within tax treaties for certain digital platforms, Israel

64. See Arthur J. Cockfield, *Shaping International Tax Law and Policy in Challenging Times*, 54 STAN. J. INT’L L. 223 (2018) (discussing populism, nationalism, and anti-globalization trends that discourage global tax cooperation).

65. ARVID A. SKAAR, PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE (1991).

66. See Luc Hinnekens, *Looking for an Appropriate Jurisdictional Framework for Source-State Taxation of International Electronic Commerce in the Twenty-First Century*, 26 INTERTAX 192 (1998). The OECD noted, however, it is not recommending a virtual permanent establishment as per Hinnekens, although its notion of a ‘significant digital presence’ is similar in nature. See also Arvid A. Skaar, *Erosion of the Concept of Permanent Establishment: Electronic Commerce*, in INTERNATIONAL STUDIES IN TAXATION: LAW AND ECONOMICS 307 (Gustaf Lindencrona, Sven-Olaf Lodin, & Bertil Wiman eds., 1999) (concluding that servers and Web sites can constitute permanent establishments under traditional interpretation). Skaar notes that the permanent establishment concept nevertheless does not seem to be relevant for purposes of taxing electronic commerce. *Id.* at 320.

67. For a review of the strengths and weaknesses of these approaches, see Arthur J. Cockfield, *Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test*, 38 CAN. BUS. L. J. 400 (2003), reprinted in TAX NOTES INT’L (2004) [hereinafter *Quantitative Economic Presence Test*].

68. PIERRE COLLIN & NICOLAS COLIN, TASK FORCE ON TAXATION OF THE DIGITAL ECONOMY, REPORT TO THE MINISTER FOR THE ECONOMY AND FINANCE, THE MINISTER FOR INDUSTRIAL RECOVERY, THE MINISTER DELEGATE FOR THE BUDGET AND THE MINISTER DELEGATE FOR SMALL AND MEDIUM-SIZED ENTERPRISES, INNOVATION AND THE DIGITAL ECONOMY (2013).

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introduced a “significant economic presence test,” and India also introduced a “significant economic presence” concept.<sup>69</sup>

In addition, some countries are interpreting a “services permanent establishment” to not require any physical presence. The services permanent establishment has typically been interpreted to require the physical presence of a non-resident for at least 183 days in any 12 month period.<sup>70</sup> According to the OECD BEPS Inclusive Framework report, some countries are interpreting the term “furnishing of services” to mean services used or consumed in the source jurisdiction, thus including services performed remotely if the other requirements of the permanent establishment definition are met.<sup>71</sup> This view has been officially endorsed in Saudi Arabia and within some case law in India.<sup>72</sup>

In the longer run, the European Union similarly hopes for more fundamental reform that allows for taxation of non-resident firm profits without any physical presence, assuming above-threshold sales (€7 million), amount of consumers affected (currently set at 100,000 consumers), or contacts between the non-resident firm and other EU-based businesses (currently set at 5,000 contacts).<sup>73</sup> This Significant Digital Presence test focuses exclusively on companies involved in digital commerce. The above-threshold sales test, for instance, encompasses only sales related to “digital services,” which generally includes all services delivered over computer networks.<sup>74</sup>

Economic presence tests, if properly designed, offer a straightforward way for market countries to tax profits associated with significant sales from non-resident firms. These tests are explored further in Part IV.B.

### B. Withholding Taxes

Withholding taxes are another way to allocate more taxing authority to source countries: a government simply needs to pass a tax law that forces a resident payor to assess, withhold, and remit the tax to the local taxing authority. Doernberg previously vetted the core issues surrounding the imposition of withholding taxes to income generated by digital goods and services, including design issues surrounding foreign tax creditability and exemptions.<sup>75</sup>

69. OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT, TAX CHALLENGES ARISING FROM DIGITALISATION - INTERIM REPORT 2018: INCLUSIVE FRAMEWORK ON BEPS, ¶¶ 349–351 (2018) [hereinafter TAX CHALLENGES ARISING FROM DIGITALISATION].

70. See, e.g., Canada-U.S. Tax Treaty, *supra* note 18, at art. V(9).

71. OECD, TAX CHALLENGES ARISING FROM DIGITALISATION, *supra* note 69, at ¶353.

72. Id. at ¶¶ 353–54.

73. EUROPEAN COMMISSION, *Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence*, 16 COM (2018) 147 final 2018/0072 (CNS) [hereinafter *Proposal for corporate taxation*]. See also EUROPEAN UNION, FAIR TAXATION OF THE DIGITAL ECONOMY (2018).

74. EUROPEAN COMMISSION, *Proposal for Corporate Taxation*, *supra* note 73, at 14, 16.

75. Richard L. Doernberg, *Electronic Commerce and International Tax Sharing*, 16 TAX NOTES INT’L 1013 (1998). See also Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52

The OECD Inclusive Framework on BEPS notes trends in this area.<sup>76</sup> First, the report notes the trend toward broadening the withholding tax for royalties. Some countries have expanded their domestic definition of royalties subject to withholding on a gross basis by incorporating items of income traditionally classified as business profits in tax treaties.<sup>77</sup> For instance, such expansion includes payments for software (Greece and the Philippines) and payments for “visual images or sounds” transmitted through information and communication technology (Malaysia). The definitions also generally strive to bring software as a service (SaaS) transactions within the scope of the withholding tax.<sup>78</sup>

Second, the report discusses the adoption of withholding taxes on fees for technical services. An increasing number of countries create an exception to the permanent establishment threshold for certain service fees in their domestic law and/or double tax treaties, allowing a withholding tax on a gross basis in the source country when the payer is resident in that country. The OECD Model does not contain this exception, although it was added to the UN Model as part of its 2017 update in response to the view that substantial services can now be supplied without any physical presence in the market state.<sup>79</sup> The scope of this exception is typically limited to fees for technical services, generally defined as payments in consideration for the services of a managerial, technical (i.e., requiring expertise in a technology), or consultancy nature. While this definition is not specifically targeted at digital products and services, it generally includes a broad range of cloud computing services.

The academic writings on this topic accept that any new withholding taxes will be easier to administer for cross-border business-to-business transactions, with relatively limited administrative and compliance costs for both taxpayers and the tax authorities.<sup>80</sup> Collection issues become more difficult for business-to-consumer transactions, as individual consumers have little knowledge or incentive to declare and pay the tax due.

### C. Transactional Taxes

In the late 1990s, commentators explored the imposition of transaction taxes for internet commerce, although the most prominent recommendation—the

TAX L. REV. 507 (1997); Yariv Brauner, *Withholding Taxes in Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy* (IBFD Working Papers, 2015).

76. OECD, TAX CHALLENGES ARISING FROM DIGITALISATION, *supra* note 69, at ¶¶ 355–56. See also Chang Hee Lee & Ji-Hyun Yoon, *General Report Subject 2: Withholding Tax in the Era of BEPS, CIVS and the Digital Economy*, 103B CAHIERS DE DROIT FISCAL INTERNATIONAL 215, 260 (2018) (noting that specific withholding taxes targeting business income generated by digital commerce have yet to become part “of most, if indeed at this stage, any” tax system).

77. OECD, TAX CHALLENGES ARISING FROM DIGITALISATION, *supra* note 69, at ¶ 355.

78. Lee & Yoon, *supra* note 76, at 250.

79. UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES: 2017 Update (2018).

80. Doernberg, *supra* note 75.

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imposition of a “bit tax”—was rejected for being technologically infeasible as well as an unacceptable departure from traditional international tax principles.<sup>81</sup>

Partially as a result of similar concerns, BEPS Action 1 rejected bandwidth/bit or other such transactional taxes as a coordinated international response to challenges posed by the global digital economy.<sup>82</sup> It nevertheless opened the door for governments to legislate “equalization levies” as long as they respected existing international legal obligations. This development has led to multiple governments proposing to implement such levies.

The OECD Inclusive Framework report details some of these developments.<sup>83</sup> Most of the levies target advertising provided by non-resident digital companies (e.g., Facebook, which monetizes users’ data by selling it to third party marketing companies).<sup>84</sup> The new levies are generally combined with broad nexus rules focused on the destination of the supplies and applied to resident and non-resident enterprises, regardless of the level of physical presence in the market state. For instance, France’s turnover tax governs taxable transactions primarily on the basis of their final destination, such as the location of the “public audience” (i.e., viewers) for the online supply of digital content.<sup>85</sup> In 2016, the tax was broadened to capture online video services such as YouTube provided for “free” to consumers (YouTube generates revenue mainly from advertisements associated with video content).<sup>86</sup> The report notes that the scope of the advertisement tax in Hungary is similarly dependent on the location of the targeted public (deemed to be Hungary when displayed online predominantly in the Hungarian language).<sup>87</sup>

The report notes that under both the French and Hungarian approaches, a tax liability may arise where the payment is for the display of advertisements to in-country internet users, such as online multi-sided platforms, irrespective of the location or residence of the payer and supplier. These approaches cover the situation where, for example, a subsidiary A of a multinational group (resident in country A) buys online advertisement services from the subsidiary of an advertising group (resident in country B) and the online advertisement is targeted to customers in country C (the taxing jurisdiction).

