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The European Union's Economic Substance Rules in Commonwealth Caribbean Jurisdictions: What Is the Purpose?

This article criticizes the EU concept of economic substance regarding Commonwealth Caribbean international financial jurisdictions, refuting the arguments on which it is based and demonstrating the impracticality of the "test of substance" under Criterion 2.2. It also argues that common law is effective in addressing tax avoidance and determining substance.

1. Introduction

The Commonwealth Caribbean international financial jurisdictions – the Bahamas, Barbados, Bermuda, the British Virgin Islands and the Cayman Islands – passed economic substance statutes to comply with Action 5 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) initiative and the EU Criterion 2.2 to address what the European Union identifies as harmful taxation and abusive tax practices by non-EU jurisdictions. This article provides a critique of the EU concept of substance, with a view to pointing towards more applicable and established approaches provided by the common law.

The article is organized as follows. Section 2. provides a brief background to the European Union's economic substance criterion and critiques the extraterritorial nature of the Code of Conduct against which non-EU jurisdictions, such as Commonwealth Caribbean jurisdictions, are assessed by the European Union to determine whether these jurisdictions are engaging in harmful taxation. The authors then undertake an overview and comparison of the economic substance laws passed by Commonwealth Caribbean jurisdictions to comply with the European Union's Criterion 2.2. Section 3. provides a critique of the concept of "economic substance" as propagated by the European Union by not only refuting the erroneous premises on which the European Union's argument is based, but by demonstrating the impracticality of the EU mandated test for economic substance. Having shown the flaws of the European Union's concept of economic substance, the authors demonstrate, through a resort to case law, that the common law already has an existing arsenal of flexible and well-understood principles to address tax avoidance and issues of substance and form, such as the control and residence of a company, shams and fraudulent conveyancing. Conceptually and practically, the authors aim to demonstrate that the EU approach to economic substance is flawed and should be rejected. Section 5. concludes with a discussion of the history of the development and economic importance of the offshore sector to the economies of the Caribbean international financial jurisdictions.

2. The European Union's Economic Substance Criterion 2.2 and the Commonwealth Caribbean

2.1. Background and the extraterritoriality of the Code of Conduct for Business Taxation

On 1 December 1997, a resolution was reached between the Economic and Financial Affairs Council (ECOFIN) of the European Union and Representatives of Governments of the Member States on the Code of Conduct for Business Taxation (the Code).[1] The resolution highlighted three areas for a comprehensive approach which included "business taxation, taxation of savings income and the issue of withholding taxes on cross-border interest and royalty payments between companies".[2] The European Union was aiming to develop at an EU level, a coordinated approach to:

> tackle harmful tax competition in order to help achieve certain objectives such as reducing the continuing distortions in the single market, preventing excessive losses of tax revenue or getting tax structures to develop in a more employment friendly way.[3]

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1. Conclusions of the Economic and Financial Affairs Council (ECOFIN) Meeting Concerning Taxation Policy on 1 December 1997, (98/C 2/01), which contained, as Annex 1, the Resolution of the Council and the Representatives of the Governments of the Member States, meeting with the Council on a Code of Conduct for Business Taxation, 1 December 1997 [hereinafter the Code].
2. Id.
3. Id.

The Code sought to have the Member States refrain from introducing new measures that constitute harmful tax competition (standstill)[4] and re-examine, amend or abolish their existing tax measures that constituted harmful tax competition (rollback).[5] However, the Code was to also have extraterritorial effect. In this respect, it stated that the:

> principles aimed at abolishing harmful tax measures should be adopted on as broad a geographical basis as possible. To this end, Member States commit themselves to promoting their adoption in third countries; they also commit themselves to promoting adoption in territories to which the Treaty does not apply.[6]

The resolution also provided for the establishment of the Code of Conduct Group (COCG). On 9 March 1998, the COCG was established to assess the tax measures that may fall within the Code's ambit and to furnish reports regularly on the subsequent measures to address harmful tax measures within the European Union and associated territories of the Member States. Importantly, on economic substance, which is the focus of this article, the COCG maintained that many holding companies were "wholly or mainly for tax planning reasons", and these companies with little or no economic substance were in the COCG's view "no more than brass plate companies" that may be used "as a tax efficient holding point for profits or as a tax efficient conduit".[7] The COCG stated that such holding companies were "potentially highly mobile, and business taxation measures can have a significant effect on their location in the [EU] Community".[8] Interestingly, the European Union appears somewhat unable to address what it deemed harmful taxation within the European Union for such companies. The extraterritorial reach of the EU Code on harmful tax competition appears to have had success within Commonwealth Caribbean international financial jurisdictions, as these jurisdictions, which have been subject to blacklisting as a form of political pressure and erosion of their tax sovereignty, introduced economic substance laws conforming with the Code, as explored in sections 2.2. and 2.3. At the same time, recent EU court decisions showed that some Member States, such as Ireland, continue to exercise tax sovereignty with regard to the European Union.[9]

4. Id., at para. C.
5. Id., at para. D.
6. Id., at para. M.
7. Code of Conduct Group (Business Taxation) Report to the ECOFIN Council, 29 November 1999 (SN 4901/99), para. 47 [hereinafter Code of Conduct Group Report]. This report was a key report regarding business taxation as it sought to conclude discussions on the matter after two interim reports of the COCG were presented to the ECOFIN Council on 1 December 1998 and 25 May 1999 respectively (docs. 12530/98 FISC 164 and 8231/99 FISC 119).
8. Id.
9. In its decision of 30 August 2016, the European Commission found that the tax treatment provided by Ireland to Apple in that jurisdiction amounted to unlawful State aid. However, on Ireland's and Apple's appeal, the EU General Court in its decision of 15 July 2020 overruled the European Commission's finding that Ireland had provided illegal State aid to Apple. *See* IE: European Commission, 30 Aug. 2016, *Commission decision of 30.8.2016 on state aid* SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) and IE: EU General Court, 15 July 2020, Cases T 778/16 and T 892/16, *Ireland v. Commission* [2020].

2.2. Criterion 2.2 and economic substance

The purpose of the criteria developed by the European Union to apply the Code was to screen jurisdictions in order to establish a "list of non-cooperative jurisdictions for tax purposes".[10] Jurisdictions were assessed cumulatively on their compliance with tax transparency, fair taxation and the implementation of the measures of the OECD/G20 BEPS Project.[11] Criterion 3 supported the implementation of anti-BEPS measures, specifically Criterion 3.1 that "the jurisdiction should commit, by the end of 2017, to the agreed OECD anti-BEPS minimum standards and their consistent implementation".[12] Accordingly, on 5 December 2017, the European Union issued a list of non-cooperative jurisdictions for tax purposes, stating that the countries had until December 2018 to comply.

Under Criterion 2.1, a jurisdiction fell within the scope of Criterion 2.2 in "the absence of a corporate tax or applying a nominal corporate tax rate equal to zero or almost zero".[13] Consequently, the location of a business activity was linked to taxation, as the European Union attempted to focus on countries it considered to engage in harmful tax competition. Criterion 2.2 stated that "[t]he jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits, which do not reflect real economic activity in the jurisdiction".[14] This position appeared to conceptualize economic substance by the European Union. Criterion 2.2, using five measures previously established as paragraph B of the Code and to be interpreted by analogy, assessed the legal framework of, and certain economic indications from, a jurisdiction to determine whether it complied with the Code.[15]

10. Council of the European Union conclusions on the EU list of non-cooperative jurisdictions for tax purposes, 5 December 2017 (15429/17, FISC 345, ECOFIN 1088), Annex V (Criteria on tax transparency, fair taxation and implementation of anti-BEPS measures that Member States undertake to promote), pp. 23-25 [hereinafter EU Council Conclusion 2017].
11. Id.
12. Id., at Annex V, para. 3.1 (p. 25).
13. Id., at Annex VII, para. A.1 (p. 30). This was an application of paragraph A of the Code, *supra* n. 1: "Without prejudice to the respective spheres of competence of the Member States and the [EU] Community, this code of conduct [the Code, *supra* n. 1], which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community".
14. Id., at Annex VII (scope of Criterion 2.2), Terms of reference for the application of the Code test by analogy para. A (General framework), (p. 30); Annex V (Criteria on tax transparency, fair taxation and implementation of anti-BEPS measures that Member States undertake to promote); para. 2.2 (p. 25).
15. According to the Code, *supra* n. 1, para B and the of Conduct Group Report, *supra* n. 7, p. 3, these measures were:
    1. Whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or;
    2. Whether advantages are ring-fenced from domestic market, so they do not affect the national tax base, or
    3. Whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or
    4. Whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within The Organization for Economic Co-operation and Development (OECD), or
    5. Whether the tax measures lack transparency, including where legal provisions are relaxed at an administrative level in a non-transparent way.

In order to evaluate whether advantages were granted even without any real economic activity and substantial economic presence (SEP), the European Union then set out four guidelines.[16] These guidelines were as follows.

First, it had to be established that a company or any other undertaking "mandated the carrying out of real economic activities and a substantial economic presence".[17] For interpretation by analogical purposes, "real economic activity" related to the "nature of the activity that benefits from the non-taxation…".[18] On the other hand, "substantial economic presence" related to the "factual manifestations of the activity that benefits from the non-taxation…".[19] In order to assess real economic activity and SEP, the guidelines stated that the following should be considered taking into account the features of the industry and/or sector under examination:

> adequate level of employees; adequate level of annual expenditure to be incurred; and physical offices and premises, investments or relevant types of activities to be undertaken.[20]

Second, there was an assessment of:

> whether there is an adequate de jure and de facto link between real economic activity carried on in the jurisdiction and the profits which are not subject to taxation.[21]

Third, this involved a consideration of:

> whether the governmental authorities, including tax authorities of a jurisdiction, are capable of (and are actually doing) investigations on the carrying out of real economic activities and a substantial economic presence on its territory, and exchanges of relevant information with other tax authorities.[22]

Fourth, it was necessary to assess "whether there are any sanctions for failing to meet substantial activities requirements".[23]

Accordingly, the Code was to be applied "consistently and by analogy for the purpose" of Criterion 2.2.[24] If a jurisdiction failed the assessment in that its structures and arrangements due to rules and practices did not reflect real economic activity in the jurisdiction, the European Union stated that it was "reasonable" to ask the jurisdiction to amend or introduce rules to be compliant with Criterion 2.2,[25] as the EU had done with the Commonwealth Caribbean and economic substance rules as discussed below in section 2.3.[26]

2.3. Economic substance laws in the Commonwealth Caribbean

As noted in section 2.2., it is clear that the European Union intended its rules to be extra-jurisdictional in application regarding the Code and, in 2017, a list of non-cooperative jurisdictions for tax purposes was adopted. Despite this, some Member States, such as France[27] and the Netherlands,[28] continue to maintain their own national lists and criteria for determining non-cooperative tax jurisdictions. Others, such as Ireland,[29] maintain competitive tax systems within the European Union. This creates a situation of triple condemnation – first, by the European Union, second, by individual Member States and, third, even if unintended, by the Member States that are allowed to practise what the European Union would normally view as harmful tax competition in a non-EU jurisdiction. The economic substance laws introduced in Barbados,[30] the Bahamas,[31] the British Virgin Islands,[32] Bermuda[33] and the Cayman Islands[34] complied with EU Criterion 2.2 and as a response to the blacklisting as non-cooperative jurisdictions in the December 2017 EU List of Non-cooperative Jurisdictions for Tax Purposes with the December 2018 deadline for compliance. These jurisdictions passed economic substance laws by 1 January 2019.

The national laws passed in the Caribbean jurisdictions complied with the European Union's Criterion 2.2, as can be demonstrated by comparing the four guidelines explored in section 2.2. with regard to the national laws. These laws are considered in the following paragraphs.

First, in relation to the requirement that a company in a jurisdiction must have real economic activities and an SEP, all the laws passed in the Caribbean satisfied the first EU guideline of the economic substance test.[35] These provisions included: (1) an adequate level of employees; (2) an adequate level of annual expenditure to be incurred; (3) physical offices and premises; and (4) investments or relevant types of activities to be undertaken.

16. EU Council Conclusion 2017, *supra* n. 10, Annex VII (scope of Criterion 2.2), at para. D (pp. 35-36).
17. Id.
18. Id.
19. Id.
20. Id.
21. Id.
22. Id.
23. Id.
24. Id., at p. 32.
25. Id.
26. Id., at Annex I (The EU list of non-cooperative jurisdictions for tax purposes) and Annex II (State of play of the cooperation with the EU with respect to commitments taken to implement tax good governance principles).
27. France, by a decree of 6 January 2020, updated its list of non-cooperative states and territories within the meaning of FR: *Code Général des Impôts* (General Tax Cade, CGI) art. 238-0 A. *See* Baker McKenzie, *The French List of Non-cooperative States and Territories Is Completely Overhauled* (23 Jan. 2020), available at www.bakermckenzie.com/en/insight/publications/2020/01/the-french-list-noncooperative-states (accessed 20 July 2020).
28. NL: *Ministerie van Financiën* (Ministry of Finance), Netherlands publishes own list of low-tax jurisdictions in fight against tax avoidance (28 Dec. 2018), available at www.government.nl/latest/news/2018/12/28/netherlands-publishes-own-list-of-low-tax-jurisdictions-in-fight-against-tax-avoidance (accessed 20 July 2020).
29. *See supra* n. 9.
30. BB: The Barbados Companies (Economic Substance) Act, 2019-43 [hereinafter Barbados ES Act].
31. BS: Bahamas Commercial Entities (Substance Requirements) Act, 2018 [hereinafter Bahamas ES Act].
32. BVI: British Virgin Islands Economic Substance (Companies and Limited Partnerships) Act, 2018 [hereinafter BVI ES Act].
33. BM: Bermuda Economic Substance Act 2018 [hereinafter Bermuda ES Act].
34. KY: Cayman Islands International Tax Co-operation (Economic Substance) Law, 2018 [hereinafter Cayman ES Act].
35. Sec. 5 Bahamas ES Act; sec. 4 Cayman ES Act; sec. 6 Barbados ES Act; sec. 8 BVI ES Act; and sec. 3 Bermuda ES Act.

The second EU guideline, covering the legal and practical links between economic activity and profits not being taxed has been realized within the Caribbean laws, in that the laws have provided for the understanding of "relevant activities". These activities consisted of, for example, banking, insurance, fund management, financing, leasing and acting as a headquarters.[36]

With regard to non-compliance, the third EU guideline that entities subject to the economic substance requirements must comply with is to file economic substance reports or declarations to the relevant authority was fulfilled.[37] These reports are used to help determine if entities are complying with the economic substance law. The Bahamas economic substance statute, for example, provides for electronic submission of declarations via the relevant authority's electronic portal in respect of the automatic exchange of information.[38]

As to the fourth EU guideline on sanctions, the laws in the Caribbean realized this test by providing sanctions for misleading information, non-compliance and obstruction. These sanctions range from fines to imprisonment with the possibility of an appeals procedure to contest any penalties.[39] As compliance is one of the key aspects the European Union looks for, it is likely that these jurisdictions may have to demonstrate to the European Union that they are enforcing the local economic substance laws, through such metrics as the number of successful prosecutions.

3. Critiquing Economic Substance

3.1. Introductory remarks

The legal distinction between what is considered to be allowable tax planning as opposed to "aggressive" tax planning, as with many standards in law, tends not to a bright line and can present a "definitional quagmire" for understanding tax avoidance.[40] The authors acknowledge this quagmire, but do not fully explore it here and for the purposes of this article. This article only considers some of the definitional issues necessary to arrive at a working understanding of tax avoidance, which drives approaches to supposedly curb this avoidance, such as the EU economic substance Criterion 2.2 as discussed in section 2.2. The authors propose a two-pronged approach, conceptual (*see* section 3.2.) and technical (*see* section 3.3.), to unpack and to provide a critique of economic substance.

3.2. Contextualizing economic substance and the issue of value creation

Tax avoidance, simply and broadly, "means to choose an option that leads to a lower tax liability than would otherwise apply had another option been chosen".[41] It can also mean "all arrangements to reduce, eliminate or defer a tax liability".[42] However, the simplicity of both definitions belies the definitional quagmire in trying to pinpoint a definition of tax avoidance in that "many conversations take place about tax avoidance as if it were a singular concept, when actually the participants are talking about different things".[43] For instance, the line between tax evasion, an *ex post* activity after the "crystallization of a tax liability" and tax avoidance occurring *ex ante*, so "prior to the crystallization of tax liability",[44] where an individual or corporation is permitted within the law to reduce their tax liability can be lost when arguments are made that any form of reduction of tax liability is illegal and unethical.[45] Additionally, the use of terms such as "paying a fair share of taxes", "improper tax planning" and "aggressive tax planning" can be arbitrary[46] and have the unintended effect of reducing the clarity of decisions makers regarding tax behaviour.[47] Fairness, for example, is a "perception and so may be shaped and manipulated" by those trying to "convey a sense of dissatisfaction" with the tax system.[48] These concepts can be seen at play in the discussions in the European Union to the effect that the Caribbean countries are regarded as "offshore" "tax havens".

Given the nebulous nature of the term "tax avoidance", it is no surprise that it has become blurred into economic substance, which is the focus of this article, to seemingly widen the net in respect of what can be considered to be improper tax planning.[49] The OECD tried to address what it determined was the problem of the allocation of business profits across countries for multinational enterprises (MNEs), as the OECD maintained that such corporations had the ability to artificially shift profits to low-tax countries in manipulation of the arm's length principle (ALP).[50] The issue is that corporations in a free market

36. For a list of "relevant activities", *see* sec. 4 Bahamas ES Act; sec. 3 Barbados ES Act; sec. 6 BVI ES Act; sec. 2 (Interpretation) Bermuda ES Act; and schedule (Construction of words and expressions) Cayman ES Act.
37. Sec. 8(1) Barbados ES Act; sec. 11 BVI ES Act; sec. 1 Bermuda ES Act; sec. 7 Cayman ES Act; and sec. 11 Bahamas ES Act.
38. Sec. 11 Bahamas ES Act.
39. Secs. 10-14 Barbados ES Act; secs. 12-14 BVI ES Act; secs. 13 and 14 Bermuda ES Act; sec. 8 Cayman ES Act; and pt. IV (Offences and Penalties) Bahamas ES Act.
40. J. Freedman, *The Tax Avoidance Culture: Who Is Responsible? Governmental Influences and Corporate Social Responsibility*, in *Current Legal Problems* p. 361 (J. Holder & C. O'Cinneide eds., Oxford U. Press 2006).
41. L. Oats & P. Tuck, *Corporate Tax Avoidance: Is Tax Transparency the Solution?*, 45 Acctg. & Bus. Research 5, pp. 565, 568 (2019).
42. Freedman, *supra* n. 40, at pp. 335-6.
43. Oats & Tuck, *supra* n. 41, at pp. 567-568.
44. Id., at p. 568.
45. D. Payne & C. Raiborn, *Aggressive Tax Avoidance: A Conundrum for Stakeholders, Governments and Morality*, 147 J. Bus. Ethics, pp. 469-487 (2018).
46. P. Lamberts, *Fair Taxation: Truth Is in the Eye of the Beholder*, 45 Intertax 1, p. 49 (2017).
47. J. Hasseldine & G. Morris, *Unacceptable Behaviour and Corporate Responsibility*, in *The Routledge Companion to Tax Avoidance Research* pp. 430-457 (N. Hashimzade & Y. Epifantseva eds., Routledge 2018).
48. Freedman, *supra* n. 40, at p. 122.
49. Oats & Tuck, *supra* n. 41, at p. 569.
50. *OECD Model Tax Convention on Income and on Capital* art. 9 (21 Nov. 2017), Treaties & Models IBFD sets out the ALP as follows:
    (1) Where
    a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State,
    or
    b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in

could take advantage of competitive tax environments to reduce their tax liability. It is, therefore, ironic that OECD member countries promote free market economies, enterprise and economic sovereignty but not with regard to taxation. The OECD maintains that transfer price manipulation can result in "outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group".[51] Consequently, the purpose of the OECD/G20 BEPS Project was to align tax, economic substance and value creation. Specifically, Action 5 required the "align[ment] [of] taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created".[52] This approach appeared to be an amalgamation of several concepts, that is, economic substance requiring that activities are performed, some form of value created in the performance of these activities, the place of the value creation is where to locate substance and, therefore, to apply taxes. Yet, it appeared that the OECD did not define value creation.[53] The OECD proposition regarding transfer price manipulation implied that the OECD viewed the "arm's length market price of an (intermediate) good or service as equivalent to its value".[54] Value may not be created in a single place and can be relocated across the different businesses of an MNE in different countries. The possibility exists that "value might be created by entities not under common control" within an MNE as market prices are not a reflection of value but, rather, rent extraction in the global value chain (GVC).[55] Given the proliferation of the GVC due to globalization, it can make claims for economic substance as a means to address tax evasion nebulous, as no single jurisdiction may be in a position to make a full and legitimate claim to be the only or main source of value creation for goods or services.[56] Additionally, and critically, as Quentin (2017) stated that:

> If part of the value added in a multinational group comes from forcing down the prices of squeezed suppliers further up the chain, it seems perverse or even positively unjust to say that the "value creation" is being effected in whatever jurisdiction the mechanisms of market domination are located: as a matter of economic substance the value is clearly being created by the suppliers and extracted from them by means of that dominance so as to be realised by the lead firm. It would follow that a corporate tax base which is truly aligned for tax purposes with "value creation" or "economic substance" might find itself in a different jurisdiction from any of the jurisdictions in which the group realising the profits has any kind of corporate footprint.[57]

Despite concerns about the basis of economic substance, there still appeared to be consensus that a jurisdiction tax where value is created as articulated by the OECD. The European Union as discussed in section 2. linked taxation to location as a way to determine where value was created. The G20 noted that profits should "be taxed where economic activities deriving the profits are performed and where value is created".[58] Non-governmental organizations (NGOs), such as Christian Aid, Oxfam and the Tax Justice Network (TJN), support taxing where value was created based on political narratives of "fair taxes" and "good tax payers".[59] These narratives also resonated with corporations.[60] Not only was there consensus that corporate profits should be taxed where the economic activities on which those profits have occurred took place, the consensus was also shared among developed country international organizations, NGOs and corporations,[61] which makes rebutting the basis of economic substance difficult, even if it has been shown to be flawed.

3.3. Technical issues

3.3.1. Base erosion by Caribbean international finance jurisdictions low tax rates

The European Union's blacklist is based on the false premise that the tax bases of its Member States are being eroded by MNEs shifting profits to jurisdictions with low tax rates, including in the Caribbean. This does not consider that low-tax jurisdictions within the European Union themselves facilitate large US MNEs reducing their tax liability, a fact that the European Commission has found to be so.[62] Corporate income tax rates vary across the EU-27, from as low as 9% in Hungary to as high as 34.4% in France, thereby putting the European Union's corporate income tax rate only slightly higher than the global average.[63] However, when weighted by

their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

51. OECD, *Action 8-10 Final Report 2015 – Aligning Transfer Pricing Outcomes with Value Creation* pp. 9-10 (OECD 2015), Primary Sources IBFD.
52. OECD, *Action 5 Final Report 2015 – Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance* p. 23 (OECD 2015), Primary Sources IBFD.
53. L. van Apeldoorn, *Exploitation, International Taxation, and Global Justice*, 77 Rev. Soc. Econ. 2, p. 4 (2019) and D. Quentin, *Corporate Tax Reform and "Value Creation": Towards Unfettered Diagonal Re-allocation across the Global Inequality Chain*, Acctg., Econ. & L.: A Convivium p. 4 (2017).
54. Van Apeldoorn, *supra* n. 53, at p. 4.
55. Quentin, *supra* n. 53, at p. 5. *See also* Van Apeldoorn, *supra* n. 53, at especially pp. 12-14.
56. Quentin, *supra* n. 53, at p. 5. *See also* Van Apeldoorn, *supra* n. 53, at especially pp. 12-14.
57. Quentin, *supra* n. 53, at p. 6.
58. G20 Saint Petersburg Declaration (2013).
59. Christian Aid, Oxfam and ActionAid, *Getting to Good: Towards Responsible Corporate Tax Behavior* pp. 11, 15 and 16 (2015), available at https://oxfamilibrary.openrepository.com/oxfam/bitstream/10546/582243/4/dp-getting-to-good-corporate-tax-171115-en.pdf (accessed 20 July 2020).
60. *See* M. Forstater, *Publishing corporate tax strategies*, Tax J. (4 Aug. 2016), available at www.taxjournal.com/articles/publishing-corporate-tax-strategies-04082016 (accessed 20 July 2020). For instance, in the United Kingdom, where corporations are required to publish their tax strategies, a review of these strategies showed that a quarter of the FTSE 100 companies committed to "paying the right amount of tax where value [was] created". Unilever, for example, stated that "We aim to pay an appropriate amount of tax according to where value is created within the normal course of commercial activity. Any transfer pricing is always calculated using the 'arm's length' principle. We do not use contrived or abnormal tax structures that are intended for tax avoidance, have no commercial substance and do not meet the spirit of local or international law."
61. Van Apeldoorn, *supra* n. 53.
62. *See supra* n. 9.
63. *See* E. Asen, *Corporate Income Tax Rates in Europe*, Tax Fund. (7 Feb. 2019), available at https://taxfoundation.org/corporate-tax-rates-

gross domestic product (GDP), the situation is slightly different. Research from the Tax Foundation shows that, on average, Europe, has the lowest regional average rate, at 20.27%, but 25.13% when weighted by GDP.[64] This rate is lower than the worldwide average statutory corporate income tax rate, measured across 176 jurisdictions, which was 24.18%, and 26.30% when weighted by GDP.

Accordingly, it seems politically disingenuous to accuse the Caribbean countries of unfair tax competition, and compel the implementation of economic substance laws, where some Member States also have low tax rates.

3.3.2. Technological advances

The requirement of physical presence under the economic substance laws appears archaic, considering advances in technology which allow for online meetings, making travelling for face-to-face board meetings increasingly unnecessary.

3.3.3. Climate change

The desirability of requiring travelling for face-to-face board meetings is very questionable, especially as there are more cost-effective and environmentally friendly alternatives, such as online meeting platforms. As part of their corporate social responsibility efforts, companies have sought to reduce their carbon footprint, including increasing their use of remote meeting technologies. Requiring companies to hold face-to-face meetings appears to be a regressive step in the fight against climate change.

3.3.4. Enforcement of economic substance requirements during pandemics

With the World Health Organization (WHO) recommending that persons in countries affected by the ongoing COVID-19 pandemic practise "social distancing", an increasing number of companies are requiring employees to work from home, thus restricting face-to-face meetings in favour of remote meetings, and discouraging non-essential travel. Such COVID-19 mitigation strategies may have implications for the ability of companies to meet economic substance laws, which require that meetings of the board of directors are held in the jurisdiction concerned at adequate frequencies given the level of decision making required, and that a quorum of directors is physically present in the jurisdiction during the meetings.

COVID-19 and other pandemic mitigation strategies may also affect the ability of companies to be able to demonstrate adequately that all core income-generating activities – activities that are of central importance to a resident company in terms of generating income – occur in the jurisdiction in question. Tax authorities, therefore, must be cognizant of these realities. The tax authorities of the Commonwealth Caribbean international financial jurisdictions have released guidance to relevant entities on how they could still meet compliance with substance requirements. For instance, the guidelines of the International Tax Authority (ITA) of the British Virgin Islands recommended recourse to the appointment of alternate directors in the British Virgin Islands to meet substance requirements.[65] It further clarified that not all directors have to attend board meetings in the British Virgin Islands, and only as many as are required to meet the quorum. Additionally, only those meetings relating to core income-generating activities needed to be held in the British Virgin Islands. Lastly, the guidance provided that where it was still not possible to have a board meeting in the British Virgin Islands or to meet some other substance requirement due to restrictions (whether in the British Virgin Islands or otherwise) in connection with the COVID-19 outbreak, the ITA guidelines require entities to retain documentation so as to be able to support such claims for the applicable periods of time affected. It emphasized, however, that these are only temporary arrangements and urged businesses to "make every effort to otherwise comply with full substance requirements".[66]

Similar guidance has also been released by the other jurisdictions.[67] For instance, the Ministry of Financial Services of the Cayman Islands has extended the deadline for filing economic substance notifications.[68]

4. Cannot Common Law Already Counter Tax Avoidance?

The common law has well-understood principles regarding tax avoidance and on substance through the use of concepts, like shams, fraudulent conveyancing and central control and management, that are part of trust and company law. These principles in the Commonwealth Caribbean have roots in English common law.

The common law has addressed tax avoidance from *Duke of Westminster* (1936),[69] which respected the "form" of the transaction chosen by the taxpayer, i.e. a literal approach, to a more purposive approach in *Ramsay* (1981).[70] Under the *Ramsay* principle, the courts held that, in determining the relevant tax treatment of a preordained series of transactions, any steps that were included only for the purpose

europe-2019/#:~:text=The%20countries%20with%20the%20lowest, between%2019%20and%2025%20percent. (accessed 20 July 2020).

64. *See* E. Asen, *Corporate Tax Rates around the World, 2019*, Tax Fund. Fiscal Fact No. 679 (Dec. 2019), available at https://files.taxfoundation.org/20191209111406/Corporate-Tax-Rates-around-the-World-2019.pdf (accessed 20 July 2020).
65. BVI: Premier's Office ITA, Press Release, Update On Economic Substance During Covid-19 Pandemic (27 Mar. 2020), available at http://bvi.gov.vg/media-centre/update-economic-substance-during-covid-19-pandemic (accessed 20 July 2020).
66. Id.
67. BB: Barbados' Financial Services Commission Circular, Coronavirus (Covid-19) & Economic Substance Test (20 Mar. 2020), available at www.fsc.gov.bb/index.php/en/education-and-media/our-media/send/47-public-notices/1039-coronavirus-covid-19-economic-substance-test-est (accessed 20 July 2020).
68. KY: Ministry of Financial Services, Cayman Islands Government, Extension Given for Annual Returns and Economic Substance Notifications (25 Mar. 2020), available at www.mfs.ky/news/extensions-given-for-annual-returns-and-economic-substance-notifications/ (accessed 20 July 2020).
69. *See* the UK House of Lords (UKHL) decision in UK: UKHL, 1936, *IRC v. Duke of Westminster*, [1936] AC 1.
70. UK: UKHL, 12 Mar. 1981, *W.T. Ramsay Ltd.; D.M.E. Rawling v. Commissioners of Inland Revenue; Eilbeck (H M Inspector of Taxes)*, [1981] STC 174; 125 SJ 220, [1982] AC 300, Case Law IBFD.

of tax avoidance could be disregarded and the transaction could be viewed as a whole, composite transaction and taxed accordingly. Courts have continued to develop the application of the *Ramsay* principle as an approach to statutory interpretation.[71] In the Hong Kong case of *Arrowtown Assets Ltd*. (2003), the principle was formulated as "the ultimate question was whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically".[72]

The common law has also addressed control and management, an issue at the core of discerning substance. The seminal case of *De Beers Consolidation Mines Ltd* (1905) set out the central management and control test as "A company resides... where its real business is carried on.... And the real business is carried on where the central management and control actually abides".[73] This case confirmed that determining management and control was a matter of fact in applying the 1876 cases of *Calcutta Jute Mills Co* and *Cesena Sulphur Co*.[74] Accordingly, it followed that it was not simply about where a company's meetings are held that determined the company's residence, but where control was exercised.[75] More recent cases, such as *Laerstate BV* (2009), have been instructive in distinguishing between a fully functional board and a one that rubber stamps decisions on questions of where to tax a sale of a share option.[76] The central management and control test in the context of a tax avoidance scheme was considered in 2019 by the UK Upper Tribunal (UKUT) in *Development Securities plc* (2019).[77] This case was critical in that the residence of the company for purposes of tax avoidance was deemed irrelevant to the issue of residence. The case applied Lord Neuberger's judgment in *Secret Hotels 2 Ltd* (2014) to the effect that:

> ... one must be careful before stigmatizing the contractual documentation as being "artificial", bearing in mind that EU law, like English law, treats parties as free to arrange or structure their relationship so as to maximise its commercial attraction, including the incidence of taxation...[78]

Importantly the UKUT in applying *Wood v. Holden* (2006) determined that special purpose vehicles (SPVs) "fulfil important functions within international groups, and they are principals, not merely nominees or agents, in whatever roles they are established to undertake".[79] Accordingly, the central management and control test should be applied with care to distinguish between influence and control of a subsidiary, as the fact that an SPV as a subsidiary is 100% owned by a parent and carries out a purpose for which it was set up does not mean that central management and control abides with the parent.[80] Moreover, there is case law covering the issue of companies in more than one jurisdiction and determining residence, as in *Union Corporation Ltd*, *Johannesburg Consolidated Investment Co Ltd* and *Trinidad Leaseholds Ltd*, all of 1953, which were decided together and affirmed by the UK House of Lords (UKHL).[81] The UKHL was of the view that residence was a matter of fact and degree. A finding that a company is resident in more than one country:

> ought not to be made unless the control of the general affairs of the company is not centred in one country but is divided or distributed among two or more countries. The matter must always be one of degree... and one factor to be looked for is the existence in the place claimed as a residence of some part of the superior or directing authority by means of which the affairs of the company are controlled.[82]

Based on the preceding limited discussion, two things stand out regarding the introduction of economic substance laws in the Caribbean as a way to tackle tax avoidance. First, the common law courts have been dealing with the matter of tax avoidance and substance as an issue of central control and management for some time now. Second, and perhaps more critically, in applying the economic substance laws, the courts in the Commonwealth Caribbean may have to turn to established common law principles on the issues in interpreting the new economic substance laws. If the courts in the common law Commonwealth Caribbean already have access to flexible principles related to understanding whether a company is actively and actually engaged in activities in the jurisdiction, this not only calls into question the suitability of a transplanted EU Code, but the value it adds to the common law legal systems of the Commonwealth Caribbean in addressing tax avoidance.

5. Conclusions

The authors only expect debates regarding taxes and the role of the international financial jurisdictions in facilitating the reduction of tax liability for corporations and individuals to become more intense, polarized and unresolved, as many countries before the global health pandemic COVID-19 were running large budget deficits coming out of the 2008 global economic recession. These deficits will only get worse in light of the global pandemic because numerous countries in addressing the pandemic

71. *See*, for example, UK: UKHL, 25 Nov. 2004, *Barclays Mercantile Business Finance Ltd v. Mawson*, [2004] UKHL 51.
72. *See* the decision of the Hong Kong Court of Final Appeal (HKCFA) in HK: HKCFA, 4 Dec. 2003, *Collector of Stamp Revenue v. Arrowtown Assets Ltd*, [2003] HKCFA 46, quoted with approval in *Barclays Mercantile Business Finance Limited* (2004), *supra* n. 71, at para. 36.
73. *See* the decision, *De Beers Consolidated Mines, Ltd v. Howe* (1906) 5 TC 198 para. 458.
74. *Calcutta Jute Mills Company, Ltd v. Nicholson* (1876) 1 TC 83; *Cesena Sulphur Company, Ltd v. Nicholson* (1876) 1 TC 88.
75. *See*, for example, UK: House of Lords, 30 Nov. 1959, *Unit Construction Co Ltd v. Bullock*, [1960] AC 455 [1959]; UKHL TC – 38 – 712.
76. *See* the decision of the UK First-tier Tribunal (UKFT) in *Laerstate BV v. Revenue & Customs* [2009] UKFTT 209 (TC) (11 Aug. 2009).
77. UK: UKUT, 5 June 2019, *Development Securities plc & Others v. HMRC*, [2019] UKUT 0169 (TCC), Case Law IBFD.
78. Id., at para. 9. (citing the decision of the UK Supreme Court (UKSC) in UK: UKSC, 5 Mar. 2014, *The Commissioners for Her Majesty's Revenue and Customs (Respondent) v. Secret Hotels2 Limited (formerly Med Hotels Limited)*, [2014] UKSC 16, [2014] STC 937, para. 57).
79. Id., at para. 17 (citing UK: CAEW, 26 Jan. 2006, *Wood and another v. Holden (Inspector of Taxes)*, [2005] EWHC 547 (Ch) and [2006] EWCA Civ 26.).
80. Id., at paras. 17-18.
81. UK: UKHL, 9 Mar. 1953, *Union Corporation Ltd v. IRC, Johannesburg Consolidated Investment Co Ltd v. IRC and Trinidad Leaseholds Ltd v. IRC*, [1952] 34 TC 207.
82. Id., at para. 270 (citing the decision of the High Court of Australia (HCA) in AU: HCA, 26 Nov. 1940, *Koitaki Para Rubber Estates Ltd v. Federal Commissioner of Taxation*, 64 C.L.R. 15).

have used what little fiscal space they had, involving quantitative easing and direct financing from central banks. Countries will be looking to pay down these deficits and to show beleaguered citizens that governments are tough on tax leakage in any form.[83] Corporations provide easy fodder for politicians, when "there is danger that appeals to public outrage in effect refer to manufactured indignation based on deliberate misinformation".[84] NGOs and civil society groups have been key in moving esoteric issues of tax from the realm of lawyers and accountants to media headlines.[85] However, the reality is that a corporation or individual making a decision to reduce their tax liability does so for the simple reason that tax is treated like any other business input or expense.

The political attacks are all too easy to make on Caribbean international financial jurisdictions, being "exotic", a socio-culturally loaded term. The Caribbean can be invoked as a narrative to raise the spectre of bad men and women, pirate-like characters hiding away plundered treasure in the warm tropics while sipping rum cocktails on sun-drenched beaches, whereas dutiful, tax-paying citizens in faraway crowded metropolises are hard at work. However, onward investment from Caribbean offshore jurisdictions would be taxed in accordance with the law. Further, the Caribbean is a small player[86] in international investment facilitation compared to places and jurisdictions, such as London, New York and the European Union, where, incongruously and often straight-faced, the spectre of Caribbean international financial jurisdiction is raised frequently. Perhaps, it is easier for the European Union to scare the public with bedtime stories of new age tax pirates, rather than examine internal economic policies, issues of competitiveness – tax and otherwise – and general malaise of a union recently scarred by Brexit.

83. For instance, Belgium, Denmark, France and Poland have announced measures that are designed to exclude companies with links to international financial jurisdictions from COVID-19 related bail out programmes. *See* S. Meredith, *These European countries are refusing to offer bailouts to companies linked to offshore tax havens*, CNBC (19 May 2020), available at www.cnbc.com/2020/05/19/coronavirus-eu-countries-deny-bailouts-to-firms-linked-to-tax-havens.html (accessed 20 July 2020). The TJN has published five "bailout tests" with regard to providing bailouts during COVID-19 pandemic, which included whether the company has one or more subsidiaries in a ranking jurisdiction on the Financial Secrecy Index or the Corporate Tax Haven Index. *See* TJN, *Tax-responsible rules for Corona Bailouts* (23 Apr. 2020), available at www.taxjustice.net/wp-content/uploads/2020/04/Tax-responsible-rules-for-Corona-Bailouts-Tax-Justice-Network-April-2020.pdf (accessed 20 July 2020) and TJN, *Bail, or bailout? Tax experts publish 5-step test for Covid19 business bailouts* (23 Apr. 2020), available at www.taxjustice.net/2020/04/23/bail-or-bailout-tax-experts-publish-5-step-test-for-covid19-business-bailouts/ (accessed 20 July 2020).
84. Oats & Tuck, *supra* n. 41, at p. 568.
85. The media has also been key in shaping views on tax stories as in Ireland regarding Apple. *See* L. Kneafsey & A. Regan, *The Role of the Media in Shaping Attitudes Toward Corporate Tax Avoidance: Experimental Evidence from Ireland*, UCD Geary Institute Discussion Paper Series, Geary WP2019/04 (15 Feb. 2019) (updated 19 Apr. 2019), available at www.ucd.ie/geary/static/publications/workingpapers/gearywp201904.pdf (accessed 20 July 2020).
86. J. Fichter & B.D. Hennig, *Offshore Financial Centres*, 4(3) Political Insight (2013) p. 38), available at www.academia.edu/5954009/The_Real_Size_and_Intensity_of_Offshore_Financial_Centers (accessed 20 July 2020).

*Chimezirim Echendu**

Nigeria's Significant Economic Presence Income Tax on Digital Economic Activities: Challenges and Opportunities

In this article, the author examines the concept of a significant economic presence and how this concept relates to the new rules of the Federal Republic of Nigeria regarding the taxation of digital economic activities carried out by non-resident companies.

1. Introduction

The old principles of taxation were near-perfect for international trade in the bricks-and-mortar economy. However, with the decline of that economy and the move towards a more digitalized one, multinational enterprises (MNEs) have earned increased turnover across the globe, while avoiding a physical presence and avoiding tax liabilities. The difficulty in reaching a global consensus to counter the erosion of the tax base of nations by MNEs operating in the digital economy has led to the implementation of unilateral stop gaps by countries such as France, India and the United Kingdom.[1] The Federal Republic of Nigeria ("Nigeria"), in aiming to ensure that non-resident enterprises participating in its digital economy pay tax on revenue generated by their activities in Nigeria, has adopted "significant economic presence" as a litmus test for determining nexus. This article examines Nigeria's bold interim measure to tax economic activities in its digital space. It argues that implementing the tax as an amendment to Nigeria's Companies Income Tax Act (CITA) 1990 (amended 2019),[2] rather than as a distinct tax, raises germane political, legal and administrative concerns, which may frustrate its quest to generate revenue through the taxation of the digital economy.

The article is divided into six sections. Section 2. briefly highlights the policy challenges raised by the digital economy and the work done to date in trying to find a solution. Section 3. looks at the significant economic presence (SEP) option adopted by Nigeria. Section 4. examines the challenges faced by Nigeria in its quest to enforce its new income tax on non-resident companies (NRCs). Section 5. proffers solutions to the Nigerian situation. Section 6. concludes the article.

2. The Policy Challenges Raised by the Digitalization of the Economy

2.1. Introductory remarks

The OECD Task Force on the Digital Economy (TFDE), which is a subsidiary body of the Committee on Fiscal Affairs, has identified three specific administrative issues raised by the digital economy.[3] These issues are: (i) nexus and the ability to have a significant presence without being liable to tax; (ii) data and the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services; and (iii) the characterization of income derived from the new business model.

The TFDE received an avalanche of opinions on how to deal with the broader tax challenges raised by the digital economy. The recommendations they received included:

(1) modifying the exemptions from permanent establishment (PE) status by amending the exemptions contained in article 5(4) of the OECD Model;[4,5]
(2) establishing a new nexus based on significant digital presence;[6]
(3) replacing the concept of a "permanent establishment" with that of a "significant presence";[7]
(4) introducing a bandwidth or bit tax on the bandwidth used by NRCs;[8] and
(5) introducing a withholding tax on digital transactions as a final tax on the transactions.[9]

Following due consultation, discussions and brainstorming on these proposals, the TFDE agreed that option (1), requiring an amendment of the definition of a physical establishment under the OECD Model, had been taken

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1. *See* kpmg.com, *Taxation of the digitalized economy: developments summary* (18 Aug. 2020), available at https://tax.kpmg.us/content/dam/tax/en/pdfs/2020/digitalized-economy-taxation-developments-summary.pdf (accessed 30 Aug. 2020).
2. NG: Companies Income Tax Act (CITA) 1990 (amended 2019), Primary Sources IBFD.
3. OECD, *Action 1 Final Report 2015 – Addressing the Tax Challenges of the Digital Economy*, para. 248 (OECD 2015), Primary Sources IBFD [hereinafter *Action 1 Final Report*], also available at http://dx.doi.org/10.1787/9789264241046-en (accessed 1 May 2020).
4. Most recently, *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Treaties & Models IBFD.
5. OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 Deliverable*, ch. 8.2.1.1 (OECD 2014), Primary Sources IBFD [hereinafter *Action 1 Deliverable*], also available at http://dx.doi.org/10.1787/9789264218789-en (accessed 1 May 2020).
6. Id., at ch. 8.2.1.2.
7. Id., at ch. 8.2.1.3.
8. Id., at ch. 8.2.1.5.
9. OECD, *Action 1 Final Report*, *supra* n. 3, at para. 292.

care of by the work carried out in respect of Action 7[10] of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project. Options (2), (3) and (4) had elements that could be combined into a new concept of nexus for "net-basis" taxation – an SEP test - which reflects the situation of companies that participate in the economic life of a country consistently without having a fixed base.[11] Option (5), introducing a withholding tax, was considered a standalone tax as well as a tool to enforce compliance with net taxation based on the SEP nexus. An equalization levy[12] was also suggested as an alternative, to avoid the potential landmines inherent in taxing under the new nexus.

2.2. A new nexus based on the concept of an SEP

A combination of a bandwidth tax, replacing PEs with significant presence and the significant digital presence nexus metamorphosed into a new nexus based on an SEP. The SEP concept creates a new tax relation between a country and an NRC that has an SEP in that country. This nexus is premised on factors that point to a "purposeful and sustained interaction" with the country and its economy, albeit remotely through digitalized means, such as the revenue generated, active users, local domain name and a customized website.

3. Tax Law Reform in Nigeria: Income Tax on NRCs Based on an SEP

3.1. Introductory remarks

On 13 January 2020, the President of Nigeria signed the Finance Act 2019 ("the Act")[13] into law. The Act amended, inter alia, section 13(2) of the CITA 1990 (amended 2019), dealing with the source principle of taxation for NRCs by introducing two new paragraphs, (c) and (e). Accordingly, the profits of a company other than a Nigerian company from any trade or business is deemed to be derived from, or taxable in, Nigeria:

> (c) If it transmits, emits or receives signals, sounds, messages, images or data of any kind by cable, radio, electromagnetic systems or any other electronic or wireless apparatus to Nigeria in respect of any activity, including electronic commerce, application store, high frequency trading, electronic data storage, online adverts, participative network platform, online payments and so on, to the extent that the company has significant economic presence [SEP] in Nigeria and profit can be attributable to such activity.[14]

The amendment did not define an SEP, but section 4(c) of the Act stipulated that the Minister of Finance may determine by order what constitutes the SEP of an NRC. The Minister exercised this power on 29 May 2020 through the Companies Income Tax (Significant Economic Presence) (CIT (SEP)) Order 2020.[15] The provisions of the CIT (SEP) Order 2020 will form most of the discussion in section 3.2.

3.2. The CIT (SEP) Order 2020

As discussed in section 2.1., the OECD considered three options for countries wishing to implement an interim measure: (i) an equalisation levy; (ii) a withholding tax; and (iii) the SEP option. The idea was that an SEP would be premised on a "purposeful and sustained interaction" with the country and its economy remotely through digitalized means. The Nigerian attitude towards the taxation of the digital economy hinges the SEP on a revenue factor and a digital factor, as can be gleaned from paragraph 1 of the CIT (SEP) Order 2020 and section 13(2)(c) of CITA 1990 (amended 2019).

3.3. SEP based on a revenue factor

Paragraph 1(1)(a) of the CIT (SEP) Order 2020 provides that for section 13(2)(c) of the CITA 1990 (amended 2019), a company other than a Nigerian company has an SEP in Nigeria in any accounting year in which it derives gross turnover or income of more than NGN 25 million[16] or its equivalent in other currencies from any combination of the following:[17]

– streaming or downloading services: NRCs operating business models with digital content that is streamed or downloaded in Nigeria, such as, but not limited to, movies, videos, music, applications, games and electronic books (e-books) to any person in Nigeria. The provision is not exhaustive and also includes audiobooks, journals and articles, images, podcasts, live sports events and Technology, Entertainment, Design (TED) talks;
– transmission of data: NRCs that collect data, such as the personal information of users (from e-mail addresses to mobile telephone numbers), their web searches, cart histories, favourited items and contents generated through the use of a digital interface, such as a website or application, are also liable to income tax where they monetize the data collected from Nigerian users. This provision accounts for social media platforms and search engines;
– provision of goods and services: NRCs that engage, directly or indirectly, in the provision of goods and services to Nigeria through a digital platform fall under this heading. For example, the DHL Africa e-shop provides a service that permits Nigerians to shop for popular brands across the globe, including clothing and tech brands. It also covers online retailers offering goods to persons resident in Nigeria

10. *See*, for example, OECD, *Action 7 Final Report 2015 – Preventing the Artificial Avoidance of Permanent Establishment Status* (OECD 2015), Primary Sources IBFD.
11. OECD, *Action 1 Deliverable*, *supra* n. 5, at para. 277.
12. An equalization levy is intended to address a disparity in tax treatment between foreign and domestic businesses where the foreign business has sufficient economic presence in the jurisdiction. A certain percentage is imposed on every qualifying transaction. Countries such as France, India and the United Kingdom have all adopted models of the equalization levy as an interim measure to tax the digital economy.
13. NG: Finance Act 2019 (the "Act").
14. Section 4(a) of the Act and now section 13(2)(c) of the CITA 1990 (amended 2019).
15. NG: Companies Income Tax (Significant Economic Presence) (CIT (SEP)) 2020.
16. USD 64,210.60 as at 9 July 2020.
17. It is instructive at this point to also note that companies in Nigeria with a turnover of less than NGN 25 million are not liable to pay income tax if they comply with tax registration and tax filing stipulations under the Act. On this point, *see* sections 23(1)(o), 33(3)(b), 40 and 105 of the CITA 1990 (amended 2019).

where orders or contracts for such goods are completed digitally through a website or application. NRCs that provide services or give Nigerians access to their services for a fee also fall within the scope of this section. These services include online libraries, e-data storage and online adverts, e-gaming and e-betting platforms, subscription-based newspapers, web hosting service providers, data processing and productivity tools providers and high-frequency trading firms;[18]

– intermediary services: again, NRCs that link suppliers and customers in Nigeria through digital platforms, applications or websites are also liable to Nigerian companies income tax if they exceed the revenue threshold. An example of a company that provides intermediary services is AliExpress.

3.4. An SEP based on a digital factor

Paragraph 1(1)(b) of the CIT (SEP) Order 2020 provides that, for the purposes of section 13(2)(c) of the CITA 1990 (amended 2019), a company other than a Nigerian company has an SEP in Nigeria in any accounting year in which it uses a Nigerian domain name – for example, ".ng" or "com.ng" – or registers a website address in Nigeria. Accordingly, companies with Nigerian domain names have an SEP and are liable to pay income tax if they have a turnover of more than NGN 25 million.

The last leg of this provision appears to confer an SEP on an NRC if the NRC registers a website address in Nigeria. The exact intention of this provision is not clear, as it could confer an SEP on an NRC that registers a website with a Nigerian web hosting platform or an NRC that applies to a Nigerian regulator to register its website.

On the other hand, paragraph 1(1)(c) of the CIT (SEP) Order 2020 provides that, for the purposes of section 13(2)(c) of the CITA 1990 (amended 2019), a company other than a Nigerian company has an SEP in Nigeria in any accounting year in which it has a purposeful and sustained interaction with persons in Nigeria by customizing its digital page or platform to target persons in Nigeria, including reflecting the prices of its products or services in Nigerian naira or providing options for billing or payment in Nigerian naira. This provision infers that a purposeful and sustained interaction with Nigeria exists where an NRC includes features in its website or application that reflect the local environment such as language, currency, delivery, payment and local support.

It is important to add that notes, memoranda, writing or any electronic inscription acknowledging payment made to NRCs for the provision of goods and services are recognized as receipts and will be subject to a one-off stamp duty of NGN 50.[19] The duty to make a disclosure of the details of the transaction and thereafter pay the NGN 50 duty is on the Nigerian resident to whom a receipt has been issued by the NRC.[20]

3.5. The tax base and rate of tax

An NRC carrying out economic activity in Nigeria is charged tax on the profits it derives in Nigeria from its activities.[21] A significant challenge in implementing Nigeria's tax on the digital economy is determining the tax base of NRCs. Income tax is imposed on the net profits of a company in a relevant accounting period and not on its gross turnover. Nigeria's SEP income tax imposes tax on the profits made by a company from its activities in Nigeria in the relevant accounting year. This situation appears to restrict the taxable profit to payments received by NRCs for goods and services supplied to persons in Nigeria. However, the tax, being an income tax, is not imposed on the gross amount of receipts from Nigeria, as the NRC is entitled under the CITA 1990 (amended 2019) to deductions to determine its taxable profit. Accordingly, the NRC is entitled to deduct all expenses wholly, exclusively, necessarily and reasonably incurred in the production of the profit chargeable to tax.[22] The expenses allowed under Nigerian law for companies include any sum payable as interest on debt borrowed and employed as capital in acquiring the profits,[23] rent,[24] salary, wages or other remuneration paid to the senior staff or executives[25] and expenses incurred for the repairs, renewal or alteration of plant, machinery and fixtures employed in generating the profit.[26]

Section 30 of CITA 1990 (amended 2019), which the Nigerian tax authority, the Federal Inland Revenue Service (FIRS), in the recent past used as a tool to assess NRCs to tax on a fair and reasonable percentage of their turnover does not extend to NRCs without a PE in Nigeria. Thus, the deemed profit approach cannot be used by the FIRS to legally subject NRCs operating in the Nigerian digital space to income tax.

The rate of tax to which NRCs with an SEP in Nigeria are liable also differs, depending on the turnover recorded by the NRC. The general rule under Nigerian law is that a company with a turnover that does not exceed NGN 25 million is not liable to income tax, provided that it complies with its filing and regulation requirements.[27] This

18. The provision excludes from its scope the provision of goods and services under sub-paragraph (5) of the CIT (SEP) 2020. However, the need for reference to that sub-paragraph is not entirely clear; sub-paragraph (5) deals with aggregating the activities of connected companies in the accounting year in question for the sake of determining whether it meets the threshold in sub-paragraph (1).
On the scope of sub-paragraph (5), it is argued that the reference to sub-paragraph (1) is too broad and the applicability of sub-paragraph (5) must be restricted to sub-paragraph (1)(a) and should not be extended to (b) and (c), which have no required level, rate or amount of turnover for the creation of an SEP.
19. Sec. 54 of the Act and Sec. 89 of the Stamp Duties Act 1939 (amended 2019).
20. *See* https://www.firs.gov.ng/sites/Authoring/SiteAssets/Lists/Content/GetContent/2019%20FA%20Information%20Circular-Stamp%20Duties.pdf (accessed 31 Aug. 2020).
21. Sec. 9 CITA 1990 (amended 2019).
22. Id., at sec. 24.
23. Id., at sec. 24(a).
24. Id., at sec. 24(b).
25. Id., at sec. 24(d)(i).
26. Id., at sec. 24 (e).
27. Id., at sec. 40(a).

suggests that if a company with a turnover of NGN 25 million or below fails to comply with the filing and registration requirement, it is liable to income tax. Curiously, however, the CITA 1990 (amended 2019) contains no guidance on the applicable tax rate for such errant companies, and it is argued that the strict interpretation given to taxing statutes means that such companies are not liable to income tax in Nigeria.

Companies with a turnover that exceeds NGN 25 Million but is less than NGN 100 million,[28] i.e. a medium-sized company, pay tax at a rate of 20 kobo for every naira (20%) of taxable profits.[29] Companies with a turnover that exceeds NGN 100 million are considered to be large companies, and the applicable rate of tax for such companies is 30 kobo for every naira (30%) of taxable profits.[30] Companies are expected to self-assess and file their returns within six months of the end of the accounting year.[31] The tax base of Nigeria's income tax on NRCs with an SEP is restricted to profits from the trade or business activities of the NRC in Nigeria.

3.6. Summary

With the amendment to the CITA 1990 (amended 2019) and the subsequent CIT (SEP) Order 2020, Nigeria has succeeded in creating a new tax nexus or connection with NRCs that transcends the traditional source principle based on the existence of a physical presence. This new nexus can be created by having a Nigerian domain name – for example, ".ng" or "com.ng" – or by displaying the cost of items in naira on a website or by selling goods indirectly to Nigerians through an e-commerce platform. However, an NRC is not liable to pay income tax in Nigeria if its turnover in a year does not exceed NGN 25 million or its equivalent in other currencies, depending on the country of residence of the NRC.[32] The rate of tax also varies depending on the turnover recorded by the NRC. If the turnover exceeds NGN 25 million but is less than NGN 100 million, the applicable tax rate is 20% of profits, while if the turnover exceeds NGN 100 million, a rate of 30% applies. As a final note, the interim measure was proposed and adopted on the premise that it is temporary, ceasing to apply once a global response to the tax challenges raised by digitalization has been agreed on and implemented. Countries were expected to maintain a commitment to achieving a global consensus or agreement,[33] and this commitment is visible in the Nigerian approach. The CIT (SEP) Order 2020 provides that, from the day a multilateral or consensus agreement to address the tax challenges arising from the digitalization of the economy becomes effective, any company resident in a country that is a party to that agreement will be subject to the agreement, and not Nigerian law. In other words, when an international consensus is reached on the Pillar One and the Pillar Two principles[34] and subsequently adopted by Nigeria, the consensus agreement will determine the right to tax an NRC resident in a country that is also a party to the agreement.[35]

4. The Challenges of Nigeria's SEP Provision

4.1. SEP income tax and political challenges

The most evident political challenge is the possibility of a trade war or retaliatory measures.[36] Although these might not come from countries such as France, India, the United Kingdom and others that have adopted a unilateral approach, the United States has clearly indicated that it regards taxes on the digital economy as an attack on US companies. Recently, the United States Trade Representative (USTR) opened an investigation under section 301 of the Trade Act (1974)[37] into the digital services taxes of nine countries and the European Union.[38] The USTR also announced that it was suspending talks with the OECD on the Pillar One option.[39] The stance of the United States might encourage affected companies resident in the United States to be defiant and uncooperative with tax authorities seeking to impose tax on their digital economic activities in foreign jurisdictions. Statistics available from the USTR website show that, in 2018, Nigeria exported goods worth USD 5.6 billion to the United States.[40] Nigeria risks facing a significant tariff on its exports to the United States – one which it can ill afford, considering the impact of the COVID-19 pandemic on the world economy. The threat of an increase in tariffs made France suspend the collection of its digital services

28. USD 257,989, as of 10 July 2020.
29. Sec. 40(b) CITA 1990 (amended 2019).
30. Id., at sec. 40(c).
31. Id., at sec. 53.
32. *See supra* n. 17. It is further argued that the failure to comply with the tax registration and filing requirements under section 23(1)(o) CITA 1990 (amended 2019) also do not give rise to a tax liability, as the law is silent on the applicable rate of tax for a company with a turnover of NGN 25 million and below.
33. OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018* (OECD 2018), Primary Sources IBFD [hereinafter *Interim Report*], also available at http://dx.doi.org/10.1787/9789264293083-en (accessed 1 July 2020).
34. Although outside the scope of this article, Pillar One (the unified approach) creates a new nexus for highly digitalized businesses and consumer-facing businesses based on sales and not physical presence. It also supplements the current profit allocation mechanism (the arm's-length principle, ALP) with a three-tier profit allocation mechanism (amounts A, B and C) that encompasses different taxable profits that may be allocated to a market jurisdiction. Pillar Two seeks to develop rules that will allow jurisdictions to tax untaxed profits in situations where jurisdictions with the primary taxing right have failed to exercise their rights or have undertaxed the taxable income. *See* OECD, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD 2020), available at www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps.htm (accessed 3 July 2020).
35. Para. 1(3) and (4) CIT (SEP) Order 2020.
36. L. V. Faulhaber, *Taxing Tech: The Future of Digital Taxation*, 39 Va. Tax Rev. 2, p. 145 (2019), available at https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID3500986_code1548301.pdf?abstractid=3460741&mirid=1 (accessed 15 June 2020).
37. US: Trade Act (1974).
38. *See* D. Bunn, *The U.S. Trade Representative Expands Its Digital Services Tax Investigations* (2 June 2020), available at https://taxfoundation.org/us-trade-representative-ustr-digital-services-tax-investigations/ (accessed 15 June 2020).
39. *See* S. Fleming et al., *US upends global digital tax plans after pulling out of talks with Europe* (17 June 2020), available at https://www.ft.com/content/1ac26225-c5dc-48fa-84bd-b61e1f4a3d94 (accessed 18 June 2020).
40. *See* USTR, Nigeria, available at https://ustr.gov/countries-regions/africa/nigeria (accessed 15 June 2020).

tax (DST) until the end of 2020.[41] Sadly, and as Faulhaber (2019)[42] points out, if unilateral measures are continually met with retaliatory measures, an inefficient and vicious cycle of taxing and tariffs will result. The biggest losers will be the consumers, and the underlying issue will be left unaddressed. Nigeria, however, cannot afford to exempt companies resident in the United States from the operation of its SEP income tax, as such an action would breach its most-favoured nation (MFN) obligations under the World Trade Organization (WTO) General Agreement on Trade in Services (GATS).[43]

4.2. SEP income tax and Nigeria's tax treaties

Currently, Nigeria has 13 comprehensive tax treaties[44] that regulate the taxation of non-resident enterprises, but no tax treaty with the United States. The effect of these tax treaties is that the profit of an enterprise is only taxable by the authorities of the country in which it is resident, unless the enterprise carries on business in another country through a PE situated there. The profits are taxed in the country of the physical establishment, but only as much as is attributable to that PE. However, such a tax must be covered by the relevant tax treaty.[45] Nigeria's SEP income tax operates as a "tax on the profits of a company other than a Nigerian company" under section 13(2)(c) of the CITA 1990 (amended 2019), which is a covered tax under article 2(b) of the China (People's Rep.)-Nigeria Income Tax Treaty (2002). It is axiomatic that Nigeria's income tax on NRCs with an SEP cannot apply to an enterprise that is resident in any of the countries with which it has a tax treaty regarding the taxation of NRCs in place. The reason is that none of these tax treaties includes an SEP as a test for a foreign enterprise's PE in Nigeria. In the case of a dispute between an international treaty and a domestic law, the position under Nigerian law is encapsulated in the decision of Nigeria's apex court in *Abacha* (2000) delivered by Ogundare (Justice of the Supreme Court):

> I would think that if there is a conflict between it (international treaty) and another statute (domestic), its provision (international treaty) will prevail over those of that other statute (domestic) for reason that it is presumed that the legislature does not intend to breach an international obligation... the Charter possesses a greater vigour and strength than any other domestic statute...[46]

Article 25 of the China (People's Rep.)-Nigeria Income Tax Treaty (2002) permits a taxpayer that believes that the actions of a contracting party result, or will result, in taxation at variance with the provisions of the tax treaty either to take advantage of the remedies provided under the domestic laws of the contracting state or to present its case to the competent authority of the contracting state in which it resides. This situation means that a Chinese company operating in the digital economy can challenge the legitimacy of Nigeria's income tax on NRCs with an SEP in Nigerian courts.

4.3. SEP income tax and double taxation of companies

Countries are generally more predisposed to increasing their tax bases than reducing them. Where there is a tax treaty between countries, there is an agreement on how to limit their taxing rights in a bilateral setting. Nigeria's tax on the income of NRCs with an SEP increases Nigeria's tax base. However, its effect on the tax base of the country of residence of NRCs operating in Nigeria's digital economy is very dependent on whether the countries in question recognize Nigeria's SEP income tax and grant unilateral double tax relief. In many countries, a condition for unilateral foreign tax credit relief is that the income in question is sourced in the other country (Nigeria in this case). This foreign-source question is determined by the country giving the relief according to its own rules on the source of income. Often, for digital transactions, it is not recognized that the source is in the country in which consumption took place without physical presence. It should be expected that unilateral foreign tax credit relief may be denied in many cases, with the result being unresolved double taxation. Again, as Nigeria's SEP income tax is covered under 13 of its 14 tax treaties that deal with NRCs, the PE requirement effectively absolves the contracting states from providing treaty relief to resident companies. NRCs facing this double taxation challenge might have to cease operations in Nigeria or shift the tax burden to a user base in Nigeria. In a situation in which an NRC decides to continue to participate in Nigeria's digital economy, the tax, despite being couched as an income tax, economically will behave like a tariff on goods and services due to the increase in the cost of the output.

4.4. SEP income tax and the enforcement and/or compliance conundrum

A tax provision, no matter how wide, no matter how ingenious, fails if the administrative wheels on which it moves are not well oiled. Tax collection has not been a forte of Nigeria's tax administrator, the FIRS. However, one thing

41. *See* VATupdate.com, *French Finance Minister confirms temporary suspension of Digital Services Tax* (29 Jan. 2020), available at www.vatupdate.com/2020/01/29/french-finance-minister-confirms-temporary-suspension-of-digital-services-tax/ (accessed 15 June 2020).
42. Faulhaber, *supra* n. 36, at p. 145.
43. WTO: General Agreement on Trade in Services (1995), art. II.
44. The tax treaties are with Belgium, Canada, China (People's Rep.), the Czech Republic, France, the Netherlands, Pakistan, the Philippines, Romania, the Slovak Republic, Singapore, South Africa and the United Kingdom. The tax treaty between Nigeria and Italy is an air and shipping agreement only. *See* the website of the Nigerian Federal Inland Revenue Service (FIRS), available at https://www.firs.gov.ng/TaxResources/TaxTreatiesNew (accessed 31 Aug. 2020).
45. For instance, *see Agreement between the Government of the People's Republic of China and the Government of the Federal Republic of Nigeria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* art. 7 (15 Apr. 2002), Treaties & Models IBFD [hereinafter the *Nig.-P.R.C. Income Tax Treaty* (2002)]. Article 5(2) of the *Nig.-P.R.C. Income Tax Treaty* (2002) states that a PE includes:
    (a) a place of management;
    (b) a branch;
    (c) an office;
    (d) a factory;
    (e) a workshop;
    (f) a sales outlet; and
    (g) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
46. NG: NSC, 28 Apr. 2000, Case S.C. 45/1997, *General Sanni Abacha & Ors v. Chief Gani Fawehinmi*, [2000] 6 NWLR 228.

is clear: without more resources being applied to its collection, the establishment of a new nexus based on a sustained and valuable interaction with Nigeria will not generate the revenue that the country envisages taking from NRCs with an SEP in Nigeria. The ability of the FIRS to monitor remote sales is crucial to the success of this system, but monitoring remote sales through payments made via commercial banks and other financial institutions that provide payment facilities is not enough. There also exists the considerable challenge of knowing what activities are taking place, on what scale, who the sellers are and, ultimately, ensuring compliance. Similarly, the nature of digital transactions means that they may not yield themselves easily to detection in the client's country of residence.

The provision, as noted in section 3.6., will apply until a global consensus is reached on how to tax the digital economy. However, a considerable capital outlay on the part of the NRCs and the tax administrator for the enforcement of the tax might not be a cost-effective option, with companies that have many new nexus rules to navigate being the worst hit.

The enforcement quagmire is exacerbated by the so-called revenue rule of international private law, which is also applicable in international tax law. This rule prevents the tax authorities of a state from initiating a legal action to claim or enforce its revenue, directly or indirectly, in a foreign court.[47] However, recent developments in the field of international law, such as the Convention on Mutual Administrative Assistance in Tax Matters (1988), which Nigeria has ratified,[48] could help Nigeria conduct tax examinations abroad as well as recover income taxes that are not in contention. However, it should be noted that the Convention does not affect the rights and safeguards guaranteed to persons by the law or the administrative practice of the state requested to provide information.[49] Nor does it impose an obligation to provide assistance if the country in question considers the taxation in the applicant state to be contrary to generally accepted taxation principles, a tax treaty or any other convention between the two states.[50] The Multilateral Competent Authority Agreement on Country-by-Country Reporting (the Agreement)[51] is another tool that can help tax authorities get around the revenue rule. The agreement obligates competent tax authorities to automatically exchange country-by-country (CbC) reports received from reporting entities resident for tax purposes in its jurisdiction with all such other competent authorities of jurisdictions with which it has a bilateral agreement in place for that purpose.[52] However, the CbC report must show that the reporting entity has a constituent entity resident in that jurisdiction for tax purposes or subject to tax based on a PE.[53] This means that there is no requirement to exchange information in relation to NRCs operating in the digital economy.

Determining the taxable income will also be a challenge, as income tax is imposed on the profit of a company and not on its gross turnover. The tax authorities might not be able to appreciate some of the deductible expenses that these MNEs may claim, and attributing profit to digital economic activities overly complicates the administration of the tax. The FIRS may also encounter difficulties in auditing and verifying the accuracy of tax returns filed by NRCs.[54] Further, Nigeria might not be able to enjoy the advantage of exchanging information with contracting states as provided in its tax treaties due to the friction between those treaties and its income tax on NRCs with an SEP. Seeing how difficult it might be to obtain assistance and cooperation from the most prominent players in the digital economy, i.e. China and the United States, there is now a glaring need for the FIRS to be proactive and zestful in administering the tax.

4.5. The SEP income tax burden

Tax incidence assesses who bears the actual burden of the tax. The burden of the tax is defined as the ultimate resting point of the tax after taking into account any tax shifting that might occur once the tax has been imposed.[55] Shifting is the process whereby persons who bear the legal responsibility for paying tax, i.e. the "legal incidence", alter output or input prices, thereby transferring the burden to labour, capital or consumers. The final resting point for the tax is the "economic incidence" of the tax.[56] Even if the legal incidence of corporate income tax lies with an NRC, a company may shift the tax by paying labour less, increasing the cost of their output or reducing the dividend paid to shareholders on their investments. The market dynamics that confront the NRC dictate whether the company shifts the tax to labour and capital or to consumers. Factors such as the existence of competition, the sensitivity of consumers to changes in price and the response of labour to compensation and of capital to a reduction in investment all have a substantial bearing on the behaviour of the NRC. The OECD's tax incidence analysis envisages the new corporate income tax on NRCs with an SEP as a "selective excise", and rightly so, as it only applies to a select group of companies.[57] The report holds the view that the initial effect of the new tax is to reduce the rate of return on capital for investors, while the cost of labour and output remains the same.[58] However, in the long run, NRCs will possibly respond to a reduction in after-tax return by adjusting the price of output, the level of output or cost of inputs. The strategy adopted by these enterprises will depend very much on whether the

47. On this issue, *see* the decision of the UK House of Lords in UK: HL, 20 Jan. 1955, *Government of India v. Taylor*, [1955] 1 All ER 292 and the US Supreme Court in US: USSC, 13 May 2002, *Attorney General of Canada v. R.J. Reynolds Tobacco Co*, [2002] 535 U.S. 1052.
48. *Convention between the Member States of the Council of Europe and the Member Countries of the OECD on Mutual Administrative Assistance in Tax Matters* (25 Jan. 1988), Treaties & Models IBFD.
49. Id., at art. 21(1).
50. Id., at art. 21(1)(e).
51. OECD, Multilateral Competent Authority Agreement on Country-by-Country Reporting (27 Jan. 2016).
52. Id., at sec. 2.
53. Id.
54. OECD, *Interim Report* (2018), *supra* n. 33, at p. 179.
55. OECD, *Action 1 Final Report* (2015), *supra* n. 3, at p. 277.
56. Id.
57. Id., at p. 278.
58. Id., at p. 279.

market structure is perfectly or imperfectly competitive.[59] However, the less prepared customers are to stop buying a specific service or to shift to another, less taxed, service, the higher the incidence of the tax on them.[60] Such a situation might also increase the cost of input for a business relying on the output of these NRCs.[61]

5. What Next for Nigeria?

The one-size-fits-all solution to the challenges considered in this article appears to be one whereby Nigeria suspends the operation of its interim measure in favour of a global consensus, which is an implausible position at this point. Exempting select NRCs due to the fear of sanctions from their countries of residence is also not an option, as it would breach Nigeria's MFN obligations under GATS.

That said, Nigeria, in its quest to successfully tax the digital economy, must chart a diplomatic course first. A mutual understanding with other signatories to the Convention on Mutual Administrative Assistance in Tax Matters would be important to help ease the administrative burden of the FIRS, and would create a defined working relationship. Although not necessary for the enforcement of the provisions of the Convention, a memorandum of understanding with different signatories, particularly those with companies that may fall under the SEP provision, would reduce the likelihood of friction in the administration of the tax and the provision of assistance. However, the signatories to the Convention – for example, the United States – are not under any obligation to provide administrative assistance if and insofar as they consider the taxation in the applicant state – Nigeria in this case – to be contrary to generally accepted taxation principles.

Enforcing Nigeria's SEP provision as an income tax on companies rather than as a distinct digital services tax brings the country into conflict with existing tax treaties. It might be that the idea is to target NRCs resident in countries with which Nigeria has not concluded a tax treaty. However, in that case, an opportunity for treaty shopping might arise, as target NRCs could incorporate intermediaries in countries that have tax treaties with Nigeria and serve the Nigerian market through such intermediaries while escaping tax liability. One option open to Nigeria would be to amend the profit attribution provision in its tax treaties to bestow legitimacy on the SEP nexus. The issue with this action, however, is that an amendment must be agreed to by the parties to the tax treaty and may require a lot of good will, patience and political compromise to achieve, considering that it will significantly reduce the tax base of the other contracting state. Given that treaty (re)negotiation takes years, sometimes decades, to achieve, this option would appear to be otiose, especially considering that the SEP income tax is an interim measure. A feasible and quicker option open to Nigeria would be to repeal and re-enact its SEP provisions[62] as a sui generis digital services tax. This new digital services tax would operate outside the scope of Nigeria's companies income tax and outside the provisions of the tax treaties that restrict the taxation of non-residents to instances in which they have a PE in the country seeking to impose the tax. The applicable tax rate of 20% or 30% for the digital services tax will have to be adjusted, however, and the tax charged on revenue and not profit. The current tax rate is quite high and would significantly reduce the after-tax rate of return for target enterprises, thereby making it very likely that the burden of the tax would be transferred to the consumers of the output in Nigeria. The monetary threshold of NGN 25 million should also apply across the board to every form of economic activity within the Nigerian digital economy under paragraph 1 of the CIT (SEP) Order 2020.

Finally, the obvious administrative difficulties and political tensions surrounding the implementation of a temporary tax on the digital economy and the proliferation of new nexus rules give rise to the likelihood that some companies may not prioritize immediate compliance. Nigeria can adopt a creditable withholding tax system as a means of collecting its digital services tax. Leveraging on the requirement by the Central Bank of Nigeria (CBN) that financial institutions must maintain internal records on card-related transactions, banks and other financial institutions providing payment platforms should be commissioned as third-party agents for the collection of the withholding tax.[63] The applicable withholding rate could be around 3-5% of the transaction fee.

The importance of this move would be three-fold for the FIRS:

- it would secure an advance payment of digital services tax from NRCs operating in the digital economy;
- it would provide a clear view of the revenue generated by NRCs operating in Nigeria's digital economy; and
- it would increase the tax net, as it would enable the attainment of a reasonable knowledge of the NRCs operating in the digital economy.

At the end of each accounting year, NRCs would be subject to a two-pronged test to determine whether it had an SEP. The first test would determine whether the NRC had carried out digital economic activities in Nigeria, while the second test would determine whether the enterprise had a turnover exceeding NGN 25 million, and whether it would therefore be liable to digital services tax in Nigeria. If the enterprise were deemed to have an SEP, the first NGN 25 million of gross turnover would be exempt from tax, but all subsequent revenue would be subject to tax at a prescribed rate. The Nigerian Ministry of Communication and the Digital Economy would coordinate the work with the FIRS.

59. Amazon, for example, raised its seller's fee in France by 3% after the French government passed its DST into law, thereby effectively passing the cost onto users. *See* E. Schulze, *Amazon is passing along costs of a new digital tax to thousands of French sellers*, CNBC (19 Aug. 2019), available at www.cnbc.com/2019/08/19/amazon-blames-frances-digital-tax-for-higher-seller-fees.html (accessed 15 June 2020).
60. OECD, *Interim Report* (2018), *supra* n. 33, at p. 179.
61. Id.
62. Sec. 4 Finance Act 2019 and the CIT (SEP) Order 2020.
63. CBN, *Guidelines on Operations of Electronic Payment Channels in Nigeria*, para. 4.5.3.6. (April 2016).

Notwithstanding the fact that Nigeria's SEP provision does not require bandwidth or monthly active users to determine the threshold, the available data on these indices would assist the FIRS in obtaining an insight as to how significant a presence an NRC has in Nigeria. The FIRS, now armed with overwhelming evidence of a sustained and economically valuable interaction with the Nigerian economy, would undoubtedly be better placed to evaluate the tax filings of these NRCs. Where it could be demonstrated that an enterprise had a sustained economic interaction with Nigeria, but its turnover for the year did not exceed NGN 25 million, the amounts withheld by the financial institutions would be credited back to the NRC. This new framework would also take care of the rather complex issue of determining value creation and attributing profit to the enterprise.

6. Conclusions

This article argues that Nigeria's new income tax on companies with an SEP – broad as its scope may be – is fraught with implementational challenges that are strong enough to prevent its operation. Apart from breaching most of Nigeria's tax treaties, the extant international principles of taxation are too old to offer comprehensive support for administering cross-border international income tax on digitalized activities. The prescribed rate of tax also appears to be quite high and may compel target enterprises to transfer a large part of the tax burden to the consumers of their output. Further, the article examines the issue of juridical double taxation, whereby the countries of residence of NRCs refuse to grant unilateral tax relief. The article highlights that the threat of trade retaliation by countries that view such a tax as an attack on their companies might encourage companies resident in its jurisdiction to become defiant and uncooperative. The article concludes by suggesting that the remodelling of the Nigerian SEP tax as a sui generis digital services tax with a reduced rate is a viable way to resolve the challenges created by the new income tax on NRCs with a sustained and valuable interaction with the Nigerian economy.

*Craig Elliffe**

International Tax Frameworks: Assessing the 2020s Compromise from the Perspective of Taxing the Digital Economy in the Great Lockdown

This article provides an assessment of the new international tax framework for taxing the digital economy as proposed by the OECD/Inclusive Framework. In this critique of the new regime, the author refers to the prospective new international tax architecture as the "2020s compromise", as opposed to the currently applicable "1920s compromise".

1. Introduction

1.1. In general

The extraordinary consequences of the COVID-19 crisis mean that the world arrives at the crossroads of international tax reform with a greater sense of urgency.[1] The "Great Lockdown" has been described as the worst recession since the Great Depression and certainly is much worse than the Global Financial Crisis.[2] Most countries around the world will have largely emptied their coffers, and borrowed heavily, to fund strategies to support their businesses and workers. Back in April 2020, the International Monetary Fund (IMF) forecast[3] that the cumulative loss to global GDP over 2020 and 2021 from the pandemic crisis could be around USD 9 trillion, greater than the economies of Japan and Germany combined, but the latest information suggests that this is optimistic.[4] Governments will need revenue from every source and multinationals are likely to be part of a logical tax base, particularly when cross-border trade recovers, as no doubt it will.

1.2. The dominance of highly digitalized businesses over their more traditional counterparts

In many respects, the COVID-19 crisis confirms the dominance of many highly digitalized businesses in certain key areas highlighted by the effect of the pandemic. This situation has arisen because many countries to slow the rapid contraction of the virus have imposed rules requiring self-isolation or small group isolation. Most people in such situations have become even more reliant on social media, remote and online shopping, streamed entertainment, online education and many other forms of technology-enabled connection. As one commentator has suggested, in the days of COVID-19 and "mandated shutdowns and restricted activity", so essential is the digital method of business to staying in business, that "it's go digital, or go dark".[5]

1.3. Corporate tax under threat anyway from highly digitalized business models

The OECD's analysis of corporate tax statistics reveals that, in 2016, corporate tax revenues (for resident and non-resident entities) accounted for 13.3% of total tax revenues on average across the 88 jurisdictions for which data is available. This figure was an increase from 12% in 2000, despite the overall trend of falling corporate tax rates in that period. Corporate taxation is even more important in developing countries, comprising on average 15.3% of all tax revenues in Africa and 15.4% in Latin America and the Caribbean, compared to 9% in the OECD member countries.[6] In the traditional business models, in addition to corporate tax payments, non-resident companies employ local employees who pay employment taxes and social security contributions, while the companies themselves are responsible for property taxes (to both central and local governments), consumption taxes and environmental taxes. Corporate taxation remains important to government revenues. Corporate tax is also important from an integrity perspective. Residents have confidence

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1. IMF, *World Economic Outlook Update A Crisis Like No Other, An Uncertain Recovery* p. 1 (IMF 2020). Global growth is projected at minus 4.9% in 2020, 1.9 percentage points below the April 2020 World Economic Outlook (WEO) forecast. The COVID-19 pandemic has had a more negative impact on activity in the first half of 2020 than anticipated, and the recovery is projected to be more gradual than previously forecast.
2. G. Gopinath, *The Great Lockdown: Worst Economic Downturn Since the Great Depression* (IMF 2020).
3. Id.
4. *See* IMF, *supra* n. 1 for the synchronized and deep downturn has led to consumption and services output dramatically falling in conjunction with reduced mobility and a severe hit to the labour market.
5. BDO USA, *COVID-19 is Accelerating the Rise of the Digital Economy* (BDO 2020), where it is stated that: "If there were any lingering doubts about the necessity of digital transformation to business longevity, the coronavirus has silenced them. In a contactless world, the vast majority of interactions with customers and employees must take place virtually. With rare exception, operating digitally is the only way to stay in business through mandated shutdowns and restricted activity."
6. OECD, *Corporate Tax Statistics*, first edition, (2019), available at https://www.oecd.org/tax/tax-policy/corporate-tax-statistics-database-first-edition.pdf (accessed 26 Aug. 2020).

in a tax system when they see multinationals paying their fair share of tax.

The many benefits of digitalization include business-related attributes such as increasing efficiency, productivity and positive economic changes. These features generally result in a higher standard of living for people. The consequences of these changes are being felt in a range of different areas, with a huge social impact in its broadest sense (including such things as the live streaming of terror attacks, alleged interference with electoral processes and selective exposure to self-justifying news sources), on privacy law and data protection. In the area of taxation, the changes are just as dramatic. New ways of doing business, and better ways to do existing business practices, are currently challenging, and will in the future dramatically challenge, the existing tax system. The combination of businesses using direct and indirect network effects, together with the efficiencies of that marketplace and the low cost of operation, and a global marketplace made available through the Internet, means that there is a superior way to sell goods and services for many businesses. It is an obvious point, but much of this business does not require a physical presence in a jurisdiction. Many transactions involving consumer-to-consumer (C2C), business-to-consumer (B2C), and business-to-business (B2B) dealings no longer need someone "on the ground" to organize the deal.

1.4. How to tax the cross-border digital economy?

The combination of taxation shortfalls, increased government spending and the irrefutable growth in the digital economy adds impetus to resolving the most vexing question in contemporary international tax policy. This question is how to appropriately and fairly tax the digital economy?

For some time, there has been a prevailing view that the international tax rules are not fit for purpose. Originally, this was driven by a variety of aggressive tax planning techniques and countries entering into or permitting, tax competition between themselves. The Action Plan regarding the OECD/G20 Base Erosion and Profit Shifting (BEPS)[7] Project and the BEPS package itself consisting of 15 Action Points were agreed to by all OECD and G20 countries in November 2015.[8] The BEPS package was designed to achieve certain fundamental changes in behaviour from both countries and multinational enterprises (MNEs), such as (among other things):

– discouraging tax competition that had occurred based on a lack of transparency;
– preventing the artificial location of profit where there is little or no economic activity; and
– eliminating the exploitation of loopholes or differences in countries' tax systems (cross-border arbitration).

A multilateral forum, the OECD/Inclusive Framework, has been established with more than 130 countries representing over 95% of global GDP. There has been much progress made in a remarkably short period.

Notwithstanding all these cooperative and multilateral actions, the tax challenges of the digitalization of the economy have been identified as one of the key foci of the BEPS Action Plan. The Report on Action 1 includes two key conclusions:

(1) the whole world economy is digitalizing, and it is difficult, if not impossible, to ring-fence the digital economy; and
(2) that beyond BEPS (and aggressive tax planning), the digitalization of the economy raises several challenges relating to the question on the allocation between countries of taxing rights.[9]

This question of how to tax the digital economy is, arguably, the most difficult issue in the whole of the OECD/G20 BEPS programme.[10] Even though the "Tax Challenges Arising from Digitalisation" were highlighted as BEPS Action 1, little progress was made in this area relative to the other 15 action reports released in 2015. The reason for this is that changes to taxation concerning the digital economy involved examining solutions, which would propose changes that go right to the heart of the existing international tax framework. Because of the necessity for such seismic change, the view of most countries is that there is a clear advantage to implementing a new multilateral consensus-driven international tax framework.[11] With such change, it would be necessary to address key issues relating to the nexus of an entity in a foreign country (the fact that a non-resident enterprise requires a physical presence in a jurisdiction) and the allocation of income (what portion, if any, of the profits are attributable to the activities carried on in the market or source jurisdiction). As the solution to these problems comes from a radical overhaul of the international tax "architecture",[12] it is little wonder that any possible alternative has involved extensive planning and policy-making over several years. It also involves attempting to obtain political consensus and agreement to change the fundamental basis of cross-border taxation.

Whether there is the political will to achieve this consensus remains to be seen. The US Treasury Secretary,

7. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), Primary Sources IBFD.
8. OECD, *OECD/G20 Base Erosion and Profit Shifting Project 2015 Final Reports Information Brief*, available at https://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf (accessed 26 Aug. 2020).
9. OECD, *Action 1 Final Report 2015 – Addressing the Tax Challenges of the Digital Economy* (OECD 2015), Primary Sources IBFD [hereinafter *Action 1 Final Report* (2015)].
10. For a history of the OECD's various reports and discussions, *see* OECD, *Action 1 Tax Challenges Arising from Digitalisation the BEPS Actions* [hereinafter *Action 1 Tax Challenges*], available at www.oecd.org/tax/beps/beps-actions/action1 (accessed 26 Aug. 2020).
11. OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, Inclusive Framework on BEPS para. 407 (OECD 2018), Primary Sources IBFD [hereinafter *Tax Challenges Arising from Digitalisation – Interim Report* (2018)].
12. OECD, *Action 1 Tax Challenges*, *supra* n. 10, where, under the heading "Change the allocation of taxing rights through a coherent and concurrent review of the profit allocation and nexus rules (Pillar 1)", it is stated that: "The implications of these proposed solutions reach into fundamental aspects of the current international tax architecture, as they entail modifications potentially going beyond the arm's length principle and no longer constrained by physical presence requirements".

Steven Mnuchin, indicated in a letter to four European Finance ministers in mid-June 2020 that discussions had reached an "impasse".[13] The OECD continues to work towards a multilateral solution, thereby recognizing that such a solution is "long overdue"[14] and they have made it clear, according to Pascal Saint-Amans (the director of the OECD's Centre for Tax Policy and Administration, CTPA), that discussions are continuing.[15]

1.5. International tax at the crossroads

It can, therefore, be said that the international tax system stands poised at the crossroads of reform. This reform will either be in the format proposed by the OECD and the Inclusive Framework and representing a consensus-driven multilateral response, or it will see the introduction of more interim, or unilateral, domestic taxes. These domestic taxes vary in their design and scope, but the most common form is a group most commonly known as digital services taxes (DSTs). There is concern that a failure to obtain consensus will result in a proliferation of DSTs around the world.[16]

This article assesses the effectiveness of the multilateral response to identified challenges to the existing international tax framework. It is, from necessity, a rather brief format for a much larger analysis.[17] The approach taken is to detail the key features of the current international tax framework (*see* section 2.) before identifying seven challenges to this framework posed by the digital and modern economy (*see* section 3.). In section 4., the article describes the OECD/Inclusive Framework's multilateral solution in broad terms, before attempting to assess whether the new framework will adequately deal with the challenges posed by the digital economy (*see* section 5.). The conclusion reached in section 6. is that the OECD/Inclusive Framework's solution is a very positive step on the journey to a new international tax consensus that is much-needed for the 2020s and beyond.

2. How Did We Get Here?

2.1. The history of the 1920s compromise

In order to lay some foundational groundwork for the examination of the taxation of digitalized business, it is necessary to understand a little of the history of the original "1920s compromise".[18] Commentators trace the current international tax regime to the model originally developed as a result of the unification of Germany in the second half the 19th century and applied in tax treaties entered into by the predecessor states of the German Empire.[19] The first international tax treaty was concluded on 21 June 1899 between the Kingdom of Prussia and the Austro-Hungarian Empire and it dealt with the double tax issue in a way that is very familiar to us all, by allocating taxing rights to the state of domicile (which of course we now think of as residence) concerning personal taxes, and the state of source concerning business and property taxes.[20]

In the years following the First World War, the world was increasingly moving from a territorial system to a worldwide residence system of taxation and, at the same time, increasing rates of tax. This was necessary to pay for the enormous expenditure incurred by many economies around the globe. The resultant combination of juridical double tax and high tax rates led the International Chamber of Commerce (ICC) conference held in Brussels in 1920 to initiate a request to the League of Nations to address the problem of double taxation. In turn, the Financial Committee of the League of Nations asked four economists to consider the economic consequences of double taxation (from the perspective of the equitable distribution of burdens and interfering with the free flow of capital), to propose any general principles to remove the "evil consequences of double taxation" and to ascertain whether such principles were capable of application to a new international convention.[21]

It is beyond the scope of this article to discuss the history of the 1920s compromise in detail, but some key points should be made.[22] The original 1923 Report by the four economists[23] referred to previously concluded that an exemption from source taxation (i.e. pure residence-based

13. S. Fleming et al., *US Upends Global Digital Tax Plans after Pulling Out of Talks with Europe* (Fin. Times 2020), where the letters were sent to the Finance Ministers of France, Italy, Spain and the United Kingdom on 12 June 2020 (all of whom are members of governments which are keen to progress proposals to tax digital companies and which have advanced these proposals into planned or existing arrangements to introduce digital services taxation through a specific unilateral DST.
14. OECD, *Secretary-General Angel Gurría has Reacted to Recent Statements and Exchanges Regarding the Ongoing Negotiations to Address the Tax Challenges of the Digitalisation of the Economy* (OECD 2020).
15. I. Gottlieb, *U.S. Still Committed to Digital Tax Talks, OECD Tax Chief Says* (Bloomberg Tax 2020), where Saint-Amans confirmed that "the U.S. has not walked away from the negotiation, the U.S. has not pulled out". *See also* OECD, *OECD Tax Talks* (OECD 2020), where it is still expected that the G20 Finance Ministers will sign off on a developed blueprint for both Pillar I and Pillar II by October 2020.
16. KPMG, *Taxation of the Digitalized Economy: Developments Summary* (KPMG 2020), which states that 38 countries have implemented, or are seriously contemplating, unilateral direct taxes (such as DSTs, withholding taxes or digital permanent establishments (PEs)).
17. C. Elliffe, *Taxing the Digital Economy: Theory, Policy and Practice* (Cambridge U. Press 2021) (forthcoming).
18. M. Graetz & M. O'Hear, *The 'Original Intent' of US International Taxation*, 46 Duke L.J., p. 1026 (1997). This is the terminology employed by Graetz and O'Hear (1997) in their outstanding article on the history of the US tax policy and, in particular, the impact of T. Adams, a professor of economics at Yale and tax advisor to the US Treasury Department and the US Treasury's principal adviser on issues of tax policy and administration.
19. J. Hattingh, *On the Origins of Model Tax Conventions: 19th Century German Tax Treaties and Laws Concerned with the Avoidance of Double Taxation*, Studies in the History of Tax Law (J. Tiley ed., Hart Publishing 2016) and M. Evers *Tracing the Origins of the Netherlands' Tax Treaty Network*, 41 Intertax, 375 (2013).
20. S. Jogarajan, *Preclude to the International Tax Treaty Network: 1815-1914 Early Tax Treaties and the Conditions for Action*, 31 O.J.L.S. 4, p. 679 (2011).
21. G. Bruins et al., *Report on Double Taxation submitted to the Financial Committee: Economic and Financial Commission Report by the Experts on Double Taxation – Document EFS 73 F 19* (League of Nations 1924).
22. *See* Elliffe, *supra* n. 17, ch. 1.3 *The history of the 1920s compromise*, at para. 1.3.
23. Bruins et al., *supra* n. 21.

taxation) was the preferred international method, but conceded that such an outcome was unlikely, given that countries would insist on source taxation. They, therefore, proposed an allocation of taxing rights between residence and source countries, so that some items of income, such as income from rents of land, were subject to source taxation while others were not (with the result that some income would be fully subject to residence-based taxation).[24] Following on from the 1923 Report, further work was performed to thrash out a compromise between source and residence taxation.[25] An expanded group of countries were added to the group of Technical Experts[26] and developments took place of great significance including the introduction of the concept of a "permanent establishment". The consequence of all of this was that business profits in the draft bilateral convention contained in the report of the Committee of Technical Experts in 1927 (the 1927 Report) would be taxable only in the source state where they possess permanent establishments (PEs).[27] As a result, the allocation of taxing rights originally determined in the 1920s and adopted as the framework for the international tax system can best be viewed as "an arbitrary compromise, albeit one that has come to be accepted by large parts of the international community".[28]

2.2. Taxing remote sales under the 1920s compromise

How a country imposes taxation on a non-resident multinational entity conducting a highly digitalized business in another jurisdiction narrows down to the question of what taxing rights are allocated to the source jurisdiction under the current international tax framework. Digitalization allows business activities to be carried out remotely, thereby enabling a multinational business to operate in a reasonably comprehensive way in the other jurisdiction without maintaining a physical presence or triggering any of the other PE thresholds. This carrying on of a highly digitalized business includes processing, analysing and utilizing information where these processes can be performed across the border or automatically by machines. Where multi-sided platforms are concerned, the entity usually makes its money from advertising, subscription, or most commonly, commission. Even where services must be performed in the geographic location (such as, accommodation or transportation) the multi-sided platform allows the two end-users sufficient control to enable them to perform key tasks in the negotiation of the contract, provision of the goods or service, and receiving payment, often quite independently of the firm operating the platform. This situation means that the multi-sided platform firm can remain physically remote from the end-users on either side of the platform and any activities they perform. The expanding customer base which is now worldwide (distance being a limited, or no, barrier to international trade using the Internet), together with the changing roles of staff has resulted in significant disintermediation of entities based in the customers' jurisdiction. This removal of the trading entity (disintermediation removing the need for a subsidiary or branch in the source jurisdiction) has significantly diminished the utility of the traditional method, which required physical presence for imposing corporate income tax.

Corporate tax paid by non-resident companies "doing business" in a jurisdiction (with due acknowledgement of the difficulties in defining exactly what "doing business" is) is likely to be an important part of the overall tax take for most jurisdictions. Many jurisdictions take the view that the international tax framework currently does not allocate taxing rights to the source state in circumstances where the multinational is carrying on what can be described as "remote sales". In other words, that source taxing rights only arise when a multinational is trading "in" rather than trading "with" a country. This principle is well expressed in the UK's document on Corporate Tax and the Digital Economy as follows:

– The overall principle underpinning that framework is to tax a multinational group's profits in the countries in which it undertakes its value-generating activities, such as where major operating decisions are made and where important assets and risks are controlled.

– That is a principle that the government continues to support. It does not, for example, believe that another country should have a general right to tax profits that a UK business generates from a product that is designed in the UK, manufactured in the UK, marketed in the UK and then sold remotely to that country's customers.

– Equally, it does not believe that the UK should have a general right to tax the profits that a foreign business generates for a product that is designed in another country, manufactured and marketed in that country and then sold remotely to a UK consumer.[29]

If the 1920s compromise is no longer effectively operated to tax highly digitalized businesses operating in a source jurisdiction, described as the "vanishing ability to tax business profits" in the discussion of the seven challenges (*see* section 3.), perhaps, other alternatives are possible. The 19th century concept of PE could be updated with something more appropriate in light of technological developments occurring in the 21st century. One such concept which was more than flirted with by the OECD is that involving "value creation".

24. Id., at paras. 41-42.
25. League of Nations – Technical Experts from Belgium, Czechoslovakia, France, Great Britain, Italy, Netherlands and Switzerland, Double Taxation and Tax Evasion (League of Nations 1925); League of Nations – Technical Experts from Argentina, Belgium, Czechoslovakia, France, Germany, Great Britain, Italy, Japan, Netherlands, Poland, Switzerland, USA, Venezuela, Double Taxation and Tax Evasion (League of Nations 1927); and League of Nations – General Meeting of Government Experts, Double Taxation and Tax Evasion (League of Nations 1928).
26. Expanding the group from 7 to 13 members.
27. League of Nations – Technical Experts from Argentina, Belgium, Czechoslovakia, France, Germany, Great Britain, Italy, Japan, Netherlands, Poland, Switzerland, USA, Venezuela, *supra* n. 25, at para. 10.
28. M. Devereux & J. Vella, *Are We Heading Towards a Corporate Tax System Fit for the 21st Century?* (Oxford U. Ctr. Bus. Taxn. 2014).
29. HM Treasury, *Corporate Tax and the Digital Economy: Position Paper* paras. 2.4-2.6 (HM Treasury 2017).

2.3. Taxing remote sales on the economic activity and value created in the market jurisdiction?

One of the most important and significant international tax debates is the adoption by the OECD and G20 of the mantra that "the profits are taxed where economic activities take place and value is created".[30] This value creation principle originally was the touchstone for the BEPS Project and was focused on preventing harmful tax competition, protecting corporate tax and, consequently, reducing (if not eliminating) aggressive tax planning by multinationals.

The European Commission expressed its view on this debate as follows:

> The application of the current corporate tax rules to the digital economy has led to a misalignment between the place where the profits are taxed and the place where value is created. In particular, the current rules no longer fit the present context where online trading across borders with no physical presence has been facilitated, where businesses largely rely on hard to value intangible assets, and where user generated content and data collection have become core activities for the value creation of digital businesses.[31]

Here, the European Commission is articulating the commonly held view that the international tax rules are no longer "fit for purpose". These views are largely shared by many other countries including Australia,[32] New Zealand[33] and the United Kingdom.[34]

Moving value creation from the touchstone of the BEPS Project to becoming a guiding principle for taxing corporate profits has been criticized because it is a principle that has neither been widely agreed nor properly considered.[35] Commentators have justifiably criticized value creation for its vagueness and imprecision,[36] while, at the same time, pointing out that it could permit market or source countries to claim a share of the tax base if the impact of the market's consumer supply-based factors forms part of the creation of value, together with other infrastructural aspects such as the legal, physical and technological framework for doing business is considered. This situation is why Devereux and Vella (2017) argue, and they must be right, that it is not logical to, on the one hand, say that taxation should take place where value is created, and on the other, support the proposition that remote sales can never result in value being created in the source state.[37]

2.4. Radical new taxing rights allocated to the market jurisdiction – Introducing the 2020s compromise

The majority of countries have conventionally seen the existing rules on international tax leave remote sales as outside the scope of source-based taxation for foreign-owned entities. It is, therefore, a truly radical step to propose new taxing rights to the market jurisdiction. The current thinking from the OECD, however, does exactly that and indicates that a new consensus may arise which would allocate more taxing rights to the jurisdiction of the consumer and/or the user:

> ... in situations where value is created by business activity through (possibly remote) participation in that jurisdiction that is not recognised in the current framework for allocating profits.[38]

The current OECD/Inclusive Framework proposal suggests that a new taxing right may emerge for market or source countries simply because of the presence of the customer and/or the digital user in the market jurisdiction. The most profound change in the 2020s compromise is, therefore, a movement towards destination-based taxation arising from an allocation of residual profit of an MNE to the marketplace or source jurisdiction.[39] This article briefly discusses how these new rules operate (*see* section 4.), but, to evaluate them, it is first necessary to identify the major problems and challenges of the existing international tax framework (*see* section 3.).

3. The Seven Big Problems with the 1920s Compromise

3.1. Introductory remarks

3.1.1. In general

This discussion identifies seven big problems with the 1920s compromise (*see* sections 3.1.2. to 3.1.8.).[40] Not all these issues are exclusively concerned with the digital

30. OECD, *OECD/G20: Base Erosion and Profit Shifting Project Explanatory Statement* p. 1 (OECD 2015).
31. European Commission, Proposal for a Council Directive Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence, COM(2018) 147 final, Primary Sources IBFD.
32. AU: Treasury of Australia, The Digital Economy and Australia's Corporate Tax System para. 2.2 (2018), where the discussion recognizes that foreign businesses have for decades operated business models where a majority of profit-generating assets and labour have been located offshore, but notes that "... increasing digitalisation an increasingly mobile intangible assets intensify this challenge, particularly in the sectors of the economy most affected by Digital disruption".
33. NZ: New Zealand Inland Revenue Department (NZIRD), Options for Taxing the Digital Economy: A Government Discussion Document [1.4] (Policy and Strategy of Inland Revenue 2019), which states that "the digital economy provides many benefits to New Zealanders, and it is an important source of future growth for the country. However, it is under-taxation impacts the sustainability of Government revenues in the fairness of the tax system. It also distorts investment in favour of digital multinationals, which pay lower worldwide income tax compared with other industries."
34. HM Treasury, *supra* n. 29, at [4.2], which states that "There needs to be broad international acceptance of the need to address the challenges that digital businesses create for the tax system and agreement on a process and timetable for achieving meaningful reform of the international tax framework".
35. M. Devereux & J. Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System* (Oxford U. Ctr. Bus. Taxn. 2017).
36. J. Hey, *"Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative*, 72 Bull. Intl. Taxn. 4/5, sec. 2 (2018), Journal Articles & Papers IBFD, S.C. Morse, *Value Creation: A Standard in Search of a Process*, 72 Bull. Intl. Taxn. 4/5, sec. 2 (2018), Journal Articles & Papers IBFD, A.J. Martin Jimenez, *Value Creation: A Guiding Light for the Interpretation of Tax Treaties?*, 74 Bull. Intl. Taxn. 4/5 (2020), Journal Articles & Papers IBFD, R.M.Kysar, *Value Creation: A Dimming Lodestar for International Taxation?*, 74 Bull. Intl. Taxn. 4/5 (2020), Journal Articles & Papers IBFD.
37. Devereux & Vella, *supra* n. 35.
38. OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* p. 23 (OECD 2019) [hereinafter *Programme of Work for the Tax Challenges Arising from the Digitalisation of the Economy*].
39. That is, taxation in the place of destination rather than taxation in the place of origin.
40. It is immediately conceded that there might be more, or less, than these seven challenges. Nonetheless, *see* as discussed in Elliffe, *supra* n. 17, at ch. 3.

economy. Some have been simmering away for some considerable time. Correctly, the OECD has adopted quite a broad approach in their proposals for tax reform. It is not just a case of the OECD Secretariat attempting to deal just with the consequences of the digitalization of business in isolation from other parts of the modern economy. Rather, a key conclusion from the OECD's work is that:

> ... because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes.[41]

Recognizing that it is not possible to ring-fence the digital economy means that changes to the tax system of the 1920s compromise might need to be much broader than just focusing on multi-sided platforms and remote sales. Business already uses technology to a greater or lesser extent, but there is an increasing trend to utilize highly digitalized business models. For instance, and there are many examples, take the way airlines carry on the business. They provide a classic service of passenger travel, i.e. physically carrying people. This is not, at least at this stage, remotely digital. Their booking services, however, together with ticketing, boarding passes, pricing, luggage and loyalty schemes all employ highly digitalized features. Airlines also use multi-sided platforms to enable users to book other services, such as hotel accommodation, the rental of cars, parking and taxis, none of which are directly provided by themselves. This is a good example of a modern business integrating traditional services and multi-sided platforms that can enable remote sales and the generation of income without physical presence. There is no limitation on the possibility of connecting customers on one side of the multi-sided platform (passengers booking airline tickets) to service or goods providers on the other side of the platform (hotel accommodation providers).

3.1.2. The first challenge: The vanishing ability to tax business profits

The vanishing ability to tax business profits is a compound challenge. It can be split into two components. The first is one of nexus or taxing rights. Without a taxable presence in a jurisdiction, there is no taxation under existing rules. The second component concerns the allocation of income. Even if the first challenge is overcome, it is important that a fair allocation of income occurs, so that the source or market jurisdiction receives a sensible allocation of income. As discussed in sections 2.1. and 2.2., the commonly held view is that the PE definition has not kept pace with technological developments, and that a 19th-century concept is not fit for purpose in the 21st century.[42]

The first component of this challenge, namely establishing a nexus to a taxable presence, is that digitalization allows business activities to be carried out remotely, thereby enabling a multinational business to operate in a reasonably comprehensive way in a jurisdiction without maintaining a physical presence or triggering any of the other PE thresholds. This situation of carrying on business includes processing, analysing and utilizing information where these processes can be performed across the border or by machines automatically. The expanding customer base that is now worldwide (distance being a limited, or no, barrier to international trade using the Internet) together with the changing roles of staff has led to significant disintermediation of entities based in the customers' jurisdiction. This removal of the trading entity (disintermediation removing the need for a subsidiary or branch in the source jurisdiction) has significantly removed the traditional method of establishing a taxable nexus, which required physical presence for imposing corporate income tax. As is described in section 4., under the OECD/Inclusive Framework's Pillar I, a new taxing right (or nexus) will be established that allocates part of the residual profit of an MNE to the market jurisdiction.

Unlike the nexus issue, the second part of the challenge posed by the vanishing ability to tax business profits is not caused by a gap in the existing rules (which is one way to view the lack of physical presence and/or PE threshold problem), but more with a concern with the current international tax framework rules concerning the allocation of profits. The allocation of profits is a twofold issue. The first and most difficult problem is trying to work out how much profit should be allocated to the market jurisdiction in respect of activities carried on by the multinational there. This is relatively uncharted territory if, and when, there is a new taxing right deemed under the introduction of the new Pillar I nexus rules. Furthermore, as this new taxing right is introduced, it is also necessary to ensure that the existing rules work adequately to address the second problem, which is ensuring that adequate profits are allocated to the market jurisdiction.

The problem can be illustrated as follows, insofar as the current transfer pricing regime allocates profits to low-risk distributing entities. An MNE with a highly digitalized model has been making remote sales to a large consumer market. Concerned about the tax risk associated with their structure and the possibility of attack under expanded definitions of PE and the amendments to the PE article brought about by Action 7 of the BEPS Action Plan,[43] the multinational restructures and establishes a limited-risk distributor (LRD) in the large consumer jurisdiction. This local affiliate is structured so is to have no ownership interest in intangible assets, does not perform development, enhancement, maintenance, protection and exploitation (DEMPE) functions, and does not assume any risks related to assets. A modest allocation of profit is allocated to this LRD entity.[44] It can immediately be seen that addressing the nexus problem through

41. OECD, *Action 1 Final Report* (2015), *supra* n. 9, at p. 11.
42. W. Schön, *Ten Questions about Why and How to Tax the Digitalized Economy*, 72 Bull. Intl. Taxn. 4/5, sec. 1 (2018), Journal Articles & Papers IBFD.
43. *See* OECD, *Action 7 Final Report 2015 - Preventing the Artificial Avoidance of Permanent Establishment Status* (OECD 2015), Primary Sources IBFD.
44. *See* OECD, Base Erosion and Profit Shifting Project, Public Consultation Document, *Addressing the Tax Challenges of the Digitalisation of the Economy*, 13 Feb. 2019, at para. 13, p. 9, for the description of the issue.

the allocation of an Amount A[45] must be supported by actions to deal with the allocation of profits to entities such as LRDs (referred to subsequently as "the restructuring risk"), but the issue is more fundamental, namely how much profit do you attribute to the activities carried on in the market jurisdiction? In other words, it is necessary to consider both the restructuring risk and a sensible basis for determining the fundamental taxing right so that the correct amount of profits is allocated to the market jurisdiction in circumstances in which there is activity over a certain threshold, thereby justifying taxation.

3.1.3. The second challenge: The use of data, the contribution of users, and the measurement of their value

How data is used and the contributions of users in highly digitalized businesses are a critical part of such businesses. This challenge is one of the most "specifically" digital challenges and it is (at least) three phenomena which are all interconnected. The first is the use of data. Technology permits the remote collection, storage and use of data. Sometimes, this is subject to analysis or analytics and can occur directly with the user or indirectly through a third party. This situation can sometimes be with either the express consent of the user or sometimes the consent is implicit. However it is collected, the use of data has enabled highly digitalized MNEs to deliver superior customer experiences. The best example of this is a highly targeted advertising to those people who have identified themselves through their data as "great targets" for the product or service of the advertiser.

Integral to the capture and use of data is the role of the user which is the second aspect of this challenge. The activities undertaken by users have been a particular feature of some of the already implemented or planned DSTs. Some jurisdictions implementing DSTs have regarded the participation of the user as a critical part of the digital services model. This is because, in many cases, such users are not under the control of the multi-sided platform but operating independently, and yet they are still:

- contributing to the creation of the brand of the multi-sided platform (examples of this include quality reviews, feedback and endorsements);
- generating valuable data through their active interaction and depth of engagement with the platform; and
- expanding the customer base through their social networks, which has the effect of increasing potential users while reducing marginal costs (also known as the direct and indirect network effects).

Finally, the third part of this challenge is the difficulty in measuring what profits or value are created by these activities. Considerable complexity and uncertainty exist in this matter. Lines have been drawn between active and passive users, and some academics have helpfully commented on this.[46] In the design of the UK government's DST, for example, they excluded the mere collection of data from the scope of the tax preferring to concentrate on more active user participation and the depth of engagement of users.[47]

3.1.4. The third challenge: The reliance on, and mobility of, intellectual property

The enormous growth in many highly digitalized businesses, according to Schön (2018), is attributable to two major factors.[48] The first factor is the economies of scale created by these businesses particularly, as it relates to the network effect. Often this is achieved through the role of user participation in the business, which is discussed in section 3.1.3. The second major factor is the use of, or reliance on, intellectual property (IP), which is used to analyse data and create complex algorithms (a process or set of rules to be followed in calculations or other problem-solving operations). Using IP in this way to process information enables highly digitalized (and other) businesses to interact with customers in a tailored and individually responsive way. The problem from a tax perspective is that this IP is extremely hard to value and can be transferred from one jurisdiction to another without a great deal of legal, financial or physical effort.

This is very problematic from a tax perspective and leads Schön to observe that:

> multinational firms are therefore able to choose at will the location of central functions and value drivers, including jurisdictions which are neither the country where the ultimate consumer resides nor the country where the parent company is resident.[49]

The obvious tax consequence is that IP is located in, and sometimes moved to, entities based in low- and/or no-tax jurisdictions within the multinational group. As a consequence of the relocation of this, IP profits are shifted to such favourable tax jurisdictions.

3.1.5. The fourth challenge: The characterization of transactions and income

This challenge recognizes that many new digital products and services have a question mark over their classification and this characterization is frequently both a matter of domestic law and the definition of various categories contained in the relevant treaty. This is a broader challenge than might be first imagined. For example, the income of people called "influencers" could be characterized as business profits or income to which article 17 might apply with

45. *See* OECD, *Public Consultation Document Secretariat Proposal for a 'Unified Approach' Under Pillar One* (OECD 2019) [hereinafter *Public Consultation Document: 'Unified Approach' Under Pillar One*], where Amount A is an amount of taxable income allocated to the market jurisdiction under the proposals contained in Pillar I of the OECD/ Inclusive Framework's "Unified Approach" described in greater detail in section 5.

46. J. Becker & J. Englisch, *Taxing Where Value Is Created: What's 'User Involvement' Got to Do with It?*, 47 Intertax. 2, p. 162 (2019).

47. HM Treasury, *Corporate Tax and the Digital Economy: Position Paper Update* paras. 2.37-2.40. (HM Treasury Mar. 2018).

48. Schön, *supra* n. 42, at p. 278.

49. Id.

dramatically different tax consequences.[50] Even if special domestic law provisions or special treaty outcomes, such as those provided in article 17, do not apply, the more ordinary business income outcomes may not be straightforward. Accordingly, transactions might be classified as business profits (if they are regarded as the provision of goods or services), technical services (in which case some treaties may regard them in a special category as royalties, or in the alternative as ordinary services and so business profits) or royalties (this is particularly the case where the treaties define royalties to include payments for the rental of commercial, industrial or scientific equipment).

The tax treatment for these various types of characterization differs enormously. Business profits, under the 1920s compromise, are not taxable in the source state unless there is a PE. Royalties may have domestic withholding taxes applied, but they are conventionally deductible. Technical services may fall into either category (business profits or royalties) depending on both the domestic law and treaty analysis. As the OECD discussed in the 2015 Final Report on Action 1 Addressing the Tax Challenges of the Digital Economy,[51] there is a need for a careful examination of the rationale behind existing rules to ensure that there is not an arbitrary tax outcome for substantially similar transactions.

3.1.6. The fifth challenge: The failure of transfer pricing with certain MNEs and their transactions

The suitability of the transfer pricing regimes around the world was a key part of the BEPS Project. The Final Report on BEPS Actions 8-10[52] contained nearly 200 pages of revisions to the OECD Transfer Pricing Guidelines.[53] Despite these substantial revisions, the overriding impression is that the changes to the transfer pricing rules post BEPS still leave much to be desired. Oosterhuis and Parsons (2018) describe the application of the arm's length standard (ALS) as "plagued with difficulties and weaknesses".[54] The complexity and sustainability of the changes have been questioned,[55] their susceptibility to controversy,[56] as, indeed, has the fundamental nature of separate entity accounting (inherent in the ALS) for its inability to "attribute the effects of integration and synergies".[57]

At the heart of these concerns is the fact that MNEs that employ complex value chain structures generate profits beyond those that an independent, arm's length and separate entity approach would realize. As a result, the profits attributable to such synergies and economic rents created from such sophisticated ways of doing business cannot be allocated under the traditional arm's length principle (ALP) and, additionally, there are no arm's length entities to allocate them to.

This breakdown of the ability to allocate profits is the theoretical problem, but the practical issue is equally problematic. Many countries, particularly in the developing world, are deeply distrustful of the methodology regarding it more as an art than a science, and one that they do not have the tools to interpret accurately. The costs involved in administering the regime and managing disputes are rapidly rising. Consequently, the likelihood of disputes and significant costs arising to both taxpayers and administrations is high.

There are concerns in many countries about the required expertise, databases and experience in dealing with complex transfer pricing matters. There are numerous transfer pricing problems particularly dealing with highly digitalized businesses, but the concern is broader than the digital economy.

3.1.7. The sixth challenge: The inadequacy of residence-based taxation

The failure of source taxation to adequately deal with the carrying on of digitalized businesses in a jurisdiction without establishing a nexus and, therefore, a taxable presence (*see* section 3.1.2.) can be compounded by the inadequacy of residence-based taxation. Challenges created by problems in residence taxation include, first, the mobility and ease of establishing corporate residence.

International tax planning has relied, in part, on the ability to create subsidiary companies located in favourable tax jurisdictions. With careful attention to detail, it has been possible to establish such tax residence for both domestic and tax treaty purposes. Tests, like incorporation, central management and directorial control, are a mixture of formal and factual elements, which are often somewhat arbitrary and certainly capable of manipulation. Such residency requirements are sometimes curiously difficult to administer in practice, especially when there is a breakdown in communication between the tax director of a company and other management, thereby resulting in unexpected outcomes and unanticipated tax risks. The usual dual resident tie-breaker test – the effective place of management – has also been the subject of criticism for its ambiguity and lack of precision.[58] Coupled with the challenges of taxing digitalized businesses in source countries due to a lack of nexus, it is easy to see why Action 1 was such a controversial and political touchstone. Multinationals operating a digital business can organize

50. S. Kostikidis, *Influencer Income and Tax Treaties*, 74 Bull. Intl. Taxn. 6 (2020), Journal Articles & Papers IBFD.
51. OECD, *Action 1 Final Report* (2015), *supra* n. 9, at para. 272.
52. OECD, *Action 8-10 Final Report 2015 – Aligning Transfer Pricing Outcomes with Value Creation* (OECD 2015), Primary Sources IBFD.
53. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), Primary Sources IBFD.
54. P. Oosterhuis & A. Parsons, *Destination-Based Income Taxation: Neither Principled nor Practical?*, 71 Tax. L. Rev. p. 529 (2018), where they state that "For example, the challenge of accurately pricing intangibles, the fact that the arm's-length standard does not account for efficiencies that are achieved when transactions occur on an intercompany rather than third-party basis (as described by Coase), as well as the overall complexity of applying the arm's-length standard, have each week in the application of the standard".
55. For greater detail, *see* R. Collier & J.L. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS* chs. 7 and 8 (Oxford U. Press 2017).
56. J. Andrus & P. Oosterhuis, *Transfer Pricing After BEPS: Where Are We and Where Should We Be Going,* TAXES Tax Mag., p. 104 (2017).
57. Hey, *supra* n. 36, at sec. 2.5.
58. J.F. Avery Jones, *2008 OECD Model: place of effective management - what one can learn from the history*, 63 Bull. Intl. Taxn. 5 (2009), Journal Articles & Papers IBFD.

themselves so that they have historically been able to pay tax in a low-tax jurisdiction through the use of subsidiaries resident in that jurisdiction.

Second, the ability to separate shareholder taxation from corporate taxation exposes another inadequacy in residence-based taxation. Nearly all jurisdictions impose tax on a company as separate income from the tax on distributions made to the shareholders. The reason for this is that if tax was not imposed at the corporate level there would be very limited tax paid. Although most jurisdictions provide for some form of integration or relief, corporate tax remains as a very significant contribution to total tax in the business area.[59] The challenge arising from this separation of taxation is linked to the first point noted previously in this section. If shareholders are not subject to tax on the profits made by the company, it is possible to ensure that there is substantial deferral. Before the recent changes in international taxation in the United States, US-based multinationals could aggregate their foreign subsidiaries earnings in relatively low-tax jurisdictions without further US taxation. In many respects, much of the BEPS Project was focused on multinationals carrying out such activities. One important mechanism to overcome this challenge is the use of controlled foreign companies (CFC) regimes, which can attribute profits from a company to shareholders.[60]

The 1920s compromise enabled large digital multinationals to establish entities – usually subsidiaries – in low- and/or no-tax jurisdictions to derive profits, which were neither taxed by the country of source (no nexus), nor the country of residence of the corporation (low or no tax in that jurisdiction), nor the country of residence of the shareholders of the corporation (because of the inadequacy of CFC rules). The issues concerning residence-based taxation have been present for a significant time. So, while only the first part of this triple tax phenomena (the lack of source taxation) owes much to the digital economy, the growth in highly digitalized businesses has made the remaining two residence tax issues (residence of company and shareholders) more important than they have traditionally been.

3.1.8. The seventh challenge: Competition by states

It is easy to lose sight of an important problem with the existing international tax framework. Countries can, and do, compete with one another to attract economic activity and, sometimes, to favour domestic businesses. The problem that the BEPS Project sought to address, was in part due to the active competition of countries to attract or retain investment and in some cases, tolerance towards legitimate, if aggressive, tax planning. For instance, listed amongst a category of major BEPS risks in the area of direct taxation in the analysis by the Directorate-General for Internal Policies which was requested by the European Parliament's Special Committee on Tax Rulings, are the preferential tax regimes, including patent boxes and tax rulings.[61] This study notes:

> The fact that governments create incentives and mismatching opportunities in their fiscal policies as seen by some as "healthy" tax competition by MNEs and they believe that only tax harmonisation would bring an end to it. As investors expect MNEs to maximise their post-tax earnings (and not pre-tax earnings), they find it natural that MNEs are responding to government's incentives.[62]

The BEPS Project has seen greater cooperation from a very large number of countries who are members of the OECD/Inclusive Framework, but consistent with the preceding observation and the advice to the European Parliament are the comments written by Devereux and Vella (2014) as follows:

> If countries acting in their own interests believe that they have an incentive to undermine the international consensus, then that international consensus cannot provide a stable long-run system. There is ample evidence that countries have been doing precisely that. Furthermore, quite beyond the current uncertainty surrounding the outcome of the OECD BEPS initiative, even if it is successful in its own terms the BEPS initiative will not eliminate these competitive forces.[63]

It seems obvious and clear that these issues of competition and the possibility of undermining international consensus remain relevant in the current project to reform potential changes to the nexus and profit allocation rules. The OECD and the G20 are leading this project and attempting to manage members of the OECD/Inclusive Framework to undertake a coherent and concurrent review of:

> the profit allocation and nexus rules that would consider the impacts of digitalization on the economy, relating to the principle of aligning profits with underlying economic activities and value creation.[64]

It does seem as though there has been some evidence of greater cooperation amongst the approximately 130 members of the OECD/Inclusive Framework but the challenges are numerous. In addition to the important technical work carried out by the OECD, there is a level of political engagement and endorsement which go beyond these technical issues and "will have an impact on revenues and the overall balance of taxing rights".[65] Any proposals and developments are made by the OECD on a "without prejudice" basis[66] meaning that there is a great deal of "wait and see" by members of the OECD/G20 and the OECD/Inclusive Framework.

Tax competition by states is not necessarily seen as a problem by all people. It is seen sometimes as a healthy opportunity to attract investment to a jurisdiction, thereby

59. R.J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 World Tax J. 3, sec. 2.2. and app. Pt. I (2010), Journal Articles & Papers IBFD.
60. OECD, *Action 3 Final Report 2015 - Designing Effective Controlled Foreign Company Rules* (OECD 2015), Primary Sources IBFD.
61. European Parliament, Directorate General for Internal Policies, Tax Challenges in the Digital Economy sec. 3.4.1 (European Parliament 2016).
62. Id., at p. 29.
63. Devereux & Vella, *supra* n. 28.
64. OECD, *Tax Challenges Arising from Digitalisation – Interim Report* (2018), *supra* n. 11, at para. 397.
65. OECD, *Programme of Work for the Tax Challenges Arising from the Digitalisation of the Economy*, *supra* n. 38.
66. OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note* (OECD 2019), as approved by Inclusive Framework on BEPS [hereinafter *Digitalisation of the Economy – Policy Note*].

resulting in improving productive capacity, infrastructure, skills and output. When taken to its logical conclusion, however, tax competition can present the risk of the "race to the bottom" in corporate tax revenues. This situation necessarily means that the financial requirements of the state would need to come from other sources, such as consumption taxes, capital taxes and income taxes connected with labour and individual residence.[67] From the perspective of a so-called international tax framework, tax competition is a potentially destructive force because it does not encourage harmonization or consistency.

3.2. Interim conclusion

The seven challenges outlined in sections 3.1.2. to 3.1.8. represent, in the author's opinion, those residual issues remaining largely unresolved post the initial BEPS Project. Whether they are a complete list or whether they are more, or less, serious than described is debatable, of course. What is agreed, by the OECD/Inclusive Framework at least, is that the 1920s compromise requires some further work and they are working towards a consensus-based long-term solution in the form of what might be described logically as "the 2020s compromise".

The OECD/Inclusive Framework approved a Policy Note on 23 January 2019, which advanced two proposals ("Pillars"), both on a "without prejudice" basis:[68]

(1) Pillar I addresses the broader challenges of the digitalized economy and focuses on the allocation of taxing rights. In order to do this, there is a need to review the profit allocation and nexus rules, while raising questions of where tax should be paid (and how much) in a world where enterprises can be heavily involved in the economic life of a jurisdiction without significant physical presence.

(2) Pillar II looks at the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with the ability to tax when income has been allocated (or diverted) to a jurisdiction which has a lower rate of tax.

Section 4. outlines the key elements of the 2020s compromise.

4. The OECD's Multilateral Solution in a Nutshell

4.1. Introductory remarks

The 2020s compromise is referred to by the OECD as the "unified approach" because none of the three options proposed in the Public Consultation Document could be agreed on, but it draws upon elements of each of these three alternatives.[69] The 2020s compromise has new nexus rules, thereby eliminating the requirement that it is necessary to have a physical presence in a jurisdiction to establish a taxing right. It also has new profit allocation rules made up of a three-tier combination of amounts developed in Pillar I (called, perhaps unimaginatively, Amounts A, B, and C). These components are related only by the fact that they are part of the same international tax compromise agreement and that they are designed to operate together as a new framework. Consequently, the three components of Pillar I (*see* section 4.2.) and the rules in Pillar II (*see* section 4.3.) are aimed at different features of the international tax system.

4.2. Pillar I

4.2.1. Opening comments

Pillar I is considered first. Amount A is the most controversial and it is focused on providing a solution to the existing problem in the 1920s compromise which has been highlighted by highly digitalized businesses such as multi-sided platforms. Accordingly, Amount A (*see* section 4.2.2.) breaks new ground in proposing new taxing rights without the requirement of physical presence in the source or market jurisdiction. Amounts B (*see* section 4.2.3.) and C (*see* section 4.2.4.) continue to require a taxable physical presence in the source jurisdiction, which has long been the case under the existing international tax framework.[70]

4.2.2. What is Amount A?

Amount A will apply to both highly digitalized businesses and consumer-facing businesses. Highly digitalized businesses are those "that provide automated and standardised digital services to a large and global customer or user base".[71] Such highly digitalized businesses provide their services to customers remotely using little or no local infrastructure or physical presence. The second group of "in scope" businesses are those businesses that generate revenues from selling goods or services, directly or indirectly, to consumers. These are known as "consumer-facing businesses", but, under the OECD/Inclusive Framework's statement of January 2020, this group of businesses is now separated from the highly digitalized group referred to above.[72] These businesses are more traditional, less affected and disrupted by digitalization. They manufacture and sell products through physical distribution channels as they have done for many decades. In order to enhance their business offering, these businesses increasingly use "digital technology to more heavily interact and engage with their customer base".[73] Accordingly,

67. Assuming the expenditure is consistent between years and ignoring the effect of the government borrowing.
68. OECD, *Digitalisation of the Economy – Policy Note*, *supra* n. 66.
69. R. Collier, *Public Consultation Meeting on the Secretariat Proposal for a 'Unified Approach' under Pillar One* (discussion by Richard Collier presented to an OECD Public Conference 2019) and OECD, *Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy* [11] (OECD 2019), Primary Sources IBFD [hereinafter *Consultation Addressing the Tax Challenges of the Digitalisation of the Economy*]. The three options proposed on 13 February 2019 referred to by R. Collier in the public consultation were the "user participation", "marketing intangibles" and the "significant economic presence" proposals.
70. OECD, *Public Consultation Document: 'Unified Approach' Under Pillar One*, *supra* n. 45, at para. 50.
71. 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* para. 18 (OECD 2020) [hereinafter *Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy*].
72. Id., at paras. 18-19.
73. Id., at para. 19.

these consumer-facing businesses focus on building and sustaining relationships with individual customers, targeting their marketing and branding to these customers, frequently by collecting and exploiting individual customer data.

These in-scope businesses will have a share of deemed residual profit allocated to market jurisdictions using a formulaic approach, i.e. the new taxing right. This is calculated using the following four steps:

(1) Identify the multinational group's profits:[74] these profits are expected to be drawn from the consolidated group financial accounts.

(2) Separate out the amount of profits attributable to routine functions:[75] this is performed using an approach broadly consistent with rewarding routine functions performed under the residual profit split method in conventional transfer pricing.

(3) Attribute a portion of the non-routine profits to the market jurisdiction:[76] after identifying the portion of routine profits in step two, the non-routine profits (sometimes described as residual profits) are divided up, so that factors attributable to the marketplace receive part of the non-routine profits. These factors include marketing intangibles (brand and customer loyalty, customer lists, customer data and elements related to the consumer relationship and factors associated with users' engagement, contribution and network effect). The portion of non-routine profits attributable to other factors, such as trade intangibles, capital and risk would not be included within Amount A.

(4) Allocate the deemed income based on the non-routine profits attributable to market jurisdictions to those eligible jurisdictions:[77] the final step in the calculation of Amount A involves allocating the non-routine profits attributable to market jurisdictions to the various jurisdictions based on factors, such as sales. In other words, if a company makes 15% of its worldwide sales in a certain country, that country would receive 15% of the non-routine profits attributable to market jurisdictions.

As can be seen from the foregoing four steps, Amount A is, therefore, a new taxing right over a portion of the "in-scope" deemed non-routine or residual profits of multinational groups. The existing international tax framework rules (the 1920s compromise) will apply to the deemed routine profits applicable to the activities performed by the companies in the countries concerned.

There are several very innovative features to the new "2020 international tax compromise" concerning the deemed income under Amount A. These include:

– The creation of a new taxing right which reaches into the market jurisdiction and reflects activities (to do with marketing intangibles and the user base) carried on by certain businesses in that jurisdiction: this is a fundamental change from the position reached in the OECD Model[78] as a result of the 1920s compromise (taxation rights did not extend to the market on the sale of goods and services, but were essentially retained by the country of residence and production).

– The consequential need to change the nexus requirements for taxation so that the aforementioned new taxing right could be established, even in the absence of any physical presence in the market jurisdiction: this enables the taxation of remote sales of goods and services.

– The starting point of the multinational groups consolidated profits: this is a fundamental difference as previously the international tax system has operated on a strict separate entity accounting system attributing worldwide profits to particular entities (mostly companies) in the multinational group located in particular jurisdictions.

– The use of formulas and agreed proportions to allocate taxing rights rather than individual arm's length computations: for example, as previously detailed in the four-step process, there is a split between routine and non-routine profits, which will be agreed (perhaps on an industry by industry basis) as part of the new consensus. This purports to be broadly analogous to the existing transfer pricing rules concerning routine profits and, in that sense, attempts to keep a status quo with existing international transfer pricing rules. The use of agreed percentages is, however, an innovative and controversial measure, but if it can be implemented it should be possible to see significant improvement in reduced international compliance costs for business, easier administration by tax authorities and the possibility of a better regime for dispute resolution.

4.2.3. What is Amount B?

The second component in the OECD/Inclusive Framework's Statement and the OECD Secretariat's Proposal is also controversial but for different reasons. This part of the proposal suggests making a new fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction. The fixed return reduces compliance costs and provides certainty, thereby benefiting taxpayers and tax administrations and reducing the risk of double taxation. In essence, the quantum of income calculated under Amount B is a fixed return on

74. OECD, *Public Consultation Document: 'Unified Approach' Under Pillar One*, *supra* n. 45, at para. 53. Largely confirmed in OECD, *Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy*, *supra* n. 71, at para. 43.
75. OECD, *Public Consultation Document: 'Unified Approach' Under Pillar One*, *supra* n. 45, at para. 54.
76. Id., at para. 57.
77. Id., at para. 60.
78. Most recently *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Treaties & Models IBFD.

either sales or earnings before tax. It is a matter of negotiation with the OECD Secretariat Proposal suggesting:

> Whilst the distinction between marketing and distribution activities and others performed by an MNE group will, in most cases, be clear, there will be some borderline issues. Therefore, a clear definition of the activities that qualify for the fixed return would be required. The quantum of the fixed return could be determined in a variety of ways: it could be (1) a single fixed percentage; (2) a fixed percentage that varied by industry and/ or region; or (3) some other agreed method.[79]

It is also suggested by the OECD Secretariat Proposal that the use of this simpler formulaic approach, while still being broadly consistent with the ALP and the existing calculation of profits under article 7 of the OECD Model, would overcome some of the areas where tension has increased.[80] The tensions are different for Amount A and Amount B. In the case of the former, it is an intense pressure caused by non-taxation for remote highly digitalized activities. In the latter, the tensions are concerned with the lack of precision in transfer pricing and the consequential disputes arising.

4.2.4. *What is Amount C?*[81]

The final component in the unified approach can be regarded as a "top-up" to "correct" the outcome arrived at through the application of Amount B in situations where Amount B has been too arbitrary resulting in an unacceptable position from an arm's length perspective. Amount C, therefore, allows taxpayers and tax administrations to retain:

> the ability to argue that the marketing and distribution functions taking place in the market jurisdiction go beyond the baseline level of functionality and, therefore, warrant a profit above the fixed return contemplated under Amount B.[82]

4.3. Pillar II

4.3.1. *Opening comments*

Pillar II of the OECD's Programme of Work,[83] which was adopted by the OECD/Inclusive Framework on BEPS at its meeting of 28 and 29 May 2019,[84] focuses on unresolved base erosion and profit shifting issues.[85] Even after the comprehensive reforms proposed by the BEPS Project there was a desire amongst members of the OECD/Inclusive Framework to go further to combat the continued risk of profit shifting to entities subject to no or very low taxation. Accordingly, in the Policy Note approved by the OECD/Inclusive Framework, an agreement was reached:

> ... to explore on a "without prejudice" basis taxing rights that would strengthen the ability of jurisdictions to tax profits with the other jurisdiction with taxing rights supplies a low effective rate of tax to those profits.[86]

The Policy Note highlights that the tax issues concerning problems arising from the rapidly growing digitalized economy are more than the allocation of taxing rights between residence and source countries, which is the primary focus of Pillar I, but extends into the "larger landscape"[87] picture where multinationals have been legitimately structuring their affairs to take advantage of no or very low taxation. Under Pillar II, the continued risk of profit shifting is countered through two new (but interrelated) rules which:

> provide jurisdictions with the right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of affective taxation.[88]

These new rules include an income inclusion rule and a tax on base eroding payments.

4.3.2. *The income inclusion rule*

The income inclusion rule extends residence-based taxation, so that the income of a foreign branch or a controlled entity becomes subject to tax in circumstances where the effective rate of tax in the source jurisdiction is below a minimum rate. In broad terms, it is envisaged that the income inclusion rule would operate as a minimum tax. It is also envisaged that it would operate in a similar, but supplementary, way to a jurisdiction's CFC rules. A shareholder in a foreign corporation that was not subject to an effective rate of tax above a minimum rate would be required to "top up" their proportionate share of the underlying foreign corporation's profits.

The effect of the income inclusion rule is to ensure that the income of the multinational group is subject to tax at a minimum rate which reduces the incentive for the group to allocate profits for tax reasons to low-tax entities. As a result, according to the Pillar II Public Consultation document:

> The income inclusion rule would have the effect of protecting the tax base of the parent jurisdiction as well as other jurisdictions where the group operates by reducing the incentive to put in place intra-group financing, such as thick capitalisation, or other planning structures that shift profit to those group entities that are taxed at an effective rate of tax below the minimum rate.[89]

4.3.3. *Base erosion payments*

The proposed second new rule is a tax on base eroding payments. Broadly, these types of rules operate to reduce the risk of tax-free deductible payments being made from a jurisdiction to another related party in a low-tax jurisdic-

79. OECD, *Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy*, *supra* n. 71, at para. 63.
80. Id., at para. 18.
81. Please read this component with some care and attention to current announcements as, according to R. Finley & S. Soong Johnston, *New Detail on OECD's Pillar 1 Proposal Emerges in Draft Report,* Tax Notes Int'l, 6 Aug. 2020, the draft Pillar One blueprint report does away with the concept of Amount C due to a potential for double counting income.
82. Id., at para. 30.
83. OECD, *Tax Challenges Arising from Digitalisation – Interim Report* (2018), *supra* n. 11.
84. Subsequently approved by the G20 Finance Ministers and Leaders at their respective meetings in Japan in June 2019.
85. OECD, *Digitalisation of the Economy - Policy Note*, *supra* n. 66, at para. 1.2, as approved by Inclusive Framework on BEPS on 23 January 2019.
86. Id.
87. Id.
88. OECD, *Tax Challenges Arising from Digitalisation – Interim Report* (2018), *supra* n. 11, at para. 7.
89. OECD, *Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two Public consultation document* para. 11 (OECD 2019).

tion. Existing examples of such rules are those contained in many domestic rules dealing with thin capitalization, interest allocation and earnings stripping regimes, all of which are designed to place limitations on the amount of interest income allowable as an expense in the jurisdiction of the paying entity.

These proposals are broader and they contemplate two components:

(1) An undertaxed payments rule: this rule would either deny a deduction for payments or impose source-based taxation such as withholding tax, in respect of any payments made to a related party where the related party does not pay tax at a minimum rate.

(2) A subject to tax rule: this rule would apply to tax treaties that would have the effect of only granting treaty benefits if the item of income was subject to tax at a minimum rate. While the subject to tax rule would apply to related parties, the OECD Secretariat's proposal also contemplates exploring its application to payments made to unrelated parties insofar as articles 11 and 12 (interest and royalties) of the OECD Model are concerned.[90]

5. Assessing the 2020s Compromise

5.1. Introductory remarks

Having identified the key components of the 2020s compromise, albeit briefly, it is now possible to analyse whether the proposed changes will have the potential to address the major challenges currently found in the existing international tax framework. Some of the proposals are designed to address particular challenges arising from the digital economy, while others address wider issues. For instance, it can be seen immediately that the proposals in Pillar I address some of the problems, such as the vanishing ability to tax business profits through the lack of physical presence (and the inadequacy of the PE rules in the 21st century). Furthermore, the proposal in Pillar I also addresses how users, arguably, form a significant and integral part of a business model through their establishment of content, participation in the network effect, validation and review work as well as contributing their data.

While the proposals in Pillar I seek to address these first two significant challenges, namely the vanishing ability to tax business profits and the use of data, and the contribution of users, they also assist in two of the other challenges, namely the characterization of transactions and income and to a certain extent the failure of transfer pricing. However, there are many challenges which Pillar I does not address whereas, arguably, Pillar II does. Overlaying the proposed solution on the challenges shows us which areas are being addressed by which proposals together with any possible omissions.

5.2. Dealing with the vanishing ability to tax business profits

The response proposed by the 2020s compromise to this problem is without a doubt the most significant new development in international tax in 100 years. Very clearly, the deemed income arising under Amount A is designed as the response to the challenges posed by highly digitalized businesses and multi-sided platforms. Amount A is the most revolutionary part of the OECD Secretariat's proposal, as it posits new taxing rights without the requirement of physical presence in the source or market jurisdiction.

5.3. The nexus requirement of vanishing business profits

In simple terms, the response deals with this critical challenge. Amount A is specifically targeted at the vanishing ability to tax business profits. It does so by using formulae to allocate income to the market jurisdiction based on a portion of the residual "super profit" after the allocation of all routine profits.

In order to make sense of the unified approach proposal to introduce a concept such as Amount A, it is helpful to compare the approach under Amount A to the three original OECD/Inclusive Framework proposals (namely, user participation, marketing intangibles and significant economic presence). All three proposals had the same "over-arching objective", which was:

> to recognise... value created by business's activity or participation in user/market jurisdictions that are not recognised in the current framework for allocating profits.[91]

The different solutions considered the problem from different perspectives. One emphasizes the contribution made by users, another stresses the contribution made by marketing intangibles, while the third considered that sustained interaction with the jurisdiction via digital technology and other automated means could constitute a significant economic presence.

All three proposals recognize that it is possible to have active participation in a business in a jurisdiction without physical presence due to technological advancement in the business models. The characteristics of highly digitalized businesses, being able to achieve "scale without mass" through the utilization of the network effect, the reliance on intangible assets and the role of data and user participation enable "remote" participation in a domestic economy through digital means without a taxable physical presence.[92] The OECD justify taxation on the principle that business profits should be taxed in the countries in which value is created.[93]

As discussed in section 2.3., value creation is an imprecise and difficult concept to use as a principle of taxation. Arguably, it is not a principle per se, but it could be

90. Id., at para. 29.

91. OECD, *Consultation Addressing the Tax Challenges of the Digitalisation of the Economy*, *supra* n. 69, at para. 11.
92. Id., at para. 12.
93. Id., at para. 58.

used as a justification for taxation (the "forgotten question" in the words of Klaus Vogel).[94] If the OECD/Inclusive Framework is seeing the value creation concept simply to justify the right to consider the taxation of entities deriving income from cross-border activities in the digital age (establishing a nexus) in the absence of physical presence, and at the same time recognizing that the existing rules do not permit this due to the consequences of constraint arising from the 1920s compromise, it is submitted that this is an acceptable policy from a theoretical perspective.

One of the problems for the OECD/Inclusive Framework is that none of the three proposals were universally acceptable, and, therefore, gives rise to the need to have a unified approach that incorporates key features of all three individual approaches. The approach in Amount A, without ascribing a policy rationale from any one of the three alternatives, deals with the first challenge of nexus. The further refinement proposed in early 2020, which splits automated digital services and consumer-facing businesses, refines this nexus requirement, thereby making the former subject to tax after meeting a revenue threshold, while the latter requires some additional requirements such as a physical presence or targeted advertising. In this respect, it is possible to see more influence in the automated digital services limb coming from the "user participation" proposal. In the alternative concerning consumer-facing businesses, the influence can be seen to be coming from the "marketing intangibles" proposal. Amount A not only answers the challenge of nexus posed by the digitalization of the economy, but it goes further into other businesses involved in utilizing marketing intangibles with consumer-facing businesses.

5.4. The allocation of profits requirement of vanishing business profits

As the OECD notes, the establishment of a new taxing right in respect of remote sales requires a new method to quantify the appropriate amount of profit reallocated to the market jurisdiction (furthermore to be split amongst the market jurisdictions if the multinational is trading in more than one jurisdiction which of course is highly likely).[95] The Programme of Work considered three separate "conceptually underpinned" methods for determining the amount of profit and loss subject to the new taxing right.[96] These are:

(1) the modified residual profit split (MRPS) method;
(2) the fractional apportionment method; and
(3) distribution-based approaches.

According to the OECD, the MRPS method:

> allocates to market jurisdictions a portion of an MNE group's non-routine profits that reflects the value created in markets that are not recognised under the existing profit allocation rules.[97]

The steps in the MRPS method are exactly (or resemble very closely) those carried out under Amount A. In other words: (1) determine the total profit to be split; (2) remove routine profits; (3) determine the portion of the non-routine profits attributable to the market jurisdictions; and (4) allocate (3) to the relevant market jurisdictions using an allocation key.

The fractional apportionment method is also represented in parts of the above steps, (particularly (1), (3) and (4)). Specifically, it allocates part of the global non-routine profits to a particular market jurisdiction using an allocation key.

The distribution-based method applies a simplified approach to specify a baseline profit in the market jurisdiction for marketing, distribution and user-related activities. The proposal in suggesting Amount B involves making a new fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction and accords with this method.

So, it is clear that Amount A has elements of these first two methods (the MRPS method and fractional apportionment). In contrast, Amount B utilizes the third method on a distribution basis.

The challenge of allocating profits to the new taxing right is embraced by the formulation of Amount A. In allocating a proportion of these residual profits to the market jurisdiction this breaks new ground. Furthermore, the proposal relating to Amount B has numerous administrative and certainty-related benefits, but also can deal with the restructuring risk (the possibility that the multinational ceases remote sales and restructures to a buy-sell arrangement with an LRD, whereby profitability is limited based on the limited functions performed by the subsidiary). This enables the international tax work framework to draw a baseline on profitability for LRD entities.

Amount A is not targeted exclusively at digital businesses, but extends to customer-facing entities. This is justified on the grounds of neutrality (that it is not just highly digitalized businesses exclusively to carry on remote sales) and reflects the idea that a multinational investing in its brand in the market jurisdiction (or investing in users located in a market jurisdiction) can be subject to tax based on that activity in the market jurisdiction.

Under the current proposals, the application of Amount B to distributors is neither limited by threshold nor by activity.[98] Accordingly, this is a much more significant change than one proposed to deal with the restructuring risk referred to above. The reasons for making this change are pragmatic and driven by the business community with the trade-off of the possibility of increased tax in return for certainty and dispute prevention and resolution.

Even though the restructuring risk would necessitate something similar to the application of Amount B to LRDs involved in highly digitalized businesses, none-

94. K. Vogel, *The Justification for Taxation: A Forgotten Question* 33 Am. J. Jur. 1, p. 19 (1988).
95. OECD, *Programme of Work for the Tax Challenges Arising from the Digitalisation of the Economy*, *supra* n. 38.
96. Id., at paras. 22-35.
97. Id., at para. 28.
98. OECD, *Public Consultation Document: 'Unified Approach' Under Pillar One*, *supra* n. 45.

theless, it is clear that the wide application of Amount B goes way beyond dealing with the challenges of the digitalized economy and highly digitalized business models. It, therefore, should be seen as part of a broader 2020s compromise.

5.5. Dealing with the use of data, the contribution of users, and the measurement of their value

One of the three proposals put forward in the Public Consultation Document for consideration by the OECD/Inclusive Framework was the user participation proposal.[99] The user participation proposal was very firmly focused on dealing with this particular user data and participation challenges. Amount A is, therefore, the component of income deemed to be derived (or allocated) to the market jurisdiction where an MNE does not have a physical presence in the jurisdiction but is carrying on a "consumer-facing business" in a remote manner. The OECD Secretariat's Proposal makes it clear that it is intended to address the challenge of the use, creation and valuation of data:

> *The approach covers highly digital business models but goes wider* – broadly focusing on consumer-facing businesses with further work to be carried out on scope and carve-outs.
> [Emphasis added.][100]

The Secretariat's Proposal suggests that:

> These features could be said to be relevant for any business, *but they are most relevant for digital centric businesses which interact remotely with users*, who may or may not be their primary customers, and other consumer-facing businesses for which *customer engagement and interaction, data collection and exploitation,* and marketing and branding is significant, and can more easily be carried out from a remote location. *This would include highly digitalised businesses which interact remotely with users, who may or may not be their primary customers, as well as other businesses that market their products to consumers and may use digital technology to develop a consumer base.*
> [Emphasis added.][101]

This deemed income in Amount A, therefore, responds to the challenge that these new digitalized businesses can successfully interact with their customers (consumers) and users without the need to establish any form of physical presence in the jurisdiction in which the customers are based.

5.6. Responding to the challenges of reliance on, and mobility of, IP

The major effort regarding this challenge is provided by Pillar II and not Pillar I. This is because the challenge is not so much related to the allocation of income or questions of nexus, but relates to profit shifting and the location of profits. "Certain members"[102] of the OECD/Inclusive Framework believe that profit shifting occurs through the use of intangibles, as well as in other ways, such as capital structure and intragroup financing. While the use of intangibles to shift profits is particularly prevalent in the digital economy, the other capital and financing activities are not so limited but extend to all multinational businesses.

Both the rules of Pillar II can be of assistance in response to challenge the use, and mobility, of IP. If IP is located in a low-tax jurisdiction and held by a related entity there (owned by the parent multinational), the income inclusion rule could apply. Alternatively, if a deduction is claimed by the multinational in respect of a royalty paid for the use of IP where it is owned by a related party, the undertaxed payments rule (or the switchover rule if a treaty