ARTICLE

The Ability to Pay and Economic Allegiance: Justifying Additional Allocation of Taxing Rights to Market States

Louise Fjord Kjærsgaard*

The OECD/G20 Inclusive Framework and the UN are working intensively on how to change the allocation of taxing rights to cross border income and to adapt the international tax regime to the digitalization of the economy. A stated aim is that more taxing rights should be allocated to the market states. However, during the process it has become clear that it remains uncertain why the allocation of taxing rights should be changed. In this article, it is argued that the allocation should continue to be justified by the principle of economic allegiance in accordance with the ability of the MNEs to pay taxes. On this basis, it is analysed whether the following three measures are justifiable: the new nexus under the Pillar One Blueprint, the inclusion of software in the definition of royalties in the UN Model Tax Convention and the implementation of a shared taxing right for automated digital services in the UN Model Tax Convention.

Keywords: Allocation of taxing rights, ability to pay principle, economic allegiance, single tax principle, Inclusive Framework, Pillar One Blueprint, OECD Model Tax Convention, UN proposals on shared taxing rights, UN Model Tax Convention, Automated Digital Services

1 Introduction

The past decade has featured a growth of broad public and political attention in the field of international taxation and has given rise to the involvement of new critical actors as well as legal scholars around the world.[1] The increasing interest in the current international tax regime is arguably a result of multiple factors, including an increase in the globalization and inherent cross-border transactions inter alia facilitated by the digitalization of the economy. In addition, the aftermath of the financial crisis and the Covid-19 pandemic have implied an increase in the need for governments to finance their public spending.[2] Finally, a series of large-scale leaks exposed to the public, e.g., the so-called LuxLeaks, Panama Papers, and Paradise Papers, are all contributing factors to the increase in attention that has resulted in persistent criticisms arguing that the international tax system must be changed.[3] Further, it has been contended that the stability of the principles for allocating taxing rights is challenged by the dramatic evolution of the economy as a result of its digitalization. Accordingly, it has become a widely repeated opinion that the digitalization of the economy enables monetization in new ways that raise questions regarding the rationale behind existing principles for allocating the taxing rights as market states are alleged to often being left with no or limited revenue to tax.[4]

Notes

* Senior Associate at CORIT Advisory and Ph.D. Scholar at Copenhagen Business School. Emails: lfk@corit.dk & lfk.law@cbs.dk.

1 In addition to medias around the world, the new critical actors also include, e.g., NGOs such as Oxfam and ActionAid, whereas a few examples of the established legal scholars engaging in the debate on international taxation and increased digitalization of the economy are W. Schön, *Ten Questions About Why and How to Tax the Digitalized Economy*, 72(4/5) Bull. Int'l Tax'n. 278 et seq. (2018); E. C. C. M. Kemmeren, *Should the Taxation of the Digital Economy Really Be Different?,* 27(2) EC Tax Rev. 72 et seq. (2018); M. Olbert & C. Spengel, *International Taxation in the Digital Economy: Challenge Accepted?,* 9 World Tax J. 1, 3 et seq. (2017), and the same authors in M. Olbert & C. Spengel, *Taxation in the Digital Economy – Recent Policy Developments and the Question of Value Creation*, 2 IBFD Int'l Tax Stud. 3 (2019), G. Kofler, G. Mayr & C. Schlager, *Taxation of the Digital Economy: 'Quick Fixes' or Long-Term Solution?,* 57(12) Eur. Tax'n 523 et seq. (2017); M. de Wilde, *Preface in Sharing the Pie: Taxing Multinationals in a Global Market* (IBFD 2017), and the same author in M. de Wilde, *'Sharing the Pie': Taxing Multinationals in a Global Market*, 43(6/7) Intertax 438 et seq. (2015), and M. de Wilde, *Comparing Tax Policy Responses for the Digitalizing Economy: Fold or All-in*, 46(6/7) Intertax 466 et seq. (2018); X. Li, *A Potential Legal Rationale for Taxing Rights of Market Jurisdictions*, 13(1) World Tax J 26 et seq. (2021); J. Li, *The Legal Challenges of Creating a Global Tax Regime with the OECD Pillar One Blueprint*, 72(2) Bull. Int'l Tax'n. 84 et seq. (2021).

2 P. Saint-Amans, *The Reform of the International Tax System: State of Affairs*, 49(4) Intertax 309 et seq. (2021).

3 *See* e.g., OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note*, OECD/G20 Base Erosion and Profit Shifting Project 2–3 (OECD Publishing 2019).

4 *See* e.g., OECD, *Challenges Arising from Digitalisation – Report on Pillar One Blueprint*, OECD/G20 Base Erosion and Profit Shifting Project 11 (OECD Publishing 2020) United Nations, Committee of Experts on International Cooperation in Tax Matters, *Report on the Twenty-First Session* E/C.18/2020/CRP.41 (Virtual Session – 20-29 Oct. 2020), [hereinafter: Committee – Art. 12 B on Automated Digital Services (E/C.18/2020/CRP.41)], 6 and United Nations, Committee of Experts on International Cooperation in Tax Matters, *Note by the Subcommittee on the UN Model Tax Convention, Update of the UN Model Double Taxation Convention Between Developed and Developing Countries – Inclusion of software payments in the Definition of Royalties*, E/C.18/2020/CRP.38 (7 Oct. 2020) [hereinafter: Committee – Inclusion of software payments in the definition of royalties (E/C.18/2020/CRP.38)], 2.

The continued work of the OECD/G20 Inclusive Framework (hereinafter: IF), following after the OECD/G20's final report on Action 1 *Addressing the Tax Challenges of the Digital economy*[5] is expected to result in a final report – currently expected in mid-2021.[6] Further, other supranational organizations such as the EU and the UN have worked on measures to address the perceived challenges arising from the digitalization of the economy.[7] What appears to be apparent from the contemplated international proposals is a lack of common understanding and agreement on *why* it is fair that market states should have the right to tax more revenue that is generated from the provision of digital products and services.[8] Instead, the focus seems to be on finding a common agreement on *how* market states should be allocated such a right.[9]

On this basis, it is the intention with this article to contribute to the ongoing debate on the current international tax regime by providing a principle-based legal rationale for *why* it is fair that market states should be allocated additional taxing rights. As further elaborated in the analysis, the principle of economic allegiance is arguably the underlying principle for allocating taxing rights under the OECD Model (2017) and should plausibly also be the justification for allocating additional taxing right to market states. The reason for focusing on the underlying tax principles of the current international tax system is to strive for one coherent tax system and because it seems less realistic that any fundamental changes to the international tax systems may find consensus from contracting states around the world.[10] Another and more practical argument for focusing on these principles are because these principles have proven to be (relatively) operational in practice and are well-known by practitioners of international tax law. Lastly, the application of the same principles arguably limits the risks of any foreseen and unforeseen adverse consequences from the interaction between existing rules and potential new rules. Accordingly, even though it is acknowledged that a fundamental redesign of the entire international tax regime could potentially be preferable from a more theoretical perspective, in this article it is discussed whether a principle-based rationale for recalibrating the international tax regime can be derived from the principles underlying the current regime.

The reason behind searching for a principle-based rationale is to increase the likelihood that a potential consensus-based solution on allocation of additional taxing rights to market states will stand the test of time.[11] This should be considered regarding the ever-evolving digitalization of the economy and that any amendments with a narrow scope targeting highly digitalized businesses that are currently perceived to be undertaxed,[12] will not necessarily provide an appropriate measure for business models that are of the future.

Notes

5 OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1–2015: Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2015).

6 *See* OECD, *Report on Pillar One Blueprint, supra* n. 4, at 9, and Saint-Amans, *supra* n. 2, at 309.

7 On 21 Mar. 2018, the European Commission proposed new rules to ensure that digital business activities are taxed in a fair and growth-friendly manner in the EU, i.e., a proposal for a Council directive laying down rules relating to the corporate taxation of a significant digital presence and proposal for a Council directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services. The UN has published the following two discussion drafts *Committee – Art. 12 B on Automated Digital Services* (E/C.18/2020/CRP.41), *supra* n. 4, and *Committee – Inclusion of Software Payments in the Definition of Royalties* (E/C.18/2020/CRP.38), *supra* n. 4.

8 Committee – Art. 12 B on Automated Digital Services (E/C.18/2020/CRP.41), *supra* n. 4, at 29 and Committee – Inclusion of software payments in the definition of royalties (E/C.18/2020/CRP.38)], *supra* n. 4, at 6–7; and comments from commentators in the Pillar One Blueprint have criticized that the precise policy aim, and the scope remains ambiguous. This was also acknowledged by a representative of the OECD on the virtual meeting on the Pillar One Blueprint 14 Jan. 2021. OECD Public Consultation Meeting on the Pillar One Blueprint (14 Jan. 2021), https://www.oecd.org/tax/beps/public-consultation-meeting-reports-on-the-pillar-one-and-pillar-two-blueprints.htm (accessed 18 May 2021). The representative reasoned the insufficient clarity with the lack of consensus among members of the IF. See also Saint-Amans, *supra* n. 2.

9 *See also* X. Li, *supra* n. 1, at 27.

10 While focus within this article is the underlying principle of the current international tax system, some legal scholars have suggested that the system should be fundamentally changed e.g., to a so-called destination-based system; *see* e.g., D. Shaviro, *Goodbye to All That? A Requiem for the Destination-Based Cash Flow Tax*, 72(4) Bull. Int'l Tax'n 248 et seq. (2018); M. Devereux & R. de la Feria, *Designing and Implementing a Destination-Based Corporate Tax* WP 14/07 (2014) (for discussion purposes only). A unitary tax system has also been considered; *see* e.g., S. Picciotto, *Towards Unitary Taxation,* in *Global Tax Fairness* (T. Pogge & K. Mehta eds Oxford University Press 2016) Published to Oxford Scholarship; M. F. de Wilde, *Some Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy*, 38(5) Intertax 289 and 290 (2010). However, as Ivan Ozai notes: '*Even if,* e.g., *a unitary tax system based on formulary apportionment might provide a more efficient and fair solution to the taxation of multinational enterprises, the costs of a complete overhaul of a long-established system make it hard for such a solution to be implemented, as path dependence theory suggests. Replacing the increasingly criticized separate-entity system, arm's length principle, and transfer pricing methods by a unitary tax system would require overcoming the lock-in effect over the tax treaty network, as it would ultimately require renegotiating many of the existing treaties*'. I. Ozai, *Institutional and Structural Legitimacy Deficits in the International Tax Regime*, 12(1) World Tax J. 67 (2020). Considering the proposals presented by influential institutions, a more fundamental change to the international tax system does not seem to have political support. Finally, som authors argue that any solution addressing the challenges brought by digitalization should be completely detached from the current international tax system; *see* e.g., S. Greil & T. Eisgruber, *Taxing the Digital Economy: A Case Study on the Unified Approach*, 49(1) Intertax 53 et seq. (2021).

11 Somewhat similar argument is presented by Li, *supra* n. 1, at 27.

12 *See* e.g., PwC as member firm, in co-operation with the Center for European Economic Research (ZEW), *Digital Tax Index 2017: Locational Tax Attractiveness for Digital Business Models* (2017). Reference to the findings were e.g., made by the European Commission, *A Fair and Efficient Tax System in the European Union for the Digital Single Market*, COM(2017) 547 final (21 Sept. 2017), at 2 and 5. Against this understanding, it has been argued that the perceived under-taxation is a result of significant R&D investment and preferential R&D regimes; *see* e.g., X. Li, *supra* n. 1, at 36-38; S. Deschsakulthorn, K. Glenn, S. Boon Law, & J. A. Myszka, *Treatment of Losses Under OECD Pillars 1 and 2*, Tax Notes Int'l 325–326 (20 July 2020).

On the contrary, industry-based and facts-specific rules will likely imply that new additional rules or amendments will be necessary in the future and, taking the current struggles of coming to a consensus-based agreement into account, such a solution should arguably not be the aim. *(see section 2).*

Based on the established legal rationale for *why* market states should be allocated taxing rights, it will then be analysed whether some of the most significant currently proposed measures may be justified based on a modernized interpretation of the principle of economic allegiance. Further, the capability of these measures to actually allocate tax revenue to the market states will be considered. More specifically, the following three measures will be subject to analysis: *(1)* The contemplated new taxing right considered by the IF under the Pillar One Blueprint; *(2)* The discussion drafts for including software payments in the definition of royalties in the UN Model, and *(3)* the inclusion of a separate provision on income from automated digital services in the UN Model. The choice of measures is based on their current state of development, their contemporary political momentum in the debate on amending the international tax regime, and their common and thereby comparable aim of allocating more tax revenue to the market states.[13] The aim is to assess whether the contemplated measures can be justified according to the principle of economic allegiance. *(see* section 3*).*

Finally, the last section of the article will summarize the main conclusion and discuss wider perspectives on the findings *(see* section 4*).*

2 Understanding the current allocation principles

One of the challenges of establishing a principle-based rationale for why the digitalization of the economy implies that market states should be allocated more taxing rights under the international tax regime is that there is no such thing as international tax law.[14] Under the current international tax regime, the tax liability of a taxpayer is determined by the domestic tax law of individual jurisdictions. Tax liability established under domestic tax law may be modified by applicable tax treaties that have a long history of being a measure to limit double taxation of cross-border income. This double taxation occurs from the friction that arises between worldwide taxation and source taxation in two or more jurisdictions exercising their sovereignty to impose tax on the same income. On this basis, analysing the international tax regime will often imply an analysis of tax treaties.[15] This approach is also taken in this article when analysing the underlying principles of the current international tax regime. However, given the number of bilateral tax treaties, these will be represented by the OECD Model (2017) and its principles for allocating taxing rights.[16] Further, to analyse whether the principle of economic allegiance can justify allocation of more taxing rights to market states in a digitalized economy, the substantive meaning of the principle should be analysed – not only as formulated in its historical context but also considering the features of the digitalization of the economy.

The choice of principle to govern the international competence in taxation was founded on the theoretical

Notes

[13] Due to the well-described harmful effects of what is typically referred to as digital services taxes targeted at highly digitalized businesses – especially with respect to their applicability under tax treaties as well as the fundamental principle of ability to pay tax – these are not considered a viable and recommendable solution. Consequently, such measures will not be subject to analysis in this article. For literature on digital services taxes targeted at highly digitalized businesses, *see* e.g., D. Stevanato, *A Critical Review of Italy's Digital Services Tax*, 74(7) Bull. Int'l Tax'n. 413 et seq. (2020) and the same author in D. Stevanato, *Are Turnover-Based Taxes a Suitable Way to Target Business Profits?,* 59(11) Eur. Tax'n 538 et seq. (2019); J. F. Pinto Nogueira, *The Compatibility of the EU Digital Services Tax with EU and WTO Law: Requiem Aeternam Donate Nascenti Tributo*, 2 Int'l Tax Stud. 1 (2019); R. Ismer and C. Jescheck, *Taxes on Digital Services and the Substantive Scope of Application of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model?,* 46(6&7) Intertax, 573 et seq. (2018); J. Becker & J. Englisch, *EU Digital Services Tax: A Populist and Flawed Proposal*, Kluwer International Tax Blog (16 Mar. 2018), http://kluwertaxblog.com/2018/03/16/eu-digital-services-tax-populist-flawed-proposal/ (accessed 18 May 2021); H. S. Næss-Schmidt, M. H. Thelle, B. Basalisco, P. Sørensen & B. Modvig Lumby, *The Proposed EU Digital Services Tax: Effects on Welfare, Growth and Revenues*, Copenhagen Economics (Sept. 2018); A. Wanyana Oguttu, *A Critique from a Developing Country Perspective of the Proposals to Tax the Digital Economy*, 12 World Tax J. 4 (2020), s. 3. OECD, *Tax Challenges Arising from Digitalisation – Economic Impact Assessment*, Inclusive Framework on BEPS, 23 (OECD Publishing 2020); Kemmeren, *see supra* n. 1, at 73; L. Fjord Kjærsgaard & P. Koerver Schmidt, *Allocation of the Right to Tax Income from Digital Intermediary Platforms – Challenges and Possibilities for Taxation in the Jurisdiction of the User*, Nordic J. Commercial L. 1, 166 (2018).

[14] *See* e.g., J. Li, *supra* n. 1, at 93.

[15] See K. Vogel, *Worldwide v. Source Taxation of Income a Review and Re-evaluation of Arguments (Part I)*, 16(8/9) Intertax 216 et seq. (1988); E. C. C. M. Kemmeren, *Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach*, 60(11) Bull. Int'l Tax'n. 438–441 (2006). P. Koerver Schmidt, *The Emergence of Denmark's Tax Treaty Network – A Historical View,* Nordic Tax J.1, 49–52 (2018). S. Buriak, *A New Taxing Right for the Market Jurisdiction: Where Are the Limits?*, 48(3) Intertax 305 (2020), The reliance upon tax treaties has also been subject to criticism; see e.g., P. Harris, *International Commercial Tax* 22 (2nd ed., Oxford University Press 2020). The author argues that model tax treaties are 'reactionary, customary and, at their worst, a historical accident'. Further, the author contends that, as tax treaties are not based on conceptual structure but are built on political compromise, they do not deal with tax issues arising from international dealings but only matters when agreements can be reached.

[16] Although the OECD Model has not been ratified, it has been the predominant model for negotiating bilateral tax treaties, which as a consequence, principally contain similar policies and even language. The OECD Model has not only been used as a reference in negotiations of bilateral tax treaties between OECD members but also between OECD members and non-members and even between non-members as well as in the work of other worldwide or regional international organizations such as the UN Model which reproduces a significant part of the provisions and Commentaries of the OECD Model. *See also* C. H. Lee, & J.-H. Yoon, *General Report,* in *Withholding Tax in the Era of BEPS, CIVs and the Digital Economy*, IFA Cahiers vol. 103B, 23 (IFA 2018), where it is stated that many countries adhere to the OECD Model to a certain extent, although the allocation of taxing rights over royalties typically differs, i.e., it implies shared taxing rights similar to Art. 12 of the UN Model. *See also* J. Sasseville & A. A. Skaar, *General Report,* in *Is There a Permanent Establishment?* IFA Cahiers vol. 94A 23 (IFA, 2009); P. Baker, *Double Taxation Agreements and International Tax Law: A Manual on the OECD Model Double Taxation Convention (1977)*, 2 (Sweet and Maxwell 1991); OECD Model (2017): Commentaries to the Introduction, para. 14; C. Garbarino, *Judicial Interpretation of Tax Treaties: The Use of the OECD Commentary* 3 (Edward Elgar 2016).

work conducted by four economists appointed by the League of Nations in the early 1920s, delivering the *Report on Double Taxation* on 5 April 1923.[17] The economists held that the basis for designing the international tax framework should be that:

> '*A part of the total sum paid according to* ***the ability of a person*** *ought to reach the competing authorities according to* ***his economic interest*** *under each authority*'.(author's emphasis).[18]

Hence, the economists viewed the ability to pay principle as the most appropriate reason and measure for taxation. It is recognized in this article that the ability to pay principle does not enjoy universal support, inter alia due to its lack of attention to collecting revenue for the services provided by governments (typically considered one of the goals of taxes[19]). Further, it has been argued that the link between a taxpayer's taxable ability and the enjoyment of public services provided by the government is too remote.[20] However, despite this criticism, it has been argued that the ability to pay principle is widely endorsed in contemporary doctrine.[21]

Other principles for justifying and measuring taxation may be found inter alia in the older exchange theory that argues that taxation should be based on a social contract and on exchange between the government and the individuals or businesses.[22] Typically, the exchange theory will be based on either the cost principle (i.e., taxing in accordance with the costs incurred by the government in providing the services) or the benefit principle (i.e., taxing in conformity with the particular benefits received by the individual or business).[23] However, in this article it is argued that the challenges previously criticized in the international tax literature of relying on the benefit and cost principle makes them less preferrable. An example would be the challenges of determining the individual utility of the benefits received by a taxpayer. Further, there is a correlation that those who are the least capable of helping themselves are those to whom the protection and support of government typically has the highest value. However, they do not necessarily have the ability to pay according to the benefit or cost principle. Further, the (socialistic and egalitarian) concept of distributive justice through taxation – considered one of the goals of taxation[24] – is not achieved under the benefit or cost principle.[25] Due to the emphasized inadequacies, these principles will not be relied on in the following analysis.

Instead, while recognizing that the ability to pay principle as explained also has certain weaknesses, the ability to pay principle is relied upon in this article. This also seems to be in accordance with the findings of the four economists who argued that the ability to pay principle as a tax equity standard, arguably based on considerations of social solidarity and social redistribution, has supplanted the exchange theory.[26] The ability to pay principle as a reason and measure for taxation implies that the tax burden should be proportionate to the capacity of the taxpayer.[27] This understanding of

Notes

[17] *See e.g.*, G. W. J. Bruins, L. Einaudi, E. R. A. Seligman & J. Stamp, *Report on Double Taxation*, submitted to the Financial Committee Economic and Financial, Document E. F.S. 73. F.19 (5 Apr. 1923). The report has previously been subject to analysis in the international tax literature, *see* e.g., D. H. Rosenbloom & S. Langbein, *United States Tax Treaty Policy: An Overview*, 19 Colum. J. Transnat'l L. 359 361–364 (1981); P. Hongler, *Justice in International Tax Law* 117–119 (IBFD 2019); H. J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 Tax L. Rev. 565–566 (1992); Kemmeren *supra* n. 15, at 431–438 and Li *supra* n. 1, at 45-46.

[18] *See* Bruins et al., *supra* n. 17, at 20.

[19] *See* e.g., R. S. Avi-Yonah, *The Three Goals of Taxation*, 60(1) Tax L. Rev. 1–28 (2016).

[20] *See* e.g., F. Debelva, *Fairness and International Taxation: Star-Crossed Lovers?,* 10 World Tax J. 4, 570–571 (2018); Li *supra* n. 1, at 13.

[21] *See* e.g., Bruins et al., *supra* n. 17, at 18, W. Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1(1) World Tax J. 71–72 (2009); F. Debelva, *supra* n. 20, at 570; Li, *supra* n. 1, at 44; M. F. de Wilde, *The Obligation to Contribute to the Financing of Public Expenditure,* in *Sharing the Pie: Taxing Multinationals in a Global Market* (IBFD 2017), s. 2.2.2.1. For a thorough analysis on the ability to pay principle, refer to J. Clifton Fleming, R. J. Peroni & S. E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5(4) Fla. Tax Rev. 301–356 (2001) with references and M. S. Kendrick, *Ability-to-Pay Theory of Taxation*, 29(1) Am. Econ. Rev. 92–101 (1939). Slade argues that the ability to pay principle is justified by the sacrifice of taxpayers to the government which is linked to the concept of diminishing marginal utility of income and wealth that have given rise to several theories of progressive taxation, e.g., the equal (taxes should sacrifice all taxpayers equally), the equal-proportional (sacrifice of taxpayers should be in equal proportion to their incomes), and the least-sacrifice theories (taxes should first be levied on the incomes of the very rich; when reduced to the level of the rich, all the rich should be taxed; when reduced to the level of persons with modest means, all the persons with modest means should be taxed, etc.).

[22] *See* e.g., Bruins et al., *supra* n. 17, at 18. Since then, the international tax literature on the exchange theory and its underlying principles has become significant. For a more extensive analysis of the theories reference may be had to, e.g., Schön, *supra* n. 21, at 73–78 with references; Debelva, *supra* n. 20, at 569–577 with references.

[23] *See* e.g., Schön, *supra* n. 21, at 75; Debelva, *supra* n. 20, at 570; Li, *supra* n. 1, at 42-43; De Wilde, *supra* 21, E. Escribano López, *The Renaissance of the Benefit Principle for the 21th Century International Tax Reform*, Kluwer International Tax Blog (30 Jan. 2020), http://kluwertaxblog.com/2020/01/30/the-renaissance-of-the-benefit-principle-for-the-21th-century-international-tax-reform/ (accessed 18 May 2021).

[24] *See* e.g., Avi-Yonah, *supra* n. 19.

[25] *See* e.g., Schön, *supra* n. 21, at 75; Debelva, *supra* n. 20, at 570.

[26] *See* Bruins et al., *supra* n. 17, at 18.

[27] *See* e.g., J. Englisch, *Ability to Pay,* in *Principles of Law: Function, Status and Impact in EU Tax Law* (C. Brokelind ed., IBFD 2014); Schön, *supra* n. 21, at 71–75; Debelva, *supra* n. 20; Li, *supra* n. 1, at 44 and De Wilde, *supra* n. 21.

the ability to pay principle is also argued to incorporate the single-tax principle, i.e., that equity requires that business income is taxed only once.[28] Otherwise stated:

> *Income should be taxed only once, as close as possible to its source (as any economic activity that is taxed more than once will be discouraged while those that are not taxed will be favoured. This is both unfair and inefficient. Double taxation distorts costs and prices, interferes with production decisions).*[29]

The single-tax principle was also implicitly noted by the four economists, as they considered the ideal solution to be that the individual's entire ability should be taxed, but that it should be taxed only once.[30]

However, as also noted by the four economists, the ability to pay principle incorporating the single-tax principle does not traditionally deal with *where* taxes should be paid. Stated differently, the principle does not solve the problem of international double taxation and inter-nation equity on a stand-alone basis,[31] meaning a fair sharing of revenue from the taxation of cross-border income.[32] Notably, in this context the benefit and cost-principles arguably contain the same weaknesses in their traditional forms.[33]

The four economists concluded that the solution to *where* taxing rights to a business' ability should be allocated was to be found in the 'economic interest' of a taxpayer which should be understood as economic allegiance. Hence it is explicitly stated that:

> *The problem consists in ascertaining where the true economic interests of the individual are found. It is only after an analysis of the constituent elements of this economic allegiance that we shall be able to determine where a person ought to be taxed or how the division ought to be made as between the various sovereignties that impose the tax.*[34]

The group of economists identified the following four factors that comprise economic allegiance:[35]

1. The origin of income, i.e., all the places where the income is created or produced.
2. Situs of income, i.e., the physical location where the result of the creation or production of income is to be found.
3. The place of enforcement of the legal rights to the income.
4. The place of residence or domicile of the person entitled to consumption, appropriation or disposition of the income.

Among these four factors, the greatest weight should be given to *(1)* origin and *(4)* residence, whereas *(2)* situs and *(3)* enforcement primarily should be of importance if reinforcing the factors of origin or domicile.[36]

Origin refers to the 'production of wealth' defined as '*all the stages up to the point when the physical production has reached a complete economic destination and can be acquired as wealth*'.[37] This includes an assessment of the original physical appearance of the wealth, its subsequent physical adaptations, its transport, its direction, and its sale.[38] Although wealth and wealth production are obviously of enormous importance and are also concepts that often explicitly or implicitly are referred to in the current

Notes

[28] *See* e.g., R. S. Avi-Yonah, *Tax Competition, Tax Arbitrage and the International Tax Regime*, 61 Bull. Int'l Tax'n. 130, 133–134 (2007); Schön, *supra* n. 21, at 73. Schön explains that under the ability to pay principle, allocation rules should be framed in a way which is meant to prevent over taxation of this income. For a thorough analysis of the 'single-tax principle' *see* e.g., *Single Taxation?* (J. Wheeler eds, IBFD 2018) and E. Gil García, *The Single Tax Principle: Fiction or Reality in a Non-Comprehensive International Tax Regime?,* 11(3) World Tax J. 305–346 (2019).

[29] *See* De Wilde *supra* n. 21.

[30] *See* Bruins et al., *supra* n. 17, at 20; Gil García, *supra* n. 28, at 315.

[31] In this article, inter-nation equity is only mentioned in order to emphasize that the key issue is one among states rather than of among taxpayers, i.e., inter-individual equity. *See* similarly, Li, *supra* n. 1, at 41. The author also discusses how this interpretation of inter-nation and inter-individual equity differs from the work of R. A. Musgrave & P. B. Musgrave, *Inter-nation Equity*, in *Modern Fiscal Issues: Essays in Honour of Carl S. Shoup* (R. M. Bird & J. G. Head eds, University of Toronto Press 1972).

[32] *See* Wolfgang Schön argues that while the relevance of the ability to pay principle for the shaping of an international tax order is ambiguous and controversial, it will often provide a common framework for countries when it comes to measurement of the tax basis. In other words, Schön finds that while the ability to pay helps to define the cake it does not help to slice it. Schön, *supra* n. 21, at 72–73. Somewhat similar, Filip Debelva contends that even though it is clear that the ability to pay principle and the benefit principle were primarily designed for being applied in a domestic context and have been subject to criticism, their influence on international tax rules cannot be denied. Debelva, *supra* n. 20.

[33] *See* Bruins et al., *supra* n. 17, at 20. Recently, Xiaorong Li has argued that the benefit principle is the optimal principle for justifying the allocation of taxing rights to market states, although in a revised form. *See* Li, *supra* n. 1, at 50. According to Li, the revised benefit principle views benefits as '*a proportional scale for the purpose of comparing claims of taxing rights among jurisdictions. It is also important to emphasize here that what is being compared is not the benefits conferred to different businesses by the same state, but the contribution of final profits of the same business by various states*'. Thus, Li's revised benefit principle also seems to include elements of the ability to pay principle as competing authorities can only make a claim based on contributions to the 'final profit', i.e., contracting states can only make claims on the ability of the business.

[34] *See* Bruins et al., *supra* n. 17, at 20. It is noted that other legal scholars seem to interpret 'economic interest' in the 1923 report, as an implicit reference to the benefit principle. *See* Kemmeren, *supra* n. 15, at 431. *See also* Q. Cai, F. Wu & X. Li, *The New Taxing Right and Its Scope Limitations: A Theoretical Reflection,* 49(3) Intertax 213–215 (2021).

[35] *See* Bruins et al., *supra* n. 17, at 22–27.

[36] *Ibid.,* at 25.

[37] *Ibid.,* at 23.

[38] See also Vogel, *supra* n. 15, at 223. The author states that: '*source is unambiguously in what it excludes: taxation based on "source" is different from taxation based on residence or on citizenship. The only positive statement that can be made on the other hand is that "source" refers to a state that in some way or other is connected to the production of the income in question, to the state where value is added to a good*'.

debate on international taxation,[39] there is no commonly accepted definition and no unanimous way for businesses to create wealth.[40] However, in recent international tax literature the following description of wealth has been suggested:

> *'Wealth is considered as an accumulation of valuable economic resources that can be measured in terms of either real goods or monetary value or, for business purposes, as goods and services produced by a business that have an exchange value in the market.* … [Exchange value] *refers to an attribute of an item or service produced which indicates its ability to be exchanged on the market and as the price of a product realized at a single point in time when the exchange of it took place'.*[41]

The four economists advocated that the right to tax should generally be allocated between the places of origin (i.e., source states) and the residence state depending on the nature of the wealth. When the majority of the elements comprising economic allegiance coincide with one state, it should have the exclusive right to tax. When factors are conflicting, the right to tax should, in principle, be shared between the states based on the relative economic ties between the taxpayer, the income and the relevant states.[42]

2.1 *Economic Allegiance of Business Profit*

With respect to general business profits, the four economists did not consider such income as a separate category of income as in Article 7 of the OECD Model (2017). Instead, they considered business profits under specific types of undertakings currently typically described as 'bricks and mortar'.[43] With respect to commercial establishments with a fixed location, i.e., with a main or head office in a particular place, the four economists concluded that regarding 'origin', the influence of sales and the existence of many selling agencies or branches were of *outstanding significanc*e, implying that allocating income between the various sources of income would be of *commanding importance*. Further, it was stated that while the commercial manager would perform most of the effective work on the spot or at the head office in most cases, there were many exceptions; already at that point in time, control at a distance was far more possible than before. This is something that has become even more apparent with the development and enhancement of the information and communication technology.[44] However, because the 'situs' of a commercial business (with its nexus and environment of workers and their dwellings) could be more easily moved than a factory and obviously than mines and oil wells, the importance of 'domicile' would be relatively greater, i.e., because of the personal element in the matter of 'origin'.

Nonetheless, the group of economists concluded that the places where income was created or produced, i.e., the places of origin, were of preponderant weight and in an ideal division a preponderant share should be assigned to the place of origin. Hence, with respect to the allocation of the right to tax business profits, greatest importance should be given to the nexus understood as an identifiable connection, between business profits and the places contributing to the creation and production of wealth.[45]

When considering business profit under the OECD Model, the source state has been identified as the state where a PE is situated. While the report from 1923 did not contain a clear definition of a PE concept, it seems reasonable to argue that the PE-concept as it is currently known under Article 5 of the OECD Model (2017) encompasses the principles stated in the report back in 1923.[46] More specifically, the definition of a PE under Article 5 (1) of the OECD Model (2017) implies that it is created if the following three cumulative conditions are satisfied:

Notes

[39] In the current debate on international taxation and the allocation of taxing rights 'value' and 'value creation' are concepts that are typically mentioned; *see* e.g., OECD, *Tax Challenges Arising from Digitalisation –2018 Interim Report*, Inclusive Framework on BEPS (OECD publishing 2018), Ch. 2 Digitalization, business models and value creation, J. Becker & J. Englisch, *Taxing Where Value Is Created: What's 'User Involvement' Got to Do with It?,* 47 Intertax 2 (2019); Buriak, *supra* n. 15, at 304–306, A. J. Martín Jiménez, *Value Creation: A Guiding Light for the Interpretation of Tax Treaties?,* 74(4/5) Bull. Int'l Tax'n. 197 et seq. (2020); W. Haslehner & M. Lamensch eds, *Taxation and Value Creation*, EATLP International Tax Series vol. 19 (IBFD 2021)).

[40] *See* e.g., Becker & Englisch, *supra* n. 39, at 163–165.

[41] *See* Buriak, *supra* n. 15, at 304 and 306.

[42] For practical reasons, the four economists ended up recommending a general exemption in the source state for all 'income going abroad' to avoid double taxation. Bruins et al., *supra* n. 17, at 51. However, apparently too controversial, the League of Nation adopted the Classification and Assignment of Income method; *see also* OECD, *Action 1–2015: Final Report, supra* n. 5, at 25.

[43] *See* Bruins et al., *see supra* n. 17, at 27–31; OECD, *Action 1–2015: Final Report, supra* n. 5, at 25.

[44] *See* e.g., OECD, *Action 1–2015: Final Report, supra* n. 5, Ch. 3 Information and communication technology and its impact on the economy.

[45] *See* Bruins et al., *supra* n. 17, at 31. *See also* Kemmeren, *supra* n. 15, at 432.

[46] See e.g., J. F. Avery Jones, et al., *The Origins of the Concepts and Expressions Used in the OECD Model and Their Adoption by States*, 60(6) Bull. Int'l Tax'n. 233 and 234 (2006); F. Otegui Pita, *Article 5 – The Concept of Permanent Establishment,* in *History of Tax Treaties, The Relevance of the OECD Documents for the Interpretation of Tax Treaty* 237 (T. Ecker & G. Ressler eds, Linde 2011). The author finds that the term 'permanent establishment' or 'Beriebsstätte' derives from Prussian non-tax law from the nineteenth century. Further, for tax treaty purposes, the term was first used in the tax treaty between Austria/Hungary and Prussia (1899). Further, permanent establishment was used in a model in the first League of Nations Draft (1927/1928), the Model Convention of Mexico (1943), London (1946) and finally, the OECD included the term in its first Draft of a Double Taxation Convention on Income and Capital in 1963. E. Melzerova, *Article. 5 – Dependent Agent Permanent Establishment,* in *History of Tax Treaties, The Relevance of the OECD Documents for the Interpretation of Tax Treaty* 261 and 262 (T. Ecker & G. Ressler eds, Linde 2011). The author contends that, while the 1923 report did not result in a practical and 'ready-to-be-used' definition of a PE, the report brought an in-depth analysis of the cornerstones of international taxation and identified common treaty practice thus far. To summarize, the author finds that the report at least inspired the direction of thinking of other international tax standard-setters, e.g., the OECD.

- *Firstly*, there must be a place of business, i.e., for instance, premises, facilities, installations, machinery or equipment, at the disposal of the enterprise.[47] Arguably this reflects a condition for a specific and identifiable 'stage' in the production of wealth as described in the 1923 report. Further, as it is required that such a place of business should be tangible, it may be argued that under the PE concept as it is defined in the OECD Model (2017), it is required that the factor of physical location, i.e., 'situs' should reinforce the place of origin.[48]
- *Secondly*, the place of business must be fixed – for time and geographical purposes.[49] Again, it is argued that this condition requires that the 'situs' to some extent must reinforce the place of origin. Further, it may be reasoned that the production of wealth generally requires a certain duration to be distinguished from the mere realization of wealth and that this is reflected by the requirement for the place of business to be fixed for a certain period of time.[50]
- *Thirdly*, the business of the enterprise must wholly or partly be carried out through the fixed place of business,[51] i.e., usually (although not necessarily) by persons who, in one way or another, are dependent on the enterprise conducting the business of the enterprise through the fixed place of business.[52] It is argued that this condition aims at reflecting that the 'production' of wealth was generally considered to require capital and human resources as opposed to wealth that is merely realized in a non-residence country.[53]

Additionally, it may be argued that the Agency PE under Article 5 (5) and (6) of the OECD Model (2017), reflects the understanding that human interactions of a certain magnitude may constitute a specific and identifiable stage of the wealth production process, even when this is not reinforced by a fixed physical place of business at the disposal of the enterprise.[54]

Summarizing the above, the four economists considered economic allegiance - in the context of business profit - primarily understood as the place of origin and wealth production, as the appropriate justification for allocating taxing rights. Further, it is argued in this article that there is a link between a sufficient level of economic – and physical – presence under the existing PE-threshold and the economic allegiance factors developed by the group of economists almost a century ago. Hence, when aiming at one coherent international tax regime, any amendments resulting in the allocation of taxing rights to market states should similarly be justified by the ability (to pay) of MNEs being created in the market states.

Accordingly, while 'fairness' in taxation does not have one commonly accepted definition,[55] for the purpose of the analysis conducted in this article, equity – and thereby *why* market states should be allocated taxing rights – will be understood as an international tax system that allocates a proportion of the MNE's ability to the jurisdictions where this proportion of the ability (to pay) is created without risking international double taxation or double non-taxation of the taxpayer.[56]

2.2 *Challenges from the Digitalization*

In recent years, the applicability of the current definition of a PE in Article 5 of the OECD Model (2017) has been questioned in the digitalized age because of

Notes

47 *See* OECD Model (2017): Commentaries to Art. 5(1), paras 6, 10–19 and in respect of 'e-commerce', paras 122–131.

48 *See* OECD, *First Report of the WP 1 on the Concept of Permanent Establishment FC/WP1 (56)*, 1 (17 Sept. 1956). Here, the emphasis is made on the 'fixed place of business' or as stated by Federico Otegui Pita a 'distinct situs', *see* Otegui Pita, *supra* n. 46, at 240. *See also* Kemmeren, *supra* n. 15, at 432–433. Kemmeren argues that the principles of source and origin should be identical in respect of income taxes (although this may not always be the case) and, further, that source (origin) is an elaboration of the principle of location of wealth 'situs'. For a somewhat different view *see* e.g., P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, Working Paper 21 (2015). The authors argue that the requirement of physical presence should merely be seen as a result of the benefit theory being developed and implemented into the OECD Model at a time when neither the digital world nor computers existed, i.e., only physical benefits could occur such as streets, public transport, police.

49 *See* OECD Model (2017): Commentaries to Art. 5(1), paras 6, 21–34 and 44 and in respect of 'e-commerce', paras 122–131.

50 *See also* Otegui Pita *supra* n. 46, at 242 and Buriak, *supra* n. 15, at 306.

51 *See* Federico Otegui Pita *see supra* n. 46, at 240 and 244. Pita discusses the amendment of the words 'in which' that was amended to 'through which'. There seems to be two understandings of this amendment: (i) Those who believe that the replacement does not imply important changes, *see* e.g., IFA Cahiers vol. 94a (2009), *supra* n. 16, at 43, K. Vogel, *Vogel on Double Taxation on Double Taxation Conventions* 288 (3d ed., Kluwer Law International 1997). (ii) Those who believe that the replacement has broadened the scope, *see* e.g., R. Urban Schmidt, *Permanent Establishment. A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* 60 and 61 (Wolters Kluwer: Law and Business 2012).

52 *See* OECD Model (2017): Commentaries to Art. 5(1), paras 6, 35–41 and in respect of 'e-commerce' paras 122–131.

53 *See also* Buriak *supra* n. 15, at 306 and Kemmeren, *supra* n. 15, at 434.

54 *See* Bruins et al., *supra* n. 17, at 30.

55 See e.g., Debelva *supra* n. 20, at 565–567; P. Koerver Schmidt, *The Role of the Anti-Tax Avoidance Directive in Restoring Fairness and Ensuring Sustainability of the International Tax Framework – A Legal Assessment*, in *Tax Sustainability in an EU and International Context – Part Four: BEPS and Sustainability Goals* (C. Brokelind & S. Thiel eds, IBFD 2020); J. J. Burgers & I. J Valderrama, *Fairness: A Dire International Tax Standard with No Meaning?,* 45(12) Intertax 767–782 (2017): J. Li, supra n. 1, at 91: X. Li, supra n. 1, at 40.

56 *See also* K. Vogel, *The Justification for Taxation: A Forgotten Question?,* 33(2) Am. J. Jurisprudence 19 et seq. (1988), Schön, *supra* n. 21, at 71. Schön argues that it is the traditional legal wisdom that the principles of how to allocate taxing rights internationally somehow should reflect the justification to tax in a domestic setting including the ability to pay principle. Debelva, *supra* n. 20, at 581.

its inherent physical presence requirement.[57] It has been argued that the gap between the legal concept of a PE under the OECD Model and the economic substance has been increasing with the development of new intangible sources of wealth production and income generation, reliance on users and of new digitalized business models with the ability to cross-jurisdictional scale without mass.[58] The latter refer to highly digitalized businesses being capable of engaging in the economic life of a jurisdiction without any (or any significant) physical presence.[59] While this may appear to be correct, this perception has previously been questioned in the international tax literature. More specifically, it has been argued that, if there is indeed no 'mass' at all, i.e., no physical presence, it will be difficult to claim that a business is heavily involved in the economic life of a specific jurisdiction, since tax jurisdictions are divided by physical borders. Further, it has been claimed that:

> *even the most highly digitalized businesses cannot penetrate into the economic life of a faraway country without at least telecommunication infrastructures (such as submarine cables and signal towers), terminals or devices to transmit digital information (such as computers and cellphones), and senders and receivers of such digital information (such as users or customers in the targeted country).*[60]

Accepting that some physical presence is a prerequisite for operating in a market, it is argued in this article that it is the requirement of having a fixed physical place of business 'at the disposal' of the enterprise that creates the gap between the legal concept of a PE under the OECD Model (2017) and the economic substance of highly digitalized businesses. The requirement of 'disposal' has previously, e.g., in the context of physical servers been interpreted as exercising control over the servers as if, in fact, an individual or busienss is the owner or operator of the server.[61] Based on such an interpretation of 'disposal', it seems unlikely that the cited physical presence will be considered at the disposal of MNEs as the necessary infrastructure is now usually provided as a service or made available by the customer/user.

The role of users in some highly digitalized businesses that heavily rely on users and include significant amounts of user data in production of digital products and services have been referred to as the 'phenomenon of free labor' or 'prosumers'.[62] This feature has been argued to extend the 'Theory of the Firm' formulated by Ronald Coase in *The Nature of the Firm* dating back to 1937. According to the Theory of the Firm, companies can choose between subcontracting to suppliers and hiring employees as input in the production function.[63] This also seems to be the understanding within the commentaries to Article 5 of the OECD Model (2017), as only employees and other persons under the instruction of the business as well as subcontractors can conduct the business of an enterprise[64] – if personnel are in fact required to carry on the specific business activities at that location.[65]

However, as stated some highly digitalized businesses appear to have a third option: active user participation generating user data that may be put back into the production function potentially without users receiving monetary remuneration.[66] According to this argument, the use of customers and users located in market states as a resource or an input factor in the provision of products and services may imply that the traditional line between production and consumption is indistinct. In respect of wealth production, only recurring activity of users which are used by the MNEs for business purposes

Notes

[57] *See* e.g., Hongler & Pistone, *supra* n. 48, at 14; and M. P. Devereux & J. Vella, *Implications of Digitalization for International Corporate Tax Reform*, WP 17/07, at 25 (July 2017). Notably other views have been presented in the international tax literature, e.g., Li, *supra* n. 1, at 29. Li argues that the gap is caused by the minimal need for personnel to carry on and manage business operations. While the author of the present article agrees that a limited need for personnel may imply limited profit to market states (as no/limited decision-making functions on the control of risk will be present in market jurisdiction), the lack of personnel should not prevent the creation of a PE pursuant to OECD Model (2017): Commentaries to Art. 5, para. 127: *'The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location'.*

[58] *See* Buriak, *supra* n. 15, at 307, Becker & Englisch, *supra* n. 39, at 162; Hongler & Pistone, *supra* n. 48, at 18–19.

[59] See e.g., OECD, 2018 Interim Report, *supra* n. 39, at 51–52 and OECD, *Report on Pillar One Blueprint*, *supra* n. 4, at 24.

[60] *See* Li, *supra* n. 1, at 29.

[61] *See* J. Bundgaard & L. Fjord Kjærsgaard, *Taxable Presence and Highly Digitalized Business Model*, 97(9) Tax Notes Int'l 986–987 (2020) based on interpretation of commentaries and danish, Swedish and Canadian case law.

[62] *See* e.g., 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 49 (2013). They refer to users generating data, i.e., put back into the production chain – blurring the dividing line between production and consumption, as 'free labour'; Johannes Becker & Englisch, *supra* n. 39, at 166–170; R. Petruzzi & S. Buriak, *Addressing the Tax Challenges of the Digitalization of the Economy: A Possible Answer in the Proper Application of the Transfer Pricing Rules?,* 72(4a) Bull. Int'l Tax'n. (2018). The authors refer to users generating data as 'unconscious employees'. Y. Brauner & P. Pistone, *Some Comments on the Attribution of Profits to the Digital Permanent Establishment*, 72(4a) Bull. Int'l Tax'n. 2 (2018). The authors argue that, if the role of users becomes that of active customers, at least a portion of the income realized should be allocated to the country of the users.

[63] This also seems to be the assumption for Kemmeren who argues that income is produce only if a person utilizes the production factors of labour and potentially capital, further, that the taxation of income should be linked with this utilization. Kemmeren, *supra* n. 15, at 431.

[64] *See* OECD Model (2017): Commentaries to Art. 5 (1), paras 39 and 40.

[65] *See* OECD Model (2017): Commentaries to Art. 5 (1), paras 41 and 127.

[66] *See* e.g., Collin & Colin, *supra* n. 62; Bundgaard & Fjord Kjærsgaard, *supra* n. 61, at 993.

as part of the value creation process within the MNE can constitute a stage in the wealth production. Notably, this situation should be distinguished from the situation in which businesses only use customers as a (consumption) market where income is realized.[67]

Based on the perceived gap between the concept of PE under the OECD Model (2017) and economic substance of highly digitalized businesses and the arguments that the current allocation of taxing rights is founded on the principle of economic allegiance, it could be questioned whether this principle is capable of justifying allocation of more taxing rights to market states. A critical argument would be that this principle is already applied and is perceived to result in too little tax revenue being allocated to the market states.

While this may be correct if the understanding of the principle of economic allegiance remains static in its historical context, it is reasoned in this article that a more modern interpretation of the factors comprising economic allegiance may justify that additional taxing rights are allocated to the market states. Accordingly, if a business produces wealth in a market state, it should pay an apportioned part of its ability to this market state – even when it does not have a 'traditional' fixed physical place of business 'at its disposal' through which 'traditional' personnel carries out the business of the MNE. This also seems to find some support in the 1923 report where it is explicitly stated that:

> *The true economic location is to be distinguished from the physical location, usually termed situs. Frequently, of course, these coincide. But in the case of many classes of wealth the temporary situs may be quite distinct from the true economic location. … Physical situs is of importance in economic allegiance only to the extent that it reinforces economic location.*[68]

Modernizing the requirement of physical presence under the definition of a PE also seems somewhat in accordance with the observed tendency through previous amendments to the commentaries to Article 5 of the OECD Model, i.e., the requirement for the situs to reinforce origin has been eased over the years.[69]

The remainder of this article will be focused on whether the measures currently contemplated by the IF and the UN may be justified based on the principle of economic allegiance.

3 Solutions proposed to tackle the digitalization

Based on the perception that market states are left with too little revenue to tax under the current international tax regime, the continued work following the OECD/G20 BEPS Project – currently postponed until mid-2021[70] – has been eagerly awaited. Further, other supranational and international organizations such as the EU and the UN have proposed different measures.[71] Nonetheless, some countries have been of the opinion that there is an urgent need for allocating more tax revenue to the market states and considered, proposed or even implemented (interim) measures targeting digitalized businesses.[72] While the right to implement unilateral measures may be justified by states' sovereignty within taxation and tax competition, it is argued that a fragmented network of unilateral measures is not preferred. In the absence of a consensus-based approach, an increase of (fragmented) unilateral measures should be expected.[73] This will likely increase the practical and economic harmful effects from fragmented international taxation as well as causal negative consequences and in a worst-case scenario, trade wars.[74] Against this background, only international measures that are currently being considered and aiming for international political consensus will be analysed in the next subsections.

Notes

[67] *See also* Buriak, *supra* n. 15, at 307 and Becker & Englisch, *supra* n. 39, at 167–169. On the other hand, Klaus Vogel seems to argue that there is no valid objection against a claim of the sales state to tax part of the sales income as income received from sales would not have been earned without the market they provide, *see* Vogel, *supra* n. 15, at 400–401.

[68] *See* Bruins et al., *supra* n. 17, at 24–25.

[69] *See* e.g., V. Dhuldhoya, *The Future of the Permanent Establishment Concept*, 72(4a) Bull. Int'l Tax'n. 12 (2018) and Bundgaard & Fjord Kjærsgaard, *supra* n. 61, at 980. The authors all argue that the commentary additions of the so-called painter example and provisions on e-commerce and optional service PE, as well as the implementation of BEPS action 7 on preventing the artificial avoidance of PE status, all seem to lower the threshold for when source taxation can be established through a PE.

[70] See OECD, *Report on Pillar One Blueprint*, *supra* n. 4, at 7.

[71] On 21 Mar. 2018, the European Commission proposed new rules to ensure that digital business activities are taxed in a fair and growth-friendly manner in the EU, i.e., a proposal for a Council directive laying down rules relating to the corporate taxation of a significant digital presence and proposal for a Council directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services. The UN has published the following two discussion drafts *Committee – Art. 12 B on Automated Digital Services* (E/C.18/2020/CRP.41), *supra* n. 4, and *Committee – Inclusion of Software Payments in the Definition of Royalties* (E/C.18/2020/CRP.38)], *supra* n. 4.

[72] More than thirty countries have introduced some kind on unilateral measure, *see* Saint-Amans, *supra* n. 2, at 310. *See also* Wanyana Oguttu, *supra* n. 13. Oguttu discusses a number of the implemented unilateral measures.

[73] OECD, *Economic Impact Assessment, supra* n. 13, at 23. Raising concern that a number of states consider unilateral measures will refrain from introducing them if a multilateral consensus-based solution is reached. Conversely, it should be expected that these states will proceed with introducing unilateral measures if no multilateral consensus-based solution is reached also implying that an escalation of related trade tensions would follow.

[74] OECD, *Economic Impact Assessment, supra* n. 13. Reserving the inherent uncertainties of such a counterfactual scenario it is estimated that the negative effect on global GDP could reach up to 1.2% corresponding to worst-case scenario, i.e., trade retaliation factors going up to five times beyond proportional.

3.1 *The OECD/G20 Inclusive Framework: Pillar One Blueprint*

The continued work on addressing the perceived tax challenges arising from the digitalization of the economy has resulted in a number of reports, public consultations, and a programmes of work – the latest publication being the *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint* published on 14 October 2020.[75] However, a common agreement has at the time of writing this article not been reached and it is still uncertain whether consensus will be reached.[76]

In general, Pillar One aims to expand the taxing rights of market states when an MNE has an 'active' and 'sustained' participation in the economy of that jurisdiction through activities in, or remotely directed at that jurisdiction.[77] In this context, market states are jurisdictions where an MNE sells its products or services and, in the case of highly digitalized businesses,[78] where an MNE provides services to users or solicits and collects data or content contributions from users.[79] It seems that the underlying perception is that an active and engaged user base may create value for MNEs deploying certain business models,[80] however, there is no clearly articulated justification for *why* such active and sustained (value creating) activity should justify the allocation of a new taxing right. As discussed above, in this article, it is argued that the justification for allocating taxing rights to a market state should be based on a proportion of the MNE's ability to pay taxes that are being created in that market state. Accordingly, it is argued that only if the contemplated rules under the Pillar One Blueprint identify stages in the value creation process of in-scope MNEs (e.g., from recurring content-generating activity of users that are utilized by the MNEs for business purposes) are the contemplated rules justifiable. Given the focus on highly digitalized business model, the below analyses will in particularly focus on the provision of automated digital services.

3.1.1 *A New Taxing Right to Market States*

The scope of the new taxing right to 'Amount A' is based on an 'activity test' and a 'threshold test'.[81] The latter is intended as the primary indicator of a significant engagement in the market state as well as to minimize compliance costs of MNEs and keep the administration of the potential new rules manageable for tax administrations. It would likely include a revenue threshold (e.g., 750 mEUR as it is known from the CbCR) based on annual consolidated group revenue in the consolidated financial statement.[82] It is estimated that the number of in-scope MNEs after applying a global revenue threshold on 750 mEUR is 8,000 worldwide.[83] Further, it is contemplated to couple the global revenue threshold with a de minimis foreign in-scope revenue threshold and to ensure that smaller economies also can benefit from the new taxing

Notes

[75] OECD, 2018 Interim Report, *supra* n. 39; OECD, Policy Note, *supra* n. 3; OECD, *Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy,* 13 feb. – 6 Mar. 2019, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2019); OECD, Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2019); OECD, Public consultation document Secretariat Proposal for a 'Unified Approach' under Pillar One 9 Oct. 2019–12 nov. 2019, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2019); OECD, Public consultation document Global Anti-Base Erosion Proposal ('globe') – Pillar Two, 8 nov. 2019–2 dec. 2019, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2019); 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, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2019); OECD, *Report on Pillar One Blueprint*, *supra* n. 4; OECD, Public Consultation Meetings - Reports on the Pillar One and Pillar Two Blueprints 14–15 Jan. 2021 (2021). The Pillar One Blueprint is also discussed by A. P. Dourado, *The OECD Report on Pillar One Blueprint and Article 12B in the UN Report,* 49(1) Intertax 3 et seq. (2021); Greil & Eisgruber, *supra* n. 10; Li, supra n. 1. On the Kluwer International Tax Blog, the following blogs has been posted: H. Van den Hurk, *OECD's Pillar One and the Return of the Pencil!* (2 feb. 2021), http://kluwertaxblog.com/2021/02/22/oecds-pillar-one-and-the-return-of-the-pencil/ (accessed 18 May 2021); G. Sparidis, J.-W. Kunen & B. Middelburg, *Digital Economy Taxation Developments: A Marker for the Future of Taxes (Part 2),* (5 feb. 2021), http://kluwertaxblog.com/2021/02/05/digital-economy-taxation-developments-a-marker-for-the-future-of-taxes-part-2/?Print=print (accessed 18 May 2021); D. Frescurato & Velio Alessandro Moretti, *The Carve-out of Financial Services from Pillar One: Good Times for a Step Further?* (23 nov. 2020), http://kluwertaxblog.com/2020/11/23/the-carve-out-of-financial-services-from-pillar-one-good-times-for-a-step-further/ (accessed 18 May 2021); V. Chand & D. Canapa, *Pillar I of the Digital Debate: Its Consistency with the Value Creation Standard as Well as the Way Forward,* (24 nov. 2020), http://kluwertaxblog.com/2020/11/24/pillar-i-of-the-digital-debate-its-consistency-with-the-value-creation-standard-as-well-as-the-way-forward/ (accessed 18 May 2021); W. Byrnes, *Recommendations for the Pillar One and Pillar Two Blueprints* (18 dec. 2020), http://kluwertaxblog.com/2020/12/18/recommendations-for-the-pillar-one-and-pillar-two-blueprints/ (accessed 18 May 2021).

[76] *See* OECD, *Report on Pillar One Blueprint, supra* n. 4, at 8 and 10. This was also confirmed by the OECD at the OECD Public Consultation Meeting on the Pillar One Blueprint, *supra* n. 8.

[77] *See* OECD, *Report on Pillar One Blueprint, supra* n. 4, at 11. Among the commentators, it was widely criticized that the precise policy aim, and scope remain unclear. This was acknowledged by a representative of the OECD on the virtual meeting on the Pillar One Blueprint 14 Jan. 2021who reasoned the lack of clarity with the lack of consensus among members of the Inclusive Framework.

[78] The term 'highly digitalized business models' usually refer to business models that, to a varying extent, create value from cross-jurisdictional scale without mass, reliance on intangible assets including IP and data, and user participation and their synergies with IP. *See* OECD, *2018 Interim Report, supra* n. 39, Ch. 2: Digitalisation, business models and value creation.

[79] *See* OECD, *Report on Pillar One Blueprint, supra* n. 4, at 17.

[80] See e.g., OECD, *Report on Pillar One Blueprint*, *supra* n. 4, at 27.

[81] As an alternative to the activity test, the US has suggested applying Amount A on a Safe Harbour Basis. Under a Safe Harbour approach MNEs could elect to have all of the components of Pillar One apply to them on a global basis reducing the need to resolve contentious scoping issues. Election procedures could be provided to require that an MNE's election be made on a global and multi-year basis. However, several countries have expressed skepticism. OECD, *Report on Pillar One Blueprint, supra* n. 4, at 57.

[82] OECD, *Report on Pillar One Blueprint, supra* n. 4, at 58.

[83] *Ibid.,* at 59.

right, the local de minimis rules could be based on GDP.[84] Finally, it is discussed whether to include a temporal requirement/duration test to demonstrate that the significant engagement is sustained and not just of a one-off nature.[85] An example of the application of the global and local threshold is provided:

> *'If it were assume{d} that for the Amount A formula it is agreed that 20% of the MNE's profits in excess of a 10% profit margin would be allocated to the market. Under Amount A, the MNE's residual profits would be EUR 25 million, of which EUR 5 million (20%) would be allocated to market jurisdictions under Amount A. At a 25% corporate tax rate, this would equate to EUR 1.25 million in additional CIT or EUR 125,000 if this amount were split equally between 10 market jurisdictions.'*[86]

It is contemplated that for MNEs providing automated digital services, such a market-revenue threshold will be the only test to establish a new nexus that will allocate a taxing right to the market state.[87] On the contrary, it is considered that consumer-facing business will only have a new nexus if it generates market-revenue exceeding a higher market threshold *and* it has an additional (yet to be decided) indicator of nexus, i.e., a so-called plus-factor.[88]

The contemplated activity test implies that in-scope businesses should generate income from automated digital services (hereinafter: ADS) or consumer-facing businesses (hereinafter: CFB) with a CFB being secondary.[89] Under the Pillar One Blueprint, a CFB supplies goods or services either directly or indirectly that are of a type commonly sold to consumers and/or licenses or otherwise exploits intangible property that is connected to the supply of such goods or services.[90] Further, it is stated that, an MNE would be regarded as being a CFB if the MNE is the owner of the product and the related brands, i.e., MNEs for which their 'face' is apparent to the consumer.[91]

With respect to the activity test of ADS, the Pillar One Blueprint provides the following definition:

> *An ADS is one where:*
>
> *The service is* ***on the positive list****; or*
>
> *The service is*
>
> - ***automated*** *(*i.e., *once the system is set up the provision of the service to a particularuser* ***requires minimal human involvement*** *on the part of the service provider); and*
>
> ***digital*** *(*i.e., *provided over the Internet or an electronic network); and*
>
> - *it is* ***not on the negative list.***[92] (author's emphazis)

Hence, only if an activity carried out by an MNE is *neither* on the positive list *nor* on the negative list, recourse shall be had to the general definition of the ADS. The positive list and the negative list contain the categories of services listed below in Table 1. The Pillar One Blueprint includes definitions of the services and accompanying commentaries that are elaborating on their scope.[93]

Table 1

The Positive List	*The Negative List*
1. Online advertising services	1. Customized professional services
2. Sale or other alienation of user data	2. Customized online teaching services
3. Online search engines	3. Online sale of goods and services other than ADS
4. Social media platforms	4. Revenue from the sale of a physical good, irrespective of network connectivity ('Internet of things')
5. Online intermediation platforms	5. Services providing access to the Internet or another electronic network
6. Digital content services	
7. Online gaming	
8. Standardized online teaching services	
9. Cloud computing services	

In multi-sided business models, one side of it may be monetized through another side. For instance, a social media platform provided to users against no monetary

Notes

[84] *Ibid.,* at 65.

[85] *Ibid.*

[86] *Ibid.,* at 62.

[87] *Ibid.,* at 65–66.

[88] *Ibid.,* at 66–68. A plus-factor for the CFB may include the taxable presence under the current international rules or other plus-factors unconstrained of physical presence, e.g., exceeding an even higher market-revenue threshold, sustained presence of personnel or advertising and promotion expenditures exceeding a certain percentage of the market-revenue threshold.

[89] OECD, *Report on Pillar One Blueprint, supra* n. 4, at 38.

[90] *Ibid.,* at 37.

[91] *Ibid.,* at 38.

[92] *Ibid.,* at 23.

[93] The contemplated definition and associated commentaries of services included in the positive and negative lists are stated on at 24–32 and 32–36, respectively, of OECD, *Report on Pillar One Blueprint, supra* n. 4.

means of exchange may be monetized through the sale of online advertising services that are purchased by customers on the other side of the business who are targeting the users of the social media platform. In such situations, only the category of online advertising services will be the appropriate category – also for revenue sourcing purposes.[94]

It is estimated that the number of MNEs with a primary activity in ADS or CFB sectors *after* applying a global revenue threshold on 750 mEUR is limited to 2,300 worldwide.[95]

In the Pillar One Blueprint specific hierarchical sourcing rules are provided to determine if an in-scope MNE has realized revenue 'deriving' from a market state. With respect to CFB, the applicable sourcing rule for revenue from services is the 'place of enjoyment or use of the service' and revenue from goods sold directly or through an independent distributor is the 'place of final delivery', as reported by the independent distributor where relevant. These places are to be determined based on two lists of indicators in hierarchical order.[96]

The applicable revenue sourcing rule with respect to the ADS is dependent on the specific activity performed by the MNE although the revenue from *(1)* online advertising and *(2)* sale or other alienation of user data are prevalent revenue streams, i.e., whenever an MNE derives revenues from these activities, this revenue will be sourced according to these rules.[97] It is contemplated to divide sourcing rules to revenue from both services into:

- Sourcing rules applicable to revenue from online advertising services based on the 'real-time location of the viewer' and revenue from the sale or other alienation of user data based on the 'real-time location of the user'. The sourcing of such revenue should be based on real-time location of the viewer at the time of display, and the user who is the subject of the data being transmitted, at the time of data collection, respectively.[98] In this respect, the relevant indicators in hierarchical order are: *(i)* the jurisdiction of the 'geolocation'[99] of the device, *(ii)* the jurisdiction of the 'IP address'[100] of the device, and *(iii)* other available information that can be used to determine the jurisdiction of the real-time location of the viewer or the user.[101]
- Sourcing rules that are applicable to revenue from *other* online advertising services and *other* sale or alienation of user data. The sourcing of such revenue should be according to the jurisdiction of the 'ordinary residence' of the viewer of the advertisement or the user that is subject to data being transmitted. In this respect, the relevant indicators in hierarchical order also rely on mass data collected by an MNE such as geolocation or IP address data of users.[102]

Finally, it should be noted that if a new nexus has been established and the associated taxing right has been allocated to the market state according to the rules contemplated under the Pillar One Blueprint, the net principle is contemplated to be implemented by several different measures including a profitability test.[103] This is to ensure that the potential paying entities have the capacity to bear the tax liability and rules on losses carried-forward to ensure that there is no allocation where the relevant business is not profitable over time. More specifically, it is considered that the final solution should include 'pre-regime losses', i.e., losses incurred prior to potential implementation of the new taxing right, and 'in-regime losses', i.e., losses incurred after the taxing right enters into force.[104] Lastly, it is discussed whether to include so-called 'profit-shortfalls', i.e., the delta between the actual in-scope profit of an MNE and the profitability threshold. In other words, if

Notes

[94] OECD, *Report on Pillar One Blueprint, supra* n. 4, at 25.

[95] *Ibid.,* at 59.

[96] *Ibid.,* at 80–82.

[97] *Ibid.,* at 72.

[98] *Ibid.,* at 72–74.

[99] *Ibid.,* at 82–83. Geolocation is described as services using various data points to determine a location including a combination of IP address, GPS-derived location data, cell tower IDs and data associated with Wi-Fi positioning systems. Hence, when available, geolocation should provide a quite accurate indicator for sourcing revenue.

[100] OECD, *Report on Pillar One Blueprint, supra* n. 4, at 83. An IP address is the number assigned to each device connected to a computer network. Even though an IP address does not contain the location of the user, IP address databases are widely used by MNEs to determine the location of the user for business reasons and may be a practical indicator for sourcing revenue. It is recognized that issues regarding the use of a VPN will be a challenge in practice.

[101] OECD, *Report on Pillar One Blueprint, supra* n. 4, at 85.

[102] *Ibid.,* at 73–74.

[103] Net principle refers to taxes on (net) income which is a measure of a person's capacity to command economic resources, i.e., taxes are imposed on income only after allowing for a deduction. *See* K. J. Holmes, *The Concept of Income – A Multi-disciplinary Analysis*, Doctoral Series Vol. 1 (IBFD 2001), Ch. 1, *Tax fairness.* Further, in respect of the concept of 'income', it has previously been argued in the international tax literature that, in the economics of the twentieth century, the concept of income should be understood in accordance with 'wealth accrual' which relates to the economic ability of persons. Stated otherwise, income may be determined as the disposing power of a person who has not impaired his capital or incurred debts. This understanding of the concept of 'income' has been referred to as the Haigh-Simons concept of income or the Schanz-Haigh-Simons concept of income referring to the main contributions of G. Von Schanz, *Der Einkommensbegriff und die Einkommensgesetze*, Finanz-Archiv (1896); R. Haig, *The Concepts of Income – Economic and Legal Aspects*, The Federal Income Tax (Columbia University Press 1921) and H. Simons, *Personal Income Taxation – The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press 1983). For a thorough analysis, *see* K. Holmes, *The Concept of Income –a Multi-disciplinary Analysis*, Doctoral Series Vol. 1 (IBFD 2001), in particular Ch. 2, *Foundation Concept of Income.*

[104] OECD, *Report on Pillar One Blueprint, supra* n. 4, at 111–123.

the actual in-scope *profit* of an MNE decreases below the profitability threshold, the difference may be carried forward to offset future years' actual in-scope profit above the profitability threshold.[105]

3.1.2 *Is the New Taxing Right Justifiable?*

Recall the report conducted by the four economists back in 1923 and particularly the consideration on commercial establishments with a fixed location, i.e., with a main or head office in a particular place, the four economists concluded that the origin was of *outstanding significanc*e to such business models. This was due to the influence of sales and the existence of many selling agencies or branches and further because origin would typically be reinforced by the 'situs'. However, because control at distance was already to some extent possible at that time, 'domicile' would be of more importance compared to businesses based on factories, mines, or oil wells.

On the one hand, it may be argued that the ability of highly digitalized business models to 'scale without mass' – being a general feature of businesses rendering the ADS[106] – implies that the place of 'origin' to a less extent is reinforced by the 'situs'. Remote selling without a local physical presence is arguably decreasing the importance of 'origin'. Further, the development in the information and communication technology implies that the possibility of controlling the origin at greater distances has improved significantly, arguably increasing the importance of 'domicile'. Hence, such arguments would weaken the coherence between the principles stated in the report from 1923, and the new nexus contemplated by the IF members that is based on an increase of the importance of 'origin', which is understood as the place of local sale and wealth production represented by the real-time location or place of ordinary residence of the viewers and users.

On the other hand, the influence of sale especially through online medias is significant among highly digitalized businesses, i.e., 'origin'. At the time that the underlying principles were formulated, sales and production functions were (often exclusively) performed by agencies and branches physically present in the local markets, which would have implied that the 'situs' would reinforce 'origin'. Currently, the influence on sales of highly digitalized businesses may be performed by the MNEs (exclusively) through online interfaces at the place of the viewers. Hence, such MNEs are relying on local telecommunication infrastructures (e.g., submarine cables and signal towers), terminals or devices to transmit digital information (e.g., computers and phones), and senders and receivers of such digital information (e.g., users or customers in the targeted country).[107]

If the situs is interpreted as a digital location, this would arguably reinforce and thereby increase the importance of 'origin'.[108] Further, the inclusion of a significant amount of user data in the production function of MNEs deriving revenue from targeted advertising and sales or other alienation of user data previously referred to as the 'phenomenon of free labor' or 'prosumers' arguably produces some value.[109] According to this argument, the use of customers and users in market states as a resource or an input factor in the provision of products and services may imply that such users and customers could constitute a specific and identifiable stage in the production of wealth, i.e., a place of origin. Accepting this argument, the allocation of taxing rights to such market states based on the principle of origin might be justified. Notably, this situation should be distinguished from the situation in which businesses only use customers as a (consumption) market where income is realized. This should also question the justification for establishing a nexus in the country of the purchaser of products and services such as digital content and cloud computing if the MNE is not relying on an active and sustained user base in the provision of such product and services.[110]

In addition, it may be argued that the reliance on legal infrastructure regarding IP protection and enforcement of transactions with the users in the market states represent 'enforcement' which was one of the four factors identified in the report from 1923. This factor was primarily considered of importance if it reinforced either 'origin' or 'residence'. Arguably, 'enforcement' reinforces 'origin' in many highly digitalized business models.

Consequently, it is arguably possible to make a link between *(1)* the requirement of a sufficient level of economic presence under the contemplated new nexus of MNEs providing online advertising and sales or other

Notes

[105] *Ibid.,* at 114.

[106] *Ibid.,* at 24.

[107] *See also* Li, *supra* n. 1, at 29.

[108] *See also* Hongler & Pistone, *supra* n. 48, at 19. The authors argue that the threshold defined in Art. 5 of the OECD Model will always be somehow artificial. Accepting that there is no solid argument for an exact threshold, it may be argued that a more 'up-to-date' interpretation could be included within the underlying principles of the international tax rules.

[109] *See* e.g., Collin & Colin, *supra* n. 62. They refer to users generating data i.e., put back into the production chain – blurring the dividing line between production and consumption, as 'free labor'; Becker and Englisch, *supra* n. 39, at 166–170; Petruzzi & Buriak, *supra* n. 62. The authors refer to users generating data as 'unconscious employees'. Brauner & Pistone, *supra* n. 62. The authors argue that, if the role of users becomes that of active customers, at least a portion of the income realized should be allocated to the country of the users.

[110] *See also* Buriak, *supra* n. 15, at 307 and Becker & Englisch, *supra* n. 39, at 167–169. On the other hand, as previously stated Klaus Vogel seems to argue that there is no valid objection against a claim of the sales state to tax part of the sales income, *see* Vogel, *supra* n. 15, at 400–401.

alienation of user data and *(2)* the factor of 'origin' considered of 'preponderant weight' when assessing the economic allegiance of business profit as developed by the group of economists almost a century ago.[111] In this respect, it is noted that it has previously been criticized that the problem that Amount A is attempting to solve is not clearly articulated and, further, that the principles that might solve this indistinct problem are not clearly communicated.[112] It is argued in this article that, if the problem is that market states are left with too little revenue to tax from MNEs with active and sustained *value creation* in the market states,[113] this could be justified through the ability to pay principle incorporating a modernized interpretation of the principle of origin. Under this justification, the contemplated new nexus should constitute a specific and identifiable stage of the wealth production where this 'ability' to pay is created, i.e., 'origin'.

The new taxing right is estimated to result in a reallocation of approx. 100 billion USD to market states.[114] Hence, according to these illustrative estimates, the Pillar One Blueprint, will in fact allocate taxing rights to more tax revenue to the market states, although this estimate also includes in-scope businesses not generating revenue from online advertising and sale or other alienation of user data.[115]

However, it is argued in this article that the contemplated new taxing right should not be targeting industry-specific business models or fact-specific services. *Firstly*, as already concluded in the final report on Action 1 in the BEPS-Project, it is impossible to ringfence the digital economy as this is now the economy at large.[116] Hence, any rules specifically targeting certain business models will result in arbitrariness and will be unlikely to succeed at only affecting their target. *Secondly*, as elaborated above in section 2, it is contended that rules targeting (fact) specific business models will hardly stand the test of time. In other words, it should be expected that these rules as we know them today will have a difficult time keeping up with the ever-evolving digitalization of the economy.[117]

Another critical point is the choice of a revenue-based threshold as a part of the scope and (sole) nexus criteria, which is difficult to justify based on the principle of economic allegiance. Stated differently, it will conflict with this principle if two businesses are both producing wealth in a market state (e.g., through an active and content-producing local user base) but are not both contributing to it according to their ability created in this market state because of differences in the realization of value sourced to it, i.e., revenue just above and just under a specific and somewhat arbitrary threshold. Further, an inherent consequence of revenue thresholds is a 'cliff edge effect' meaning that a revenue threshold may create an incentive to only generate revenue just under the threshold. Nonetheless, given the compliance burden resulting from the contemplated rules,[118] it must be acknowledged that a certain threshold seems necessary, and, in this respect, a revenue-based threshold indeed seems to be a simple 'entry criterion'.

A positive point to be noted is that the Pillar One Blueprint aims at only taxing true economic benefit by taxing according to the net principle, thus respecting the ability to pay principle which in this article is argued to be an inherent part of the economic allegiance principle.[119] During the consultation process, the importance of the treatment of losses have been stressed by some of the highly digitalized businesses,[120] reminding the members of the IF that two of the features identified by the OECD as characterizing digitalized businesses providing the ADS: *(1)* they incur substantial losses in the start-up phase due to significant investment, i.e., a substantial degree of upfront human involvement and significant capital input in infrastructure and R&D, and *(2)* their business model is typically based on 'high volume – low margin'.[121] The

Notes

[111] *See also* Chand & Canapa, *supra* n. 75.

[112] *See* the OECD Public Consultation Meeting on the Pillar One Blueprint, *supra* n. 8.

[113] See OECD, *Report on Pillar One Blueprint, supra* n. 4, at 19.

[114] OECD, *Economic Impact Assessment, supra* n. 13, at 15. The estimates are based on the following illustrative assumptions. Only Amount A is modelled focusing on ADS and CFB, with a global revenue threshold of EUR 750 m, a profitability threshold percentage of 10% (based on the ratio of profit before tax to turnover), residual profit of the MNE groups that would be in scope of Amount A on 500 billion USD, a reallocation percentage of 20%, and a nexus revenue threshold of EUR 1 m for ADS and EUR 3 m. It is estimated that, on average, low and middle-income economies would gain relatively more revenue than advanced economies whereas 'investment hubs' would experience a loss in tax revenues. OECD, *Economic Impact Assessment, supra* n. 13, at 61–62.

[115] NGOs have stated that the estimated reallocation of tax revenue is too little, *see* OECD Public Consultation Meeting on the Pillar One Blueprint, *supra* n. 8 and Saint-Amans, *supra* n. 2, at 310.

[116] *See also* S. Buriak, *supra* n. 15, at 307 and Becker and Englisch, *supra* n. 39, at 167–169. On the other hand, Klaus Vogel seems to argue that there is no valid objection against a claim of the sales state to tax part of the sales income as income received from sales would not have been earned without the market they provide, Vogel, *supra* n. 15, at 400–401.

[117] *See also* Byrnes, *supra* n. 75.

[118] The significant complexity and compliance burden is also problematized by Greil and Eisgruber, *supra* n. 10. and Van den Hurk, *supra* n. 75.

[119] *See also* Byrnes, *supra* n. 75. Similarly, it has been argued in the international tax literature on turnover taxes that the lack of right to deduct costs violates the ability to pay principle; *see* e.g., Stevanato (2019), *supra* n. 13, at 417 and the same author in Stevanato, *supra* n. 13; Pinto Nogueira, *supra* n. 13.

[120] *See* e.g., the responses of The Digital Economy Group, at 11 and Spotify, at 4 and 9, to the OECD Public Consultation: *Addressing the Challenges of the Digitalization of the Economy* (6 Mar. 2019).

[121] See OECD, *Report on Pillar One Blueprint, supra* n. 4, at 24 and OECD, *2018 Interim Report*, *supra* n. 39, at 75.

combination of these two features implies that it may take several years before these businesses become profitable. More specifically, according to recently published research, approximately 80% of the companies in the information technology sector take longer than ten years to reach economic break-even.[122] Therefore, if these companies are swept into the contemplated new taxing right, it is important that any pre-regime losses and in-regime losses are accounted for prior to allocating tax revenue to the eligible market states. Otherwise, such companies could be overtaxed which violates the ability to pay tax principle.[123] Further, such rules on losses carry-forward are a way to preserve the taxing rights of residence jurisdictions that have accepted (and will continue to accept) the deduction of losses generated by a business, i.e., such rules will likely enhance inter-nation equity. Stated otherwise, the residence jurisdiction that bears the initial downside of a business activity will be able to recover these losses before a portion of the profit generated by the same activity is allocated to a market state.[124]

3.2 *Amendments to the UN Model*

Next to the comprehensive work carried out by the IF, the Committee of Experts on International Cooperation in Tax Matters under the UN (hereinafter: the Committee) has carried out its own work – also in light of the current uncertainty as to whether the members of the IF will come to an agreement on a consensus-based solution. Further, as a large part of the members of the UN are developing countries with limited administrative capacity for domestic tax authorities to apply and enforce complicated rules, an additional focus to allocating more taxing rights to the market states is simplicity for administration and compliance purposes. This also seems to be reflected in the two discussion drafts by the Committee which suggest a right to impose withholding taxes on the gross amount of payments. Such an approach is argued to be a well-established and effective method for collecting a tax imposed on non-residents.[125]

3.2.1 *Inclusion of Software in the Royalty Definition*

While the provision on royalties in Article 12 of the UN Model (2017) in many ways replicate Article 12 of the OECD Model (2017), an important difference is that the taxing right is shared between the residence state and the state where the payment 'arises' under the UN Model (2017). In this respect, if follows from Article 12 (5) of the UN Model that royalties shall be deemed to arise in a state when the payer is a resident of that state. This is unless the payer has a PE or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by the PE or fixed base. The royalties shall then be deemed to arise in the state in which the PE or fixed base is situated.

Some members of the Committee have considered broadening the scope of the definition of royalty under Article 12(3) of the UN Model (2017) to also include payments of any kind that are received as a consideration for the use of, or the right to use 'computer software'.[126]

While software is not explicitly mentioned in the current (exhaustive) definition, it follows from Article 3(2) of the UN Model that it is domestic law which is decisive when interpreting the scope of the intellectual rights, equipment, and experiences included in the definition, unless the context requires otherwise.[127] Countries typically protect rights in computer programs either explicitly or implicitly under domestic copyright law.[128] While the term 'computer software' is commonly used to describe both the program, *in* which the copyright subsists and the medium *on* which it is embodied, only the former usually enjoys copyright protection.[129] This distinction is important, as only payments for the right to use the copyright should be classified as a royalty – understood as a use that, in the absence of such right, would constitute an infringement of the copyright.[130] However, the classification of

Notes

[122] *See* Deschsakulthorn et al., *supra* n. 12, at 329.

[123] *See also* Byrnes, *supra* n. 75.

[124] See OECD, *Report on Pillar One Blueprint*, *supra* n. 4, at 111.

[125] *See* e.g., para. 11 of the proposed Commentaries in *Committee – Art. 12 B on Automated Digital Services* (E/C.18/2020/CRP.41), *supra* n. 4 and Byrnes, *supra* n. 75. Byrnes argues that a withholding based system offers an immediately implementable regime built on legacy systems and procedural simplicity and certainty, better revenue estimation for tax authorities, less complex and expensive audits, better tax risk management for taxpayers, an established procedural system for relief of double taxation and less cause for requiring MAP.

[126] Committee – Inclusion of software payments in the definition of royalties (E/C.18/2020/CRP.38), *supra* n. 4, at 2. Post the acceptance of this article, the majority of the Committee members voted not to include this proposal and the associated commentaries in the 2021-version of the UN Model, *see* United Nation, Committee of Experts on International Coorperation in Tax Matters, *Note by the Subcommittee on the UN Model Tax Convention, Update of the UN Model Double Taxation Convention between Developed and Developing Countries - Inclusion of software payments in the definition of royalties*, A/C18/2021/CRP.9, Virtual Session: 19-28 Apr. 2021.

[127] Although the exact importance is subject to ongoing debate in the international tax literature, interpretation of international tax rules is typically done according to or inspired by Arts 31 and 32 Vienna Convention as well as Art. 3(2) OECD Model (2017). However, A. P. Dourado et al., *General Definitions*, in *Klaus Vogel on Double Taxation Convention* 211–213 (4th ed., E. Reimer & A. Rust eds, Wolters Kluwer Law and Business 2015) argue against a systematic preference for interpretation from the context over interpretation by reference to national law.

[128] *See* OECD Model (2017): Commentaries to Art. 12 (3), para. 12.2 and OECD Model (2017): Commentaries to Art. 12 (2), para. 12.2.

[129] *See* UN Model (2017): Commentaries to Art. 12 (3), para. 12.2 and OECD Model (2017): Commentaries to Art. 12 (2), para. 12.2.

[130] *See* UN Model (2017): Commentaries to Art. 12 (3), para. 13.1 and OECD Model (2017): Commentaries to Art. 12 (3), para. 13.1.

royalties on this basis does not apply if the rights granted are limited to those necessary to enable the user to operate the program. Such payments – and thereby many payments for software products – should generally not be classified as royalties but instead as business income.[131] This prevents the source state from taxing such payments in the absence of a PE or fixed place in the source state to which the payments are attributed.[132]

By including 'computer software' in the definition, all payments for the right to use it should be classified as royalties – irrespective of whether a payment is paid as consideration for the use of copyright in software or for a copy of the software.[133] Notably, payments for the acquisition of the IP right itself (i.e., acquisition of property) should still be distinguished from payments for a license to a copy of the software or the right to download the software (i.e., payments for the right to use the software).

3.2.2 *Is the New Taxing Right Justifiable?*

With respect to the policy rationale of adding 'computer software', the proponent members of the Committee argued that the increasing level of engagement of computer programs and other software in the economic life of other states justifies the allocation of taxing rights to these states.[134] However, against this policy rationale, some members argued that it is unclear and problematic, e.g., in regard to countries exporting (rare) natural resources such as metals used in cell phones, or oil on which the world's economy relies. As these goods have a significant level of engagement in the economy of the states where they are used, these members argued that the underlying policy rationale of including software should similarly justify taxation in the states exporting natural resources.[135]

It is argued in this article that the opponents are generally correct in stating that '*the underlying principles, and consistency with approaches taken elsewhere, must underpin such a change*'.[136] However, it also reasoned that it is not unambiguously right or wrong, when it is stated that allocating a taxing right based on '*producers of software rely upon the legal infrastructure in that country for the protection of intellectual property rights*' contradicts the underlying principles.[137] The reliance on legal infrastructure regarding IP protection and enforcement of payment for transactions seems to be one of the four factors, i.e., 'enforcement', identified by the four economists in the 1923 report as comprising economic allegiance. Similarly, it could be argued that it is not unambiguously right or wrong when members of the Committee argue that it contradicts the underlying principles if taxation at source is based on the software provider's '*reliance on the telecommunication network of the country for the delivery of software*'.[138] A contra argument may be that, because MNEs rely on the local infrastructure, they do not need to develop their own infrastructure which arguably could have constituted a 'situs' of the MNEs in the market states.

Hence, it is contended that two of the factors, i.e., 'enforcement' and 'situs', identified by the four economists in the 1923 report as comprising economic allegiance and thereby being the basis for the design of the international tax framework, plausibly could supports a shared taxing right. However, notably, the market state (i.e., the place of 'enforcement' and 'situs') may not be the state in which the payment arises. Thus, the service can be produced and provided in one jurisdiction, while the payment arises in another.

Furthermore, the two factors ('enforcement' and 'situs') were considered of importance primarily if they reinforce either 'domicile' or 'origin'. With respect to 'origin' which was considered of preponderant weight when determining economic allegiance of business profit, the sole connection to the source state under Article 12 may be the point of sale, i.e., the market, depending on the specific business model applied by the seller. Hence, it is argued that, while the place where the payment arises may be a proxy for in which non-domicile country wealth is created and produced, there will likely be business models in which the proxy does not coincidence with the economic substance of origin.[139] In such cases, the proposed addition to the definition of royalty would arguably separate 'origin' from the source state (i.e., the state where the payment arises) also supported by 'enforcement' and 'situs' not being (significant) in the source state.

In conclusion, it seems difficult to make a satisfying link between the requirement of a sufficient level of economic presence under the proposal presented in the discussion draft and the factors comprising economic allegiance as developed by the group of economists back in 1923. While this principle is argued to provide a justification for the current allocation of taxing right to business

Notes

[131] *See* UN Model (2017): Commentaries to Art. 12 (3), para. 14 and OECD Model (2017): Commentaries to Art. 12 (3), para. 14.

[132] *See* e.g., L. Fjord Kjærsgaard, *Allocation of the Taxing Right to Payments for Cloud Computing-as-a-Service*, 11(3) World Tax J. 393–395 (2019).

[133] *Committee – Inclusion of Software Payments in the Definition of Royalties* (E/C.18/2020/CRP.38), *supra* n. 4, at 2.

[134] *Ibid.*

[135] *Ibid.,* at 4.

[136] *Ibid.,* at 5. This is also emphasized and supported by e.g., the Silicon Valley Tax Directors Group, at 60–62.

[137] *Committee – Inclusion of Software Payments in the Definition of Royalties* (E/C.18/2020/CRP.38), *supra* n. 4, at 5.

[138] *Ibid.*

[139] *See* e.g., Kemmeren, *supra* n. 15, at 434.

profit, it is recognized that the same disconnection applies to interests, royalties and technical fees under Article 11, 12, and 12A of the UN Model but without further justification, this cannot justify the new taxing right. Further, the political policy rationale, i.e., that more tax revenue should be allocated to the state where software is used, may not be reached insofar that the market state differs from the source state.

In addition to the disconnection from the principle of economic allegiance, another weakness of the proposal is the general challenges associated with shared taxing rights and source taxation imposed on gross-amounts. As also noted above under the IF's contemplated new taxing right and by the opponents of the proposal, the development of software is often expensive and may result in tax losses in the country where it is developed. In addition, the developer may have incurred substantial costs to other unsuccessful software projects.[140] Hence, even if tax-relief is provided for under Article 23 of the UN Model, loss-making MNEs will not have any taxes to off-set the source taxation, which would effectively be a final tax. Further, gross taxation at source may be problematic even for profit-making MNEs. In addition to the time-consuming administration associated with obtaining tax relief, a myriad of different and complex domestic tax rules governing tax relief will typically include tax-relief based on the net-principle and effectively imply that it is not possible to receive full relief. Hence, the result of gross-taxation at source will often result in double taxation, contradicting the ability to pay principle arguably incorporating the single-tax principle and in this article argued to be an inherent part of the economic allegiance principle.[141] Again, the argument that other provisions in the UN Model imply a similar violation does not seem convincing.

Finally, as previously discussed, it is argued in this article that a long-term solution should not be targeting fact-specific types of income which will likely result in arbitrariness, unlikely succeed at only affecting their target, and hardly stand the test of time.

3.2.3 *Shared Taxing Right to Automated Digital Services*

An additional discussion draft has been presented by the Committee.[142] Briefly explained, the new provision is proposed to be implemented as Article 12 B in the UN Model and will imply a shared taxing right to cross-border income from automated digital services (hereinafter: ADS) arising in a contracting state.[143] However, if the recipient is the beneficial owner,[144] the source taxation shall not exceed a percentage of the gross amount – to be established through bilateral negotiations; although, it is recommended to be 3% or 4%.[145]

For the purpose of Article 12 B, the definition of the ADS, is similar to the general definition of ADS under the new taxing right in the IF's Pillar One Blueprint. Accordingly, payment for the ADS includes:

> *any payment in consideration for any service provided on the internet or an electronic network requiring minimal human involvement from the service provider.*[146]

Further, the proposed commentaries include two lists exemplifying business models included and excluded from the proposed discussion draft on ADS.[147] The lists proposed in the discussion draft are identical to the positive list and negative list contemplated in the Pillar One

Notes

[140] *Committee – Inclusion of Software Payments in the Definition of Royalties* (E/C.18/2020/CRP.38), *supra* n. 4, at 5. This is also supported by a number of the non-government responders, e.g., Confederation of British Industry, 14; Dhruva Advisors LLP, 22; International Chamber of Commerce, 39–40; South Centre Tax Initiative, 77–78; United States Council for International Business, 84–85.

[141] *See also* Hongler & Pistone, *supra* n. 48, at 45; United Nations, Committee of Experts on International Cooperation in Tax Matters, *Proposed Changes to the UN Model Tax Convention Dealing with the Cyber-Based Services*, Y. Zhu E/C.18/2014/CRP.9 (30 Sept. 2014).

[142] Post the acceptance of this article, the majority of the Committee members voted to include this proposal and the associated commentaries (with certain amendments and selectable options) in the 2021-version of the UN Model, *see* United Nation, Committee of Experts on International Coorperation in Tax matters, *Report on the twenty-second session*, E/C.18/2021/CRP.1, Virtual Session 19-28 Apr. 2021.

[143] The discussion draft on Art. 12B of the UN Model is also discussed by Dourado, *supra* n. 75; Greil & Eisgruber, *supra* n. 10.

[144] The term 'beneficial owner' is elaborated in paras 18–23 of the proposed Commentaries in Committee – Art. 12 B on Automated Digital Services (E/C.18/2020/CRP.41), *supra* n. 4 and, accordingly, the term is not used in a narrow technical sense. Rather, it should be understood in its context, in particular in relation to the words 'paid … to a resident' and considering the object and purposes of the UN Model, including avoiding double taxation and the prevention of fiscal evasion and avoidance. It should be noted that, despite being subject to extensive analyses in the international tax literature, the term 'beneficial owner' is still highly debated and still not completely settled. For a thorough analysis of the term 'beneficial owner', reference may be given to A. Meindl-Ringler, *Beneficial Ownership in International Tax Law*, Series on International taxation no. 58 (Wolters Kluwer 2016). *See also* W. Haslehner, *Article 10,* in *Dividends in Klaus Vogel on Double Taxation Conventions* 816–818 (4th ed., E. Reimer & A. Rust eds, Kluwer Law International 2015) and D. G. Duff, *Beneficial Ownership: Recent Trends*, in *Beneficial Ownership: Recent Trends*, 17–22 (M. Lang et al. eds, IBFD 2013).

[145] *See* paras 4, 15, and 16 of the proposed Commentaries Committee – Art. 12 B on Automated Digital Services (E/C.18/2020/CRP.41), *supra* n. 4. It is recommended that the following is taken into account: risk that cost of the tax is passed on to customers, the risk of deterring investment, significant costs imply that withholding tax on gross payment may result in an excessive effective tax rate on the net income, the relative flows of payments in consideration for ADS (e.g., from developing to developed countries).

[146] Article 12 B(4) includes the definition whereas paras 34–37 of the proposed Commentaries in Committee – Art. 12 B on Automated Digital Services (E/C.18/2020/CRP.41), *supra* n. 4 elaborate the content similar to the guidance provided in the Pillar One Blueprint, *see* OECD, *Report on Pillar One Blueprint, supra* n. 4.

[147] *See* paras 38 and 39 which list and elaborate on the examples of business models generally considered to provide the ADS, whereas paras 40 and 41 list and elaborate on the examples of business models generally considered not to provide it. All in the proposed Commentaries in Committee – Art. 12 B on Automated Digital Services (E/C.18/2020/CRP.41), *supra* n. 4.

Blueprint and the description provided in the commentaries are similar although not fully identical.

If a payment is classified as consideration for the ADS, it follows from Article 12 B(6) that income from rendering the service shall be deemed to 'arise' in a contracting state if the payer is a resident or has a PE or a fixed base to which the obligation to make the payment is attributable and borne. However, pursuant to paragraph 7, income from the ADS shall *not* be deemed to 'arise' in a state if the payer is a resident of that state but the payment for ADS is attributable to and borne by a PE in the residence state of the recipient. An objective standard for determining that payments for ADS have a close economic connection to the state in which the PE or fixed base is situated is whether deduction of the payment is available when assessing the taxable profit of the PE or the fixed base.[148]

Interestingly, recognizing the challenges regarding gross-taxation at source also discussed under the proposal to add computer software to the definition of royalties, the proposed Article 12B(3) introduces a new feature in the context of the UN Model. The invention is an option for the beneficial owner to request that its qualified profits from the ADS for the fiscal year should be taxed based on the net-principle at the tax rate provided for in the domestic laws of the source state. If net-based taxation is requested the 'qualified profits' are 30% of the amount following the profitability ratio of the beneficial owner's ADS segment to the gross annual revenue from the ADS derived from the source state. The profitability ratio should be calculated as the annual profits divided by the annual revenue as stated in the consolidated financial statements with profit before tax as per accounts and certain adjustments.[149] It is stated in the commentaries that the qualified profit is set at 30% in recognition of the fact that entire profits arising from a market state should not be attributed to the market state and based on allocation by assigning equal weightage to assets, employees, and revenue.[150]

3.2.4 *Is the New Taxing Right Justifiable?*

As further elaborated with respect to the justification of the new taxing right under the Pillar One Blueprint, when assessing the proposed provision according to the principle of economic allegiance, the ability of ADS providers to scale without mass is argued to imply that the place of 'origin' to a lesser extent is reinforced by 'situs' at the disposal of the MNE. Otherwise stated, traditional physical presence will be of little significance under remote selling. This will plausibly decrease the importance of 'origin'.

In addition, it may be argued that the payment will often arise in the market state, i.e., the state where production and creation of wealth is located, this may not always be the case, especially in multi-sided business models. In other words, the service may be created, produced and provided in one jurisdiction while the payment arises in another jurisdiction. This may imply that what could potentially constitute the 'situs' and 'origin' in highly digitalized business models may be separated from where the payment arises. Thus, as also stated in respect of the proposal on adding computer software to the royalty definition, the state where the payment arises may be a poor proxy of the production of wealth. Hence, even if the factors comprising economic allegiance are interpreted to take into account the digitalization and inherent dematerialization of the economy, this may not justify an allocation of a taxing right to the state where the payment arises.[151]

Stated otherwise, even if a local digital presence in the jurisdiction where the ADS is rendered (local telecommunication infrastructures and devices) and active users are located (users whose data is collected, applied, and/or sold) could potentially be regarded as the 'situs' reinforcing 'origin'. This does not necessarily coincide with the country where the payment arises.

Consequently, it seems difficult to make a satisfying link between the requirement of a sufficient level of economic presence under the proposal presented in the discussion draft and the factors comprising economic allegiance as developed by the group of economists back in 1923. Accordingly, it appears to be challenging to make a satisfying link between the requirement of a sufficient level of economic presence under the proposal presented in the discussion draft and what is argued to remain the fundaments of the underlying principles for current allocation of taxing rights.[152]

Another critical point is – as also stated with respect to the other two proposals – that in this article, it is argued that rules with industry and fact-specific scope (rather than a principle-based scope) in practice will often prove to be arbitrary and will hardly stand the test of time.

On the contrary, it is argued that while the qualified profit of 30% of profitability ratio increases complexity

Notes

[148] *See* paras 56 and 57 of the proposed Commentaries in Committee – Art. 12 B on Automated Digital Services (E/C.18/2020/CRP.41), *supra* n. 4.

[149] *See* para. 28 of the proposed Commentaries in Committee – Art. 12 B on Automated Digital Services (E/C.18/2020/CRP.41), *supra* n. 4.

[150] *See* para. 30 of the proposed Commentaries in Committee – Art. 12 B on Automated Digital Services (E/C.18/2020/CRP.41), *supra* n. 4.

[151] *See also* Chand & Vilaseca, *supra* n. 75.

[152] This is somewhat recognized by the members of the Committee, as it is stated: *'The proposal is based on sourcing rule of "payment" rather than user location', the latter being an administratively difficult proposition. Consciously, the proposal has been pegged to payments. As far as 'value creation' as a concept for taxing rights is concerned, we find the whole concept of value creation to be too subjective and vague. Also, UN Model does not rely on value creation as a key factor to allocate taxing rights between States*'. See the proposed Commentaries in Committee – Art. 12 B on Automated Digital Services (E/C.18/2020/CRP.41) *supra* n. 4, at 31. See also Chand & Vilaseca, *supra* n. 75. The authors exemplify why this may not be to the benefit of developing countries.

and seems arbitrary and relatively unsupported, the possibility to request net-based taxation reduces the risk of double taxation if full credit cannot be obtained in the residence state.[153] Stated otherwise, the option for net-based taxation at source improves the proposal from the perspective of the ability to pay tax principle incorporating the single-tax principle and in this article argued to be an inherent part of the principle of economic allegiance.

4 Conclusions

The recent proposals presented by the IF and the UN focus on allocating more taxing rights to market jurisdictions that are perceived to be left with little or no tax revenue under the current international tax regime. The proposed new taxing rights should either be based on non-domiciled MNEs' 'value creation' in the market state or payments paid to the non-domiciled MNEs arising in the market states, respectively. However, neither of the proposals clearly articulate the principles for justifying such new taxing rights. While the proposals are intended to be finalized during 2021, the last consultations have revealed that neither of the proposals have provided a clear reason for *why* market states should be allocated more taxing rights.

Striving for a coherent international tax system: it is argued in this article that an amendment of the current international tax regime should be justified based on the principle of ability to pay and economic allegiance originating in the Report on Double Taxation from 1923. With respect to business profit, 'Origin' – meaning a specific and identifiable stage in an MNE's production of wealth – is considered of preponderant importance when justifying the allocation of taxing rights between competing authorities. More specifically, it is argued in this article that the international tax system should allocate a proportion of the MNE's ability to pay to the jurisdictions where this proportion of the ability is created without risking international double taxation or double non-taxation of the MNE. Accordingly, this interpretation of equity includes the ability to pay principle which may serve as a common frame of reference for determining the income to be allocated while also respecting the redistributive goal of taxation.

It is concluded in this article that, if economic allegiance is interpreted to consider the digitalization and the inherent dematerialization of the economy, this may justify that some taxing rights should be allocated to market states. More specifically, users recurringly engaging with a foreign MNE in a way that the activities of the users become part of the wealth production process of the MNE may justify allocation of a taxing right to the market state. In other words, such users may constitute a specific and identifiable stage in the wealth production of certain MNEs, e.g., generating revenue from targeted online advertising or sale of user data. Notably, the activities of the users must go beyond the existence of a loyal customer base merely reflecting the demand side of the market. Further, it is concluded that 'situs' and 'enforcement' – also being factors of economic allegiance – may reinforce the activity carried out in the market state. This is based on the use of local telecommunication and terminals or local users' devices to transmit digital information that may constitute an up-to-date situs for the users in the market states. Further, MNEs may rely on the legal infrastructure regarding IP protection and enforcement of transactions with the users in the market states which will represent 'enforcement'.

On this basis, it is concluded that the new nexus contemplated by the IF could be justified by the ability to pay principle incorporating economic allegiance where a proportion of the MNEs' ability is created in the market states. This could, in some business models, justify the creation of a new nexus with respect to online advertising and sale or other alienation of user data as contemplated by the IF. Further, while considered a simple entry criterion, a revenue-based threshold is somewhat arbitrary and difficult to justify based on economic allegiance.

As an important concern of developing countries is simplicity for administrability purposes, the two discussion drafts prepared by the Committee under the UN are based on taxation at source which is determined as the state where the payment arises. While this may be a simple measure for allocating taxing rights to non-domicile states, it is argued in this article that this cannot be justified according to the principle of economic allegiance in situations when software and the ADS are created and provided in a market state but payment arises in another state. In such a scenario, it is argued that a taxing right may be allocated to a state while none of the factors comprising economic allegiance points to this state. Stated otherwise, these proposals may fail to actually allocate tax revenue to the market states and additionally they constitute an unjustifiable separate tax system that is detached from the underlying principle and lacking economic reasoning.

Critically, it is concluded that all the three proposals target industry-specific businesses or fact-specific services where the scope seems arbitrary and will hardly stand the test of time.

Finally, it is concluded that the UN's proposal on gross taxation – and the intrinsic distortive risk of taxing loss-making MNEs or imposing double taxation on profit-making MNEs – conflicts with the ability to pay

Notes

[153] *See also* Chand & Vilaseca, *supra* n. 75; Van den Hurk, *supra* n. 75. Hurk argues that while the optional net-based taxation is complicated and discussions should be expected especially about the group ratio, the solution is not impossible.

principle incorporating the single-tax principle. Consequently, the option for the beneficial owner to request for net-based taxation under the UN's proposed provision on the ADS is an innovative improvement, although this will likely increase the complexity and compliance burden. Similarly, the new nexus contemplated by the IF enhances the ability to pay tax principle if pre-regime losses and in-regime losses are included in a losses carried-forward regime to be part of the net-based taxation of in-scope MNEs. Further, preserving the taxing rights of residence jurisdictions that have accepted (and will continue to accept) the deduction of losses generated by an in-scope business will arguably enhance inter-nation equity.

While there is yet no agreement to any of the proposals, it is argued in this article that, among the proposals currently considered in the field of international taxation, the new nexus within the Pillar One Blueprint performs best as a justifiable measure for allocating more tax revenue to the market states. This justification is based on a more up-to-date interpretation of economic allegiance which is argued to be the underlying principle of the current allocation of taxing rights. Thereby, this justification also supports the aim of one coherent international tax regime.