In contrast, the scope of proposed levies adopted by India are dependent on the location of the payer, typically a business resident in the taxing jurisdiction. India’s “equalization levy,” first proposed in 2016, targets a rather narrow class

81. See Luc Soete & Karin Kamp, *The Bit Tax: Taxing Value in the Emerging Information Society*, in *THE NEW WEALTH OF NATIONS* (Arthur Cordell & Thomas Ide eds., Between the Lines 1997).

82. See OECD, ACTION 1 FINAL REPORT, *supra* note 33, at ¶ 302.

83. OECD, TAX CHALLENGES ARISING FROM DIGITALISATION, *supra* note 69, at ¶¶ 360–62.

84. See ADAM B. THIMMESCH, TRANSACTION IN DATA: TAX, PRIVACY, AND THE NEW ECONOMY, 94 *DENV. L. REV.* 145 (2016).

85. OECD, TAX CHALLENGES ARISING FROM DIGITALISATION, *supra* note 69, at ¶¶ 361–62.

86. *Id.* at Box 4.6. The tax rate is 2%, increasing to 10% for content containing “pornography” or “incitement to violence.” *Id.*

87. *Id.* at Box 4.5.

of digital transactions: online business-to-business advertising services.<sup>88</sup> A business taxpayer resident in India will need to withhold 6% of payments for advertising services, but only to the extent the payments to one service provider exceed Rs. 1 million.<sup>89</sup>

Another related innovation involves proposed digital services taxes that tax specific firm dealings instead of income. Unlike the equalization levies, the digital services taxes do not focus on dividing revenue attributable to domestic consumers. The European Union proposed, as an interim solution, a digital services tax whereby member states should apply at a rate of 3% on gross revenues generated by non-resident companies with certain digital sales to EU consumers, even in the absence of any physical presence within the market country.<sup>90</sup> The tax will only apply to multinational firms with total annual worldwide revenues of €750 million and EU revenues of €50 million.

The United Kingdom has similar plans to target large non-resident tech firms with at least £500 million a year in global revenue, as well as other safe harbors, in a proposed digital services tax that would take effect in 2020.<sup>91</sup> Under the proposal, a 2% tax rate will be applied to the gross revenues of non-resident firms with social media platforms, internet marketplaces and search engines.<sup>92</sup> The proposed EU and UK digital tax measures apply a tax rate to gross revenues in contrast to “normal” income taxes that apply to net profits (that is, gross revenues minus business expenses).<sup>93</sup> Spain, France, Mexico, Turkey, South Korea, Italy and other countries are considering similar measures.<sup>94</sup> The digital services tax has attracted proponents who argue that it is a relatively straightforward way to collect taxes from non-resident sales while others argue that it does not follow accepted international tax norms and may violate World Trade Organization (WTO) non-discrimination rules.<sup>95</sup> Like the withholding taxes discussed previously, the digital services tax imposes taxes on a gross basis versus a “normal” income tax that is taxed on a net basis of revenues minus expenses.

While more carefully tailored in contrast to earlier ‘bit tax’ proposals, digital services taxes face administrative and enforcement challenges common to all

88. *Id.* at Box 4.3.

89. *Id.*

90. EUROPEAN COMMISSION, *supra* note 73. *See also* EUROPEAN UNION, *supra* note 73.

91. HM TREASURY, CORPORATE TAX AND THE DIGITAL ECONOMY: POSITION PAPER UPDATE (2018).

92. *Id.*

93. The approaches differ in terms of how they allocate revenues subject to the Digital Services Tax. Under the EU approach, revenue should be allocated depending on how many times targeted advertisements appear on devices and the number of users. Under the UK approach, revenue would be allocated according to revenues from sales targeting UK users or facilitating sales with these users.

94. *See* the discussion in note 11.

95. *See* Wei Cui, *The Digital Services Tax: A Conceptual Defense*, ALLARD RESEARCH COMMONS (2018) [https://commons.allard.ubc.ca/fac\\_pubs/470](https://commons.allard.ubc.ca/fac_pubs/470) (claiming the tax would enable source countries to tax location-specific rents); Gary Clyde Hufbauer & Zhiyao (Cindy) Lu, *The European Union's Proposed Digital Services Tax: A De Facto Tariff* (Peterson Institute for Int'l Econ. Pol'y Brief 18-5, 2018), <https://www.piie.com/system/files/documents/pb18-15.pdf> (arguing the DST likely violates international trade laws).

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transaction taxes. The business-to-business transaction taxes, especially if they are imposed on above-threshold cross-border payments, should be easier to enforce because they focus on forcing large resident businesses to withhold the tax.

### *D. Minimum Taxes*

Governments are also seeking to impose minimum taxes on inbound foreign direct investment via diverted profits taxes and outbound foreign direct investment via the Global Intangible Low Taxed Income (GILTI).

In recent years, some countries have initiated “diverted profits taxes” that seek to impose a minimum tax rate on profits that have been artificially diverted out of market countries.<sup>96</sup> In this sense, the taxes act like other anti-avoidance rules found within income tax legislation.<sup>97</sup> The diverted profits taxes generally govern digital and conventional commerce (although in some cases they were designed largely to tax profits generated by large non-resident digital companies).

For instance, the United Kingdom’s Diverted Profits Tax,<sup>98</sup> effective since 2015, is a stand-alone tax levied at a rate of 25% (versus the general corporate tax rate of 19%) on profits that are seen to be artificially diverted from the country. The purpose of the tax is actually not to impose additional tax measures on non-resident firms but rather to act as a deterrent and increase compliance with existing rules. Diverted profits are associated with efforts to (a) enter into arrangements that artificially avoid a UK-based permanent establishment or (b) engage in related party transactions with a UK affiliate in such a way that it leads to excessive tax deductions or understated income (e.g., charging too-low service fees).

Australia introduced a tax called the Multinational Anti-Avoidance Law that came into effect in 2016, which resembles aspects of diverted profits taxes.<sup>99</sup> Like the UK version, the tax is anti-avoidance for corporate tax purposes that focus in part on profits that have been artificially diverted to avoid a permanent establishment within Australia. It more narrowly targets large non-resident multinational firms that enter into arrangements to avoid constituting an

96. See also Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate*, TAXES 85 (Mar. 2019).

97. The base erosion and anti-abuse tax (BEAT) resembles an approach advocated by Alex Easson who suggested that, to encourage tax neutrality, source countries should deny deductions for related party payments of rent, royalties, dividends or interest. To encourage further tax neutrality, Easson also advocated the abolition of withholding taxes on parent-subsidiary dividends. Alex Easson, *Company Tax Reform and the Inter-Nation Allocation of Tax Jurisdiction*, in COMPANY TAX SYSTEMS (J.G. Head & R. Krever eds., 1997) 285 [hereinafter *Company Tax Reform*] (considering the international allocation of corporate income tax revenues. See also Alex Easson, *Taxing International Income*, in TAX CONVERSATIONS: A GUIDE TO THE KEY ISSUES IN THE TAX REFORM DEBATE (R. Krever ed., 1997) 419 (discussing the existing international tax base allocation rules and the feasibility of reform alternatives).

98. *Id.* at Box 4.7.

99. *Id.* at Box 4.8.

Australian permanent establishment when the non-resident supplies goods and services to consumers located within the country. In addition, Australia adopted a full-blown diverted profits tax in 2017 under the *Diverted Profits Tax Act*. The measure applies to both resident and non-resident companies and tries, like the UK tax, to inhibit excess deductions and understated income as long as the principal purpose for the structure was to secure these tax benefits.<sup>100</sup>

Finally, the United States adopted the base erosion and anti-abuse tax (BEAT), which became effective on January 1, 2018, as part of the tax law known as the *Tax Cuts and Jobs Act*.<sup>101</sup> Unlike the UK and Australian approaches, the BEAT seeks to apply a “true” minimum tax rate on inward investment by large multinational firms with related US-based entities. In this way, the BEAT resembles alternative minimum tax schemes familiar in many countries that deny stipulated deductions for certain high-income taxpayers.

The BEAT applies to US resident corporations and permanent establishments of non-residents that are members of a multinational group with over \$500 million in annual sales over a three-year period.<sup>102</sup> If a tax liability arises as a result of the BEAT, then it is payable in addition to any liabilities for regular corporate income. If applicable, the BEAT applies at a rate of 10% of the taxpayer’s “modified taxable income” (5% for 2018 and 12.5% after 2025), less a portion of certain tax credits.

The diverted profits taxes strive to reduce tax deductions that erode source country income tax bases. In a typical global structure, a related party within a multinational firm is situated in a low or nil tax jurisdiction so the income inclusion will be subject to low or nil tax rates. The BEAT in particular strives to deny expense deductions for payments that are not subject to a minimum tax. In this sense, the diverted profits taxes act as anti-avoidance rules that mainly target the use of tax havens in a similar fashion to controlled foreign corporation (CFC) rules, although these rules apply to outbound investments.

CFC rules and other efforts to tax foreign source passive income on an accrual basis are important because income generated from intangibles or the sale of digital goods and services is considered highly mobile. Action 3 of the OECD BEPS project suggested CFC reforms to address digital economy matters via broader definitions to capture income so that it is included as foreign source passive income. For instance, the OECD notes that new definitions may be needed to include ‘tainted’ CFC income profits generated by license fees as well as certain types of income from sales of digital goods and services.<sup>103</sup> The gist of the proposed reforms is to identify whether the CFC is engaged in substantial

100. *Id.*

101. I.R.C. § 59A.

102. *Id.*

103. OECD, ACTION 1 FINAL REPORT, *supra* note 33, at ¶ 146. *See also* the discussion in Part II.C, *supra*.

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economic activities or whether it is really supporting profit shifting of passive income that ought to be subjected to current taxation by a residence country.

With the *Tax Cuts and Jobs Act*, the United States also reformed part of its CFC regime. The legislation includes a new tax on “global intangible low-taxed income” or GILTI.<sup>104</sup> It applies corporate tax on the excess of a shareholder’s net CFC income over an ordinary return (that is, a deemed tangible income return). Under this approach, an excess return beyond the deemed tangible income return is normally considered GILTI, regardless of the actual character of the earnings. This GILTI is then subjected to a 10.5% tax rate—as long as no tax is paid abroad. To the extent GILTI has been taxed at a rate that exceeds 13.125%, then no US tax will be applied.

The innovation here arises from the rules’ initial focus on returns generated by tangible assets to arrive at a measure of ostensible returns generated by intangible assets. Unlike traditional CFC rules, the GILTI seeks to impose a minimum tax on foreign source profits regardless of the characterization of such income as being active or passive.

There is a good chance that minimum taxes like the GILTI will have a future within the broader international tax regime.<sup>105</sup> Over time, many governments have migrated from residence-based taxation of foreign source active business income to the non-taxation of such income.<sup>106</sup> With the *Tax Cuts and Jobs Act*, the United States adopted this international norm. The movement toward territorial systems provides greater incentives for firms to shift income via tax planning to low or nil tax jurisdictions, as this income is increasingly not subject to tax by the residence country. In particular, as many large companies increasingly derive value from the working of highly intangible and mobile computer code, this profit shifting of what I have termed “virtual income” is easier to accomplish.<sup>107</sup> In this environment, governments are better off cooperating to impose a minimum tax on foreign source active business

104. Proposed regulations under section 951A of the Internal Revenue Code provide guidance for U.S. shareholders to determine the amount of GILTI to include in gross income. See DEPT. OF TREASURY, *supra* note 14.

105. The OECD/G20 BEPS reforms under ‘Pillar Two’ are focusing on minimum taxes (although some countries take the position that a systematic minimum tax solution goes beyond Pillar Two objectives). The minimum taxes being explored are broken down into: (a) an income inclusion rule (similar to controlled foreign company (CFC) rules); (b) a switch-over rule (to ensure rules apply to any branches that are exempt under tax treaties); (c) an under-taxed payment rule (that denies deductions for intra-group payments like the BEAT); and (d) a subject to tax rule (that taxes certain items of income where the payment is not subject to tax at a minimum rate). OECD/G20 2020 STATEMENT, *supra* note 3, at Annex 2, ¶¶ 4, 8–19.

106. ARTHUR J. COCKFIELD, EXAMINING POLICY OPTIONS FOR THE TAXATION OF OUTBOUND DIRECT INVESTMENT: A REPORT FOR THE ADVISORY PANEL ON CANADA’S SYSTEM OF INTERNATIONAL TAXATION (2008)

107. Cockfield, *Transforming the Internet into a Taxable Forum*, *supra* note 4 at 1197–1200, 1230–35. See also the discussion in note 3.

income—otherwise it will largely be shifted to tax havens and no revenues will be collected.<sup>108</sup>

*E. Summary*

The new tax innovations violate traditional international tax guiding principles as well as the Ottawa Taxation Framework conditions.<sup>109</sup>

The tax innovations violate the principle of neutrality when the rules do not impose neutral tax treatment between conventional and digital commerce. A European Commission report also concluded that there should not be any special tax regime for digital commerce.<sup>110</sup> Action 1's Final Report of 2015 similarly advocated the need for neutral tax treatment to avoid "ring-fencing" the digital economy.<sup>111</sup> This desire to impose neutral tax treatment is challenged by some of the innovations such as proposed withholding taxes that are imposed exclusively on cross-border digital transactions. This non-neutral tax treatment will distort the market for cross-border goods and services, leading to inefficient tax planning, to blur income classification categories and thus obtain better tax treatment. These outcomes lead to dead-weight losses to economic activity, reducing national and global income levels.

The new rules also violate the principle of fairness and effectiveness because some of the new anti-avoidance rules, such as diverted profit taxes, are arguably disproportionate to the revenue loss risks involved. They violate the principle of certainty and simplicity because the rules are not clear and simple to understand, making it hard for taxpayers to anticipate the tax consequences in advance of a transaction, including knowing when, where, and how the tax is to be accounted.

In addition, the unilateral and uncoordinated measures promoted by some governments give rise to a greater risk of international double taxation as they seek to extend their taxing jurisdiction over non-resident firm profits: the resident country may claim that it already has the legal authority, pursuant to its domestic tax laws or a tax treaty, to tax these same profits, leading to double taxation. For instance, the new US GILTI rules seek to broaden US claims over foreign profits generated by intangible assets, which could conflict with non-US claims to tax this income, especially when the non-US rules define intangible income without a reference to tangible asset returns. Similarly, withholding taxes are meant to

108. See INT'L MONETARY FUND, CORPORATE TAXATION IN THE GLOBAL ECONOMY ¶ 44 (2019), <https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650>. As discussed by Easson, "In reality, the choice may be between source-country taxation and no taxation at all." Alex Easson, *Fiscal Degradation and the Inter-National Allocation of Tax Jurisdiction*, 5 EC TAX REV. 112, 112–13 (1996).

109. See the discussion in Part II.A.

110. EXPERT GROUP ON TAXATION AND THE DIGITAL ECONOMY, REPORT OF THE COMMISSION EXPERT GROUP ON THE TAXATION OF THE DIGITAL ECONOMY 5 (2014).

111. OECD, ACTION 1 FINAL REPORT, *supra* note 33, at ¶¶ 115, 364.

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increase taxation of non-resident firms and, if applied too broadly and the tax liabilities are not creditable, could encourage international double taxation.

The new rules also violate the principle of flexibility that espouses flexible and dynamic rules to ensure the new rules can follow technological and commercial developments. For instance, the digital sales tax targets existing business models and their process for generating revenues whereas these conditions may change in the near term. The United Kingdom's Digital Services Tax proposal focuses on certain online activities only—search engines, social media, and digital platforms. Similarly, the European Union's plan for a Significant Digital Presence test focuses on the provision of specified digital services to consumers, and not more broadly on conventional sales as well. These proposals are short-sighted because they focus on business models that may change in the near future.

Moreover, the Ottawa Taxation Framework conditions recognized that new rules may be needed, but that any new rules should help apply existing international tax principles. Governments should focus on developing rules to ensure “a fair sharing of the tax base while avoiding double taxation or unintentional non-taxation.”<sup>112</sup>

The new tax rules violate the principle of efficiency because they unduly raise compliance costs for taxpayers and enforcement costs for tax authorities. Some of the new taxes are complex and will require significant tax administration resources to pull off, which is particularly challenging for low income countries that do not have such resources.<sup>113</sup> The new measures also promote higher taxpayer compliance costs as firms struggle to comply with the complex new tax measures. International double taxation and high compliance costs inhibit global trade, making all countries worse off.

As noted by the OECD's Inclusive Framework on BEPS, “The proliferation of unilateral approaches is likely to have adverse impacts on investment and growth, and risks increasing double taxation and complexity for taxpayer and tax authorities alike.”<sup>114</sup> In response, the BEPS Inclusive Framework strives to exert some coordination of the recent unilateral proposals, including by advising that the new measures should be temporary in nature.<sup>115</sup> While developments are still underway, it appears that many of the rebel governments are not heeding this advice as they are legislating taxes that differ significantly in technical detail.

### IV. INCREMENTALLY CHANGING THE SYSTEM

The previous part discussed how governments are unilaterally developing tax laws to tax global digital commerce. This “tax war” will harm the global

112. OECD, *supra* note 22 at 3.

113. INT'L MONETARY FUND, *supra* note 108, at ¶16.

114. OECD, TAX CHALLENGES ARISING FROM DIGITALISATION, *supra* note 69, at ¶511.

115. *Id.*, at ¶¶ 412–63.

economy by making it more risky and costly to engage in cross-border digital transactions. The obvious solution to the war is for governments to cooperate on a coordinated solution. To attract government consensus, the international tax regime normally takes incremental reform steps. There are a number of reasons to prefer this course of action, including its political feasibility and the fact that any significant change encourages greater risks of unduly raising firm transaction costs to the point where taxes become a greater barrier to international trade and investment.<sup>116</sup> As Richard Bird has noted, incremental change in international tax policy is likely the only feasible approach because of fiscal sovereignty concerns.<sup>117</sup>

An incremental strategy could involve expanding the permanent establishment principle to include significant consumer country sales. The proposed step in this direction is a quantitative economic presence test (e.g., above US \$10 million in gross sales) that will deem a permanent establishment to exist within the market country. In turn, this could be backed up by greater resort to a modified version of an existing transfer pricing method, namely, the residual profit split method, that divides taxable profits and revenues between countries. The analysis below relies on a proposal called the Residual Profit Split by Income reform.

#### *A. Taxing the Global Digital Economy by Focusing on Consumption*

The recently proposed tax innovations depart from traditional international tax laws and principles, impose non-neutral tax treatment between conventional and digital commerce in some cases, and raise the risk of international double taxation and high taxpayer compliance costs. All of the tax innovations seek to allocate more taxing power and tax revenues to countries whose consumers are targeted by non-resident digital firms that often maintain little to no physical presence within the market country.

More fundamentally, governments around the world increasingly struggle with one question: where is value added to a global transaction? This question remains largely unresolved despite the 2015 BEPS Project's stated objective to ensure taxation "where economic activities take place and value is created."<sup>118</sup> Therefore, the lack of a common understanding of the term "value creation" in global digital supply chains continues to be a challenge for tax authorities.

116. Cockfield, *Tax as a Commitment Projector*, *supra* note 45 (discussing how significant reforms can unduly raise transaction costs facing firms)

117. See RICHARD M. BIRD, A VIEW FROM THE NORTH, 49 TAX L. REV. 745 (1994). See also BRIAN J. ARNOLD, REFORMING CANADA'S INTERNATIONAL TAX SYSTEM: TOWARD COHERENCE AND SIMPLICITY 58 (2009) (espousing skepticism about "grand theoretical designs for the international aspects of a country's tax system").

118. See OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: EXPLANATORY STATEMENT – 2015 FINAL REPORTS 4 (2015).

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Consider a firm such as Facebook involved in targeting online banner advertisements at consumers using social media. Is the value created by collecting and aggregating personal information data? Does the value lie in applying data analytics to this collected information in order to generate ads?

Is it the development of the software that is the real contributor to value, hence allocating taxes to the jurisdictions where innovators are based? Is it in fact the social media platform, such as Facebook itself, that is the real creator of value within the cross-border transaction? Is it user participation within a market country that is a driver of value creation? Should the provision of local technological or other infrastructure resources by market countries count as adding value?

The OECD acknowledges that, with respect to these matters, “there is no consensus on [the] relevance and importance to the location of value creation and the identity of the creator.”<sup>119</sup>

As previously discussed in Parts I and II, the digitization of the global economy presents two main tax challenges. First, sales are increasingly provided remotely to foreign consumers without the need to set up shop in the market country, or the country where consumers live. Second, digital goods and services are “information goods” with potentially high fixed costs of production but near-zero marginal costs for reproduction and transfer. Hence, the goods and services, or the rights to use them, can be transferred across borders at nearly no cost. From a tax perspective, this economic theory suggests that information goods that attract taxation may migrate to the lowest taxed jurisdiction because it is almost costless to do so.<sup>120</sup> Consequently, the income produced by intangible assets, including software code, should, at least as a matter of long-run economic analysis, also flee to tax havens.

The most obvious way to address these difficulties is to allocate more taxing power to market countries. The conceptual challenge to this solution is that international income tax laws have focused on taxing the production of value, and not its consumption.<sup>121</sup> Some commentators have struggled to suggest that users produce value with respect to the many digital goods and commerce, hence entitling the country where users live to tax the cross-border transaction.<sup>122</sup> For instance, the United Kingdom’s digital services tax relies on the view that users

119. OECD, INCLUSIVE FRAMEWORK ON BEPS, TAX CHALLENGES ARISING FROM DIGITIZATION – INTERIM REPORT 25 (2018). The OECD examined associating profits with the ‘life cycle’ of data and user participation. *Id.* at 53–59.

120. Cockfield, *Law and Economics of Digital Taxation*, *supra* note 4.

121. This discussion has also taken place with respect to related proposals to develop a destination-based corporate tax. See Alan Auerbach, et al., *Destination-Based Cash Flow Taxation* (Oxford Univ. Ctr. for Business Taxation Working Paper 17/01, 2017); Michael Devereux & Rita de la Feria, *Designing and Implementing a Destination-based Corporate Tax* (Oxford Univ. Ctr. for Business Taxation Working Paper 14/07, 2014). These proposals consider issues such as whether a destination-based corporate tax violates international trade law. *Id.*

122. Wei, *supra* note 95, at 29 (claiming that location-specific rents can be tied to users’ online activities).

generate value when they, for instance, “like” another person’s post on a social media platform, as this trail of personal information ultimately gets monetized through its sale to third-party marketing companies.<sup>123</sup> Similarly, the United Kingdom’s diverted profits tax as well as the US BEAT (base erosion and anti-abuse tax), both discussed in Part III, strive to tax firms based on the location of consumers.

From a theoretical perspective, there are reasons to support a shift from production to consumption in order to assign tax jurisdiction and calculate the value of taxable profits in each country. Commentators have noted that the exertion of tax jurisdiction over significant sales into a source country can be justified simply on the basis that the source country’s market presented opportunities for the profits to be generated in the first place. For example, Klaus Vogel suggests that “[i]t cannot convincingly be denied that providing a market contributes to the sales income at least to some extent as providing the goods does. There is no valid objection, therefore, against a claim of the sales State to tax part of the sales income.”<sup>124</sup>

Taxation with no physical presence can also be justified on the grounds that the source country’s government provides access to the market by building roads and other infrastructure.<sup>125</sup> Similarly, cross-border digital transactions are enabled by a market country’s telecommunication infrastructure that is often built or subsidized by governments.<sup>126</sup> Finally, permitting capital importing countries (especially developing countries) to enjoy revenue from taxing cross-border transactions offers those countries an incentive to subsidize telecommunications facilities and networks, which in turn further expands market opportunities for sales of digital goods and services from capital-exporting nations.<sup>127</sup>

### B. *Quantitative Economic Presence Permanent Establishment*

As mentioned in Part II.A, the permanent establishment rule is the main tax treaty rule whereby governments agree they will not tax cross-border income

123. See the discussion accompanying notes 11, 86, 88; *infra* note 145.

124. See Klaus Vogel, *Worldwide vs. Source Taxation of Income – A Review and Re-evaluation of Arguments*, 11 INTERTAX 393, 400 (1998). Vogel credits Georg von Schanz with focusing on the need to support source state taxation. Von Schanz proposed that the source state should levy its tax at three-quarters of the normal rate and proposed that the residence state should levy its tax at one-quarter the normal rate. See George von Schanz, *Zur Frage der Steuerpflicht*, 9 FINANZARCHIV 356 (1892). See also Charles E. McLure Jr., *Alternatives to the Concept of Permanent Establishment*, in REPORT OF THE PROCEEDINGS OF THE WORLD TAX CONFERENCE: TAXES WITHOUT BORDERS 10–16 (CTF, 2000).

125. Earlier reforms emphasized the need for source state taxation. The International Chambers of Commerce adopted a resolution advocating that the source state should have the “sole right” to tax cross-border income. See INT’L CHAMBER OF COMMERCE, AVOIDANCE OF DOUBLE TAXATION, RESOLUTION OF ICC COUNCIL AND REPORT OF COMMISSION ON TAXATION (1955).

126. This justification follows the so-called benefit principle whereby taxpayers should pay taxes to compensate the state for its provision of resources that enabled profits to be generated.

127. See Arthur J. Cockfield, *The Real Digital Divide: Electronic Commerce, Developing Countries and Declining Tax Revenues*, in UNESCO ENCYCLOPEDIA OF LIFE SUPPORT SYSTEMS 6.31.3.6 (2002).

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unless the income arises from a permanent establishment within their border. When the permanent establishment rule was introduced, it was assumed that a business would need a physical location to generate significant sales within target markets. In a sense, the permanent establishment principle was designed to serve as a proxy for significant consumption within a market country.

Skaar notes that the permanent establishment concept was diluted over the decades to account for changing business practices and the ongoing need to recognize value-adding aspects of consumption markets.<sup>128</sup> For instance, market countries are permitted to tax cross-border income of artists and athletes even in the absence of a permanent establishment.<sup>129</sup> The justification for the rule is the recognition that artists and athletes are able to earn large incomes even though they do not have a permanent establishment anywhere. A popular musical artist from country R can earn millions of dollars in revenues on a two-week tour in country S even though the artist does not maintain a fixed place of business in country S. By analogy, some countries might view entrepreneurs engaged in digital commerce in the same way. In other words, if a digital company can make significant and sustained profits in a market country despite no physical presence, it should be treated in the same way as a non-resident entertainer who does not normally reside in countries where they hold concerts.

National tax authorities should consider adopting a permanent establishment fiction in model tax treaties, a quantitative economic presence permanent establishment (QEPPE), that would permit market countries to tax significant cross-border economic activities. A quantitative threshold, such as gross sales of US \$10 million, would ensure that market countries can subject nonresident companies to their tax jurisdiction only if those nonresidents conduct significant business activities within their borders.<sup>130</sup> The rule is designed as a backstop to protect market countries' income tax bases from erosion and could promote greater business certainty surrounding the taxation of many cross-border transactions, at least when compared to the dozens of emerging unilateral solutions.<sup>131</sup>

The OECD's Secretariat Proposal agrees that the simplest approach for the new rule to provide greater taxing authority to market countries would be to define a revenue threshold.<sup>132</sup> In addition to a quantitative threshold per country

128. The requirement for a fixed place of business within source countries is typically traced back to the tax treaty between Austria-Hungary and Prussia in 1899. For background, see SKAAR, *supra* note 65, at 65–101.

129. See OECD Model Tax Treaty (2017), at Article 17.

130. This section draws from an earlier work. See Cockfield, *Quantitative Economic Presence Test*, *supra* note 67. Note that the USD\$10 million threshold is similar to the one proposed by the European Union's March 2018 proposal for a significant digital presence threshold of Euros 7 million although this test also incorporates qualitative aspects such as number of users.

131. See Part III.

132. See OECD SECRETARIAT PROPOSAL, *supra* note 3, at 8. The proposal focuses on taxing 'consumer-facing businesses', which covers highly digitized business models and other highly profitable

(e.g., US \$10 million), this proposal also considered applying a revenue threshold such as Euro 750 million for global sales before a taxpayer would be subject to the new rules. Both thresholds would need to be fulfilled before a market jurisdiction can exert its income tax powers over a non-resident firm. For instance, if a US company sold USD\$50 million in digital services to French consumers (exceeding a hypothetical USD\$10 million per country threshold) but it only had Euro 500 million in global sales then France would not be able to tax this US company. The revenue thresholds should also apply to groups that sell in a market through a distributor, whether through a related or unrelated local entity, in order to ensure neutrality between different business models and capture all forms of remote involvement in the economy of a market jurisdiction.

The Secretariat Proposal, however, envisions a new stand-alone rule apart from the permanent establishment rule, whereas the QEPPE simply extends the concept to encourage tax certainty. By relying on the permanent establishment principle, which has been interpreted by the OECD Commentaries and national courts, the QEPPE would represent a more modest reform compared to a new stand-alone rule that would represent a greater move away from traditional international tax rules and policies.

### *1. Quantitative Versus Qualitative Tests*

While reform efforts in the past have considered economic presence tests, the international tax regime has traditionally emphasized the need for a physical presence within a market country before taxing a cross-border transaction.<sup>133</sup> As mentioned, Hinnekens has discussed the potential creation of a “virtual permanent establishment” in model tax treaties, under which market countries would be permitted to tax cross-border profits as long as the nonresident company conducted continuous and commercially significant business activity within the market country.<sup>134</sup> Hinnekens suggests that countries can develop a

business models that interact with consumers. *Id.* The OECD/G20 Inclusive Framework on BEPS subsequently endorsed this general approach. *See* OECD/G20 2020 STATEMENT, *supra* note 3, at ¶ 35.

133. The suggested approach is similar to previous reform proposals. For example, a League of Nations subcommittee in 1940 investigated whether changes were necessary to the PE principle. The subcommittee drafted a model draft treaty (the so-called Mexico Draft) that maintained the fixed place of business requirement for a permanent establishment, but also permitted source state taxation when significant sales took place within the source country despite an absence of a fixed place of business. Paragraph 2 of art. IV of the Mexico Draft stated, ‘If an enterprise or an individual in one of the contracting States extend their activities to the other State, through isolated or occasional transactions, without possessing in that State a permanent establishment, the income derived from these activities shall be taxable only in the first State.’ According to Skaar, ‘[t]he criterion under this model is the regularity or location of the activities of the business operations, rather than the significance or location of the activities of the enterprise.’ Because of the advent of World War II, most of the subcommittee consisted of representatives from Latin American countries. The representatives sought to strengthen source state taxation. The Mexico Draft was never adopted by the League of Nations, and a later draft (the so-called London Draft) returned to the earlier definition of a permanent establishment that focused largely on the need for a fixed presence within a source country. Skaar, *supra* note 65 at 118–32.

134. *See* Part III.A.

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facts and circumstances test to determine whether market state nexus is met. This test would use qualitative criteria (for example, presence of computer servers or use of trademarks) and quantitative criteria, because “[e]ven significant volumes of sales may not be sufficient to prove a nexus-constitutive level of focused and purposeful penetration and performance of core activities in the market of” the market country.”<sup>135</sup>

Yet the qualitative approach to economic presence tests arguably suffer from many deficiencies. In the context of U.S. subnational taxation, critics at one point suggested that allowing state governments to tax out-of-state businesses through qualitative economic presence tests would lead to business uncertainty and onerous compliance obligations for firms with no physical presence in the tax jurisdiction.<sup>136</sup>

Despite those apparent deficiencies, qualitative economic presence tests in the federal context make at least theoretical sense because the highest court in the land can ultimately resolve compliance uncertainty.<sup>137</sup> This development obviously parallels anticipated developments in the U.S. sales and use tax following the US Supreme Court decision in *South Dakota v. Wayfair, Inc.*, which embraced an economic presence test.<sup>138</sup> This decision invoked “[t]he Internet’s prevalence and power” and the “dramatic technological and social changes” of our “increasingly interconnected economy” as the basis for replacing a physical-presence nexus standard for requiring remote sellers to collect taxes with a test based on “economic and virtual contacts.”<sup>139</sup>

In the international context, these qualitative tests make less sense because there is no world tax authority or world tax court.<sup>140</sup> Consider the OECD’s review, within the 2019 public consultation document, of the need for a “purposeful and sustained interaction with the market or user jurisdiction” to generate a taxable presence.<sup>141</sup> If this approach was implemented, tax authorities and courts throughout the world would develop their own interpretation of the factors that meet the requirements for market state taxation. Capital-importing nations will tend to interpret the factors broadly to permit their tax authorities to exert jurisdiction over nonresident firms. On the other hand, capital-exporting nations will tend to construe the test more narrowly. Different interpretations might lead to greater business uncertainty, an increase in assessments and litigation, and international double taxation.

135. HINNEKENS, *supra* note 66.

136. Hellerstein, *supra* note 13.

137. In an earlier decision, the U.S. Supreme Court denied certiorari in a case that supports qualitative economic presence tests for determining nexus for income tax purposes. *See Geoffrey Inc. v. Tax Comm.*, 437 S.E. 2d 13, at 16 (S. Ct. So. Car. 1993), cert. denied, 510 U.S. 992 (1993).

138. 138 S. Ct. 2080 (2018).

139. *Id.* at 2095, 2097, 2099.

140. Cockfield, *Rise of the OECD as World Tax Organization*, *supra* note 25.

141. See OECD 2019 PUBLIC CONSULTATION DOCUMENT, *supra* note 3.

On the other hand, a quantitative test might be relatively easy to administer and enforce, at least for large taxpayers, because the test relies on a stipulated threshold figure of sales. A firm without a traditional PE in a market state would not have to incur compliance costs and file a tax return in the market state unless the firm surpassed the delineated threshold. The proposal would catch only large multinational firms with significant global sales and the resources to comply with foreign income tax obligations in countries where they have no physical presence. The proposal is also consistent with the “significant economic presence” test discussed in the OECD’s public consultation document.<sup>142</sup>

## 2. Upholds Historical Rationale for Permanent Establishments

The proposed QEPPE would uphold the traditional rationales of the permanent establishment principle.<sup>143</sup> First, it would ensure that market countries enjoy tax revenue from significant cross-border activity that takes place within their borders. As such, it would encourage a balanced sharing of revenue between capital-exporting and capital-importing nations.<sup>144</sup> That sharing would discourage aggressive practices in nations that are losing revenue through changing commercial practices. In other words, the adoption of that test might forestall the growing use of tax innovations by net digital commerce importing nations.

The QEPPE is simple in conception and practice. The rule is pragmatic in the sense that it encourages business certainty because multinational firms would foresee whether they would be subject to market country income tax jurisdiction, similar to the notion that a physical presence signaled likely filing obligations. Further, the proposed approach would catch only the “big fish” with significant international trade; smaller firms, especially start-up technology firms, would be let off the hook, which makes sense because they have fewer resources to comply with foreign income tax laws.

A QEPPE can be portrayed as just another step in the evolution of the permanent establishment principle, as physical presence requirements have already undergone dilution through the developments previously noted. In fact, the QEPPE represents a more incremental step in the evolution of the PE principle than the server/permanent establishment (server/PE) rule adopted in the

142. *Id.*

143. See Part II.A.

144. The tax rebels, as discussed in Part III, maintain that the digital world has upset the traditional balanced sharing of tax revenues between two countries. With respect to international tax reform processes, Easson noted that theoretical considerations concerning the ‘fair’ division of the international income tax base between two countries are frequently downplayed in favour of efforts to develop bilateral tax treaties to resolve “competing tax grabs by national tax administrators [rather] than a principled attempt to allocate the tax base appropriately.” 144. As a result, “[n]otions of inter-nation equity generally fail to provide much in the way of specific guidance.” Easson, *Company Tax Reform*, *supra* note 97, at 285.

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Commentaries of the OECD model tax treaty in 2003.<sup>145</sup> Under this rule, if a non-resident company owns or leases a server (essentially a computer that has been networked to the Internet) and this server accomplishes integral aspects of a cross-border transaction, then the server will constitute a permanent establishment. I have argued elsewhere that the server/PE really represents a form of the qualitative economic presence test because maintaining a server/PE in a source country is now elective, and tax authorities will focus more on what type of economic activity is occurring within each country where a server/PE is located.<sup>146</sup>

Because there are millions of servers throughout the world that form an important component of the infrastructure of the Internet, the server/PE rule discourages tax authorities from asking what sort of a taxable presence exists within each country. Tax authorities may instead focus on the profit attribution aspects of a cross-border e-commerce transaction by raising the following questions: (1) what types of sales are being generated by the server; (2) how the server acquired rights to intangible assets; (3) what functions the server performs; and (4) what risks the server assumes. Unlike the proposed QEPPE, the server/PE does not uphold the traditional rationale for the PE because it leads to business uncertainty and will not effectively share tax revenue between residence and source countries.

The proposed economic presence test can be portrayed as a small evolutionary step from the economic presence test created by the server/PE rule.

### 3. *Fiscal Sovereignty Implications*

As mentioned, incremental change in international tax policy is likely the only feasible approach, partly because of sovereignty concerns. Importantly, countries would need to amend their bilateral tax treaties to implement the proposed QEPPE. National tax authorities, however, will not have to harmonize any of their tax rules for the economic presence test to be workable, as would occur, for example, under global formulary apportionment. The main sovereignty implications surround a heightened need to share information between national tax authorities to ensure that the threshold test would work. Interestingly, in the case of large firms, much of this sharing is already taking place under the new Country-by-Country Reporting initiative. As discussed elsewhere, information technology developments, such as the use of extranets (that is, a part of the Internet that links select partners in a secured manner) among tax authorities, could assist with information sharing.<sup>147</sup>

145. OECD, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, COMMENTARY ON ARTICLE 5, ¶¶ 122–26.

146. Arthur J. Cockfield, *Should We Really Tax Profits from Computer Servers?*, 21 TAX NOTES INT'L 2407 (2000); Arthur J. Cockfield, *Through the Looking Glass: Computer Servers and E-Commerce Profit Attribution*, 94 TAX NOTES INT'L 761 (2002).

147. Cockfield, *Transforming the Internet into a Taxable Forum*, *supra* note 4.

Also, market countries may require limited power to audit nonresident companies despite a lack of physical presence within their territories. That raises practical concerns surrounding enforcement, such as the inability to seize property for unpaid tax liabilities or to serve notices of assessment. Companies that surpass the stipulated gross revenue threshold late in the fiscal year may have to retroactively amend and file returns in source and residence countries. However, tax authorities are already presented with that challenge when they exert jurisdiction over companies because of the temporary appearance of dependent agents and entertainers.

Nevertheless, a QEPPE may also be difficult for many tax authorities to enforce. Some of these authorities, in particular those based in low income countries, lack the resources to audit the worldwide income of a multinational firm. An audit of business-to-business transfers to determine whether the requisite gross sales threshold is met might be feasible by looking to the invoices of the market country-based recipient business. This business must maintain records to justify the deduction of business expenses for tax purposes (or, alternatively, to support inclusion in a cost-of-goods-sold account). Cross-border business-to-consumer digital transfers are much more problematic because of the inability of both the source and residence country to determine the geographic location of consumers for many cyberspace transactions and because consumers typically have no recordkeeping obligations.

On the other hand, multinational firms and tax authorities often compile records for cross-border value added tax purposes (all OECD countries with the exception of the United States have national VATs or goods and services taxes), and that information could be used to enforce the QEPPE. Also, the International VAT/GST Guidelines provide guidelines for imposing VATs on imports of business-to-consumer transactions involving digital goods and services.<sup>148</sup> If those efforts prove successful, firms will need to develop accounting systems to track sales into foreign jurisdictions, and that tracking could be used to help enforce the economic presence tests for income tax purposes.

Finally, large technology companies should already be tracking the amount of consumer sales and active users in different countries. For instance, Facebook and Google track personal data generated by users in order to monetize and sell the data to third party advertisers that target based on perceived local consumer needs. Netflix subscribers in every country are offered different content partly to allow the company to target locally-generated content toward these consumers (for example, Netflix produces and displays Canadian-made movies and television shows for Canadian subscribers).<sup>149</sup> Like most large multinational firms, large technology companies will comply with the proposed economic

148. See Hellerstein, *supra* note 13.

149. See Wong, *supra* note 10.

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presence test, including by trying to accurately estimate consumer sales in every country, to reduce risks associated with reputation and audits.

### 4. *Reducing Harmful Tax Competition*

Beginning in 1997, international bodies such as the European Union and the OECD have focused efforts on reducing “harmful” tax competition.<sup>150</sup> Harmful tax competition is said to be the sort that reduces national and international welfare by distorting cross-border investment location decisions or promoting income shifting as a result of tax reasons and not out of real economic rationales.<sup>151</sup> In addition, competition leads to a greater focus on the taxation of immobile factors of production like middle-class workers, making the tax system more regressive and favoring the interests of higher income investors.

In contrast, “good” tax competition occurs when countries legislate innovative tax rules that do not unduly inhibit economic growth, lessen compliance costs, or tame the so-called Leviathan tendencies of mature industrialized nations to bloat through inefficient government spending.<sup>152</sup> The state where large consumer markets are located is not permitted to tax cross-border transactions due to an absence of a traditional permanent establishment. Therefore, the dilution of source-based taxation resulting from digital commerce and other developments in turn promotes the use of tax havens as production intermediaries.

Avi-Yonah and others have noted that permitting market states to tax significant cross-border profits would discourage the use of tax havens and inhibit harmful tax competition.<sup>153</sup> As mentioned, a global digitized economy theory suggests that income produced by information goods should migrate to the lowest taxed jurisdiction since it is near costless to do so. Similarly, a QEPPE would inhibit tax avoidance strategies as firms will be forced to pay tax in larger consumer countries.

### C. *Residual Profit Allocation by Income*

#### 1. *General Transfer Pricing Methods*

As discussed in Part II.A, the arm’s length method is the main way that countries divide taxable profits from cross-border transactions involving related parties. In essence, the arm’s length method seeks to impose market prices on these transactions by pretending that the parties are independent; thus, a company would expect to be compensated at market rates.

150. See OECD, HARMFUL TAX COMPETITION, *supra* note 62.

151. *Id.* at 8.

152. *Id.* at 8–10.

153. See AVI-YONAH, *supra* note 75.

As set out in the OECD Guidelines on Transfer Pricing as well as the domestic tax laws or policies of most tax authorities, there are different approaches, called methods, to calculate cross-border transfer prices.<sup>154</sup> The first three methods, namely, the comparable uncontrolled price method, the resale price method and the cost plus method, are sometimes referred to as “traditional methods,” as they have been around since the arm’s length method was initially devised.<sup>155</sup> The next two methods, called profit splits and the transactional net margin method, are sometimes referred to as “non-traditional methods” in large part because of their relative newness, as they have only been deployed in recent decades. Instead of looking to comparable market prices, profit split methods seek to divide up the global tax pie by looking to the contribution and expected returns of each related party transaction.

## 2. *The OECD’s Approach to Residual Profit Splits*

Within the profit splits category, there is a subcategory called the residual profit split method. Under the residual profit split method, the total profit of a multinational firm is split into two parts: routine profits and residual profits. Routine profits are profits associated with normal business operations and are the expected return on investment that an entrepreneur would demand to enter into a contract. Routine profits are also profits that a third party would be expected to earn for performing functions and activities on an outsourcing basis. This third party does not share in the overall risks of the multinational firm; therefore, its profits are not tied to the success or failure of goods and services offered by the firm. Hence, related parties that take only limited risks will be allocated routine profit.

Residual profits, on the other hand, are profits that are tied to above-normal returns associated with the entrepreneurial success or failure of the firm. Accordingly, related parties in foreign countries will only share in residual profits if they engage in risk-taking activities on behalf of the multinational firm. Under the general approach, the residual profit split method normally allocates the residual profit, according to risk-taking functions and activities, to the multinational firm’s head office jurisdiction on the basis that the head office takes the most risk. For example, the office could build a brand for the company or engage in research and development activities for new goods and services. Because residual profits represent “excess” profits beyond a normal return, they are roughly analogous with economic rent.<sup>156</sup>

Allocating these profits to different countries poses a greater challenge because the profits are often associated with intangible assets and income that

154. OECD, OECD TRANSFER PRICING GUIDELINES, *supra* note 53..

155. *Id.* at ¶ 2.2. Prior to 2010, the profit split methods were only to be used as ‘methods of last resort.’ Since 2010, there is no avowed hierarchy among methods.

156. For discussion of the nuances, see INT’L MONETARY FUND, *supra* note 108, at 63–64.

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are easier to shift to tax havens. The method to calculate residual profit splits, under the traditional approach, varies according to the specific facts and circumstances of a transaction. As mentioned, the residual profit is sometimes allocated to the head office country as it is ostensibly where the intangible assets were first developed (in the hypothetical in Part II.C, the original code of a software application could be developed in Country A and more of the risk-bearing arguably occurred in this country and hence it should be entitled to tax residual profits).

In June 2018, the OECD revised transactional profit splits pursuant to BEPS Action 10.<sup>157</sup> The reforms essentially extend the situations in which profit splits may be used.<sup>158</sup> Profit splits have been used when both related parties to a cross-border transaction made unique contributions. A lack of comparable transactions alone, however, cannot be used as a basis for implementing profit split methods.<sup>159</sup> Under the OECD approach, the residual profit split method can only be used on a case-by-case basis with different methods of calculation depending on the specific facts and circumstances.<sup>160</sup> Nevertheless, the OECD acknowledged in an earlier report that the traditional profit attribution rules, including the residual profit split method, relies on functions performed, assets used, and risks assumed, and would not allocate any significant profits to an economic presence permanent establishment.<sup>161</sup> More recently, the OECD is studying how formulas could be used to allocate more profits to countries where consumers are based while retaining the current arm's length approach in most situations.<sup>162</sup>

In an important development, in 2020 the 137 countries that constitute the OECD/G20 Inclusive Framework on BEPS endorsed a reform program that contemplates an entirely new way to tax technology firms through a revised

157. OECD, ALIGNING TRANSFER PRICING OUTCOMES WITH VALUE CREATION, ACTIONS 8–10 – 2015 FINAL REPORTS (2015).

158. Observers have noted that expanded use of profit split methods represents a slow and gradual drift toward formulaic apportionment (that is, the use of a formula using factors such as sales or number of employees instead of focusing on taxing net profits). See JINYAN LI, INTERNATIONAL TAXATION IN THE AGE OF ELECTRONIC COMMERCE: A COMPARATIVE STUDY 18 (2003).

159. More recently, the BEPS Inclusive Framework looked beyond the arm's length principle. OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT, ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY – POLICY NOTE (2019).

160. See also OECD, DISCUSSION DRAFT ON ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (2017).

161. OECD, ACTION 1 FINAL REPORT, *supra* note 33 at 110–12. The report considered a new deemed-profit method via a industry-specific profit margins and presumed expenses to calculate profits attributed to source countries. *Id.* at 112–13.

162. See OECD SECRETARIAT PROPOSAL, *supra* note 3, at 5–6. In Action 1's earlier final report, the OECD had rejected formulas (referred to as 'fractional apportionment') mainly on the grounds the approach would be a departure from international standards. See OECD ACTION 1 FINAL REPORT, *supra* note 33, at ¶ 288.

profit allocation rule.<sup>163</sup> Under this approach, a market country can tax the following amounts:<sup>164</sup>

Amount A: The portion of deemed residual profit that is allocated to a market jurisdiction (see above for discussion of the general approach);

Amount B: A fixed return for certain routine marketing and distribution activities taking place in a market jurisdiction; and

Amount C: Any profit attributable to activities in a market country that go beyond routine marketing and distribution activities, which can be calculated using the arm's length principle.

Amount A is intended to apply to two types of large businesses: (a) automated digital services (e.g., search engines, social media platforms and online marketplaces; and (b) consumer-facing businesses (e.g., retail companies). For automated digital services, a revenue threshold alone would suffice to allow a market country to tax incoming transactions and no physical presence is required. For consumer-facing businesses there needs to be additional factors such as a physical presence within the market country or targeted advertising. Similarly, Amounts B and C will still be calculated following traditional international tax laws and principles, including the arm's length standard used to calculate transfer prices.

Remarkably, the participating countries, which include all of the member countries of the OECD and the G20, have agreed for the first time to move to a formula to tax large businesses in some circumstances—even if they do not maintain a physical presence within the market country.<sup>165</sup> Consistent with the analysis within this Article, the OECD now indicates, “[T]he primary response to the tax challenges of the digitilisation of the economy is new taxing right over a portion of residuals profits allocable to market jurisdictions.”<sup>166</sup> This political consensus makes new profit allocation rules and formulas, such as the one explored next, feasible to implement.

### 3. *The Residual Profit Allocation by Income (RPA-I) Proposal*

In contrast to the OECD approach, there are policy proposals that seek to alter this environment by calling for standardized formulas to divvy up residual taxable profits in each country. Some of the policy proposals call for routine

163. See OECD/G20 2020 Statement, *supra* note 3, at ¶ 2 (endorsing the Unified Approach under Pillar One to reallocate taxing rights via a formula).

164. *Id.* at ¶ 10. Amount A will be calculated by looking to the profits from consolidated group financial accounts, and accounting for any losses incurred within the corporate group. *Id.* at 43–44. To reduce compliance costs, a multinational corporation should be able to file one tax return with the country where it is based. *Id.* at 36.

165. Because the proposal relies on using a formula, Amount A is a new way to calculate global income because it does not rely on the traditional arm's length standard to calculate cross-border profits. *Id.* at ¶ 48. Mechanisms will need to be developed to eliminate international double taxation which will be encouraged by the overlay of this new formulaic system over the traditional way to calculate profits. *Id.*

166. *Id.* at ¶ 13.

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profits to be apportioned on a basis of traditional transfer pricing techniques (e.g., a specified mark-up on third-party costs). Afterwards, residual profits would be allocated according to a formula based on destination-based sales.<sup>167</sup> The US and UK governments have also recently discussed modifying the residual profit split rule.<sup>168</sup>

The Residual Profit Allocation by Income (RPA-I) proposal similarly seeks to modify the typical approach by allocating residual profits to the country where significant sales take place.<sup>169</sup> More technically, the proposal apportions residual profit by consumer sales minus third-party costs associated with them.<sup>170</sup> For instance, if a social media platform, based in Country A, generated significant advertising revenue from consumers in Country B, then the government for Country B would be entitled to tax profits associated with the sales.

RPA-I uses two approaches to calculate the residual profit of a multinational firm. Under the first approach, the firm needs to identify the residual gross income earned in each market country, sometimes referred to as a “destination country” or “consumer country.”<sup>171</sup> The second approach looks to calculate the total residual income by taking the multinational firm’s total profits minus total routine profits, with the residual income apportioned according to the residual gross income in each consumer country.<sup>172</sup>

In essence, RPA-I seeks to expand market country tax jurisdiction by allocating residual profits to the market country.<sup>173</sup> As noted by its proponents,

167. Reuven S. Avi-Yonah, et al., *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009).

168. Under the U.K. approach, residual profits should be allocated to the jurisdiction where consumers add value to cross-border digital goods and services. The U.S. proposal differs by striving to allocate value—and taxable profits—to the country where ‘marketing intangibles’ such as brand and copyright are associated. For discussion, see Grinberg, *supra* note 96. Countries where innovative companies are based will invariably oppose the U.K. proposal or RPA-I on the basis they will lose tax revenues. As mentioned, under the current approach, the country that, for instance, develops the intellectual property surrounding goods and services ends up with a greater share of residual profits. The United States proposal seeks to allocate residual profits according to the country where consumers identify the brand. A challenge is that the reform will only affect firms with significant marketing intangibles. In contrast, the United Kingdom proposal would allocate residual profits to the country where consumers added value to the cross-border provision of digital goods and services. For instance, a U.K. Facebook user (arguably) generates value by posting content and ‘liking’ the content of other users—these activities generate personal data flows that Facebook sells to third party advertising companies. Accordingly, the U.K. proposal, like the RPA-I would allocate more taxable profits and revenues to consumer countries. HM TREASURY, *supra* note 91. See also OECD 2019 PUBLIC CONSULTATION, *supra* note 3, at 12.

169. Michael P. Devereux, et al., *Residual Profit Allocation by Income* (Oxford Univ. Ctr. for Business Taxation Working Paper 19/01, 2019).

170. The OECD Secretariat proposal similarly focuses on allocating the ‘deemed residual profits’ to markets through a formula based on sales derived from the consolidated financial accounts of the company. It also proposes to allocate a fixed return for distribution activities. See OECD SECRETARIAT PROPOSAL, *supra* note 3, at 6. For discussion of OECD developments in this area as well as a comparison to formulary taxation deployed for US. states, see Walter Hellerstein, *Reflections on the Cross-border Tax Challenges of the Digital Economy*, 96 TAX NOTES INT’L 671 (2019).

171. See Devereux et al., *supra* note 169, at 9.

172. *Id.* at 9–10.

173. Under the RPA-I, there is an element of formulary apportionment although the profits are allocated pursuant to residual gross income, and not simply sales. Empirical analysis conducted by the

the RPA-I has several advantages over the current system for calculating transfer prices.<sup>174</sup> Like the QEPPE, it would inhibit aggressive international tax avoidance because taxable profits would be allocated to the jurisdiction where significant sales take place, no matter what sort of cross-border structure is set up by tax planners. Consumers generally stay put within their borders when they order cross-border goods and services. Therefore, tax planning should be constrained from shifting income to a low or zero tax jurisdiction.

The fact that profits are divided according to residual gross income instead of sales should also reduce the ability of tax planners to shift income by manipulating sales revenues.<sup>175</sup> This move would likely require the re-negotiation of tax treaties to create some kind of economic presence permanent establishment, as noted above. The proponents of the RPA-I proposal nevertheless suggests that it “abandons existing permanent establishment rules for residual profit purposes.”<sup>176</sup> The problem with this approach is that the residual profit split method is a transfer pricing methodology that divides taxable profits among related parties, whether they are permanent establishments, corporations, or some other business entities. Hence, there must be a related party in a foreign market before the transfer pricing methodology can be applied.

#### D. Summary

A coordinated and incremental solution of allocating more taxing rights to source countries is the best way to appease the emerging conflict over digital taxation. This solution should apply neutrally to digital and conventional commerce. The most straightforward ongoing evolution of the permanent establishment principle would be to extend taxable presence based on significant sales: a Quantitative Economic Presence Permanent Establishment (QEPPE). This reform would be consistent with the traditional view of permanent establishment as a proxy for significant and sustained sales within a consumer country. The move could be accompanied by modifying an existing transfer pricing rule, the residual profit split method, to apportion taxable profits to a market country, such as by using a formula based on destination-based sales. A QEPPE will only be constituted if a non-resident firm has above threshold sales (e.g., USD\$10 million) in a particular country as well as, potentially, a global sales threshold of say EURO 750 million.

IMF indicates that residual profit is highly concentrated among a small number of firms and concentrated among firms headquartered in a few economies (mainly the United States, Japan and China). Depending on the proposal, a residual profit split method could result in many countries collecting less revenues. INT'L MONETARY FUND, *supra* note 108, at 38–40, 69–75.

174. See Devereux et al., *supra* note 169, at 6–8.

175. *Id.* at 7.

176. *Id.* The OECD Secretariat proposal would also introduce a stand-alone rule instead of a new permanent establishment fiction. See OECD SECRETARIAT PROPOSAL, *supra* note 3.

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The proposed step would represent an ongoing slow drift toward formulary taxation by allocating more profits based on sales in the market jurisdiction. While the reforms target all economic activity, they would also help to address taxing value added within digital value-added chains from innovation, development, commercialization, marketing, and sales to final consumption.

Unlike the unilateral tax innovations, the proposed coordinated approach would be consistent with the principles of neutrality, fairness, effectiveness, certainty, simplicity, and flexibility, as advocated by the Ottawa Taxation Framework Conditions.<sup>177</sup> The new rules would be fair and effective, as they would inhibit profit shifting and harmful tax competition by ensuring that the target jurisdiction can impose its income tax over above-threshold cross-border sales. No matter where the ostensible ownership or production of intangibles is shifted, the market country could still tax the transaction.

The reforms would be certain and simple, in part to support the tax needs of developing countries that have fewer tax administration resources. Large multinational firms tend to comply with all tax laws to protect their reputations or because they have the resources to do so. Accordingly, these firms will self-assess the appropriate tax liability, if any, and provide this to the relevant tax authorities.

Finally, the proposed rules would be flexible in the sense that they do not hinge on existing or expected business models (unlike, for instance, the Digital Services Tax that targets online sales platforms, search engines and social media). Cloudy the future is (Yoda, not bad grammar). The Internet is still in its relative infancy and it is very difficult or impossible to predict what new business models will emerge.<sup>178</sup> No matter what technological changes take place, market countries will be able to tax profits associated with significant sales within their borders. Overall, the proposed approach will better align existing international tax rules with a changing technological environment that promotes new global digital business models.

## V. CONCLUSION

Since the mid-1990s, the Internet and digitization have become common features in the lives of billions of consumers and businesses around the planet. As digital commerce has grown, so have the potential tax revenues that could be derived from taxing related profits. Accordingly, governments around the world increasingly eye the profits generated by tech titans like Amazon, Facebook, Google, and the corresponding potential tax revenues. Yet under traditional international tax laws, policies, and principles, these same governments are

177. See Part III.E.

178. Technology theory, in particular substantive technology perspectives developed by sociologists, warns against focusing on existing technology. Cockfield, *Towards a Law and Technology Theory*, *supra* note 12.

unable to tax these profits, mainly because the non-resident companies do not need to maintain a physical presence that enables market countries to exert their tax laws over cross-border income.

Despite international tax reform efforts that began in 2013 via the OECD and G20 Base Erosion and Profit Shifting project, countries have been unable to agree on a set of coordinated rules to govern the income taxation of global digital commerce. Similarly, the BEPS project does not challenge the fundamental incentives that encourage taxpayers to engage in digital tax planning to reduce global tax liabilities. As a result, we find ourselves in the throes of a tax “war” whereby dozens of governments are initiating unilateral tax rules to tax profits associated with the cross-border sale or use of digital goods and services.

The problem is that these new tax laws—expanded withholding taxes, economic presence tests, equalization levies, digital services taxes, minimum taxes, and so on—have the potential to wreak havoc on the international tax regime. For instance, the new taxes promote international double taxation, distort cross-border economic activities, create high taxpayer compliance costs, and enhance risk of audits. In short, they raise firm transaction costs and make it more costly to engage in global trade and investment, thereby reducing overall global economic growth and making all countries worse off.

A coordinated and incremental solution among participating countries should remain the goal. A quantitative economic presence permanent establishment (QEPPE) test would restore the traditional tax bargain whereby market countries should have the right to tax significant sales to their consumers. Under the QEPPE, a permanent establishment will be constituted if a company enjoys more than a stipulated sales threshold, such as US \$10 million, within a foreign country as well as, potentially, a global sales threshold such as EURO 750 million. Once a permanent establishment has been constituted, then profits can be allocated as if a non-resident retailer had set up a physical establishment. The QEPPE is an elegant solution that stretches, but does not break, traditional international tax norms.

The QEPPE could also be used to support efforts to reform the traditional approach to divide taxable profits between related companies based in different countries. In particular, the residual profit split transaction, as modified by an approach such as the RPA-I, could be deployed to allocate more profits to market countries. Under the RPA-I, routine profits are first calculated according to traditional arm’s length methods, and then residual profits (that is, roughly equivalent to above-normal profits) will be allocated according to a formula (e.g., amount of sales in the market country).

Ultimately, these two reforms would best address the tax challenges presented by the digitization of the global economy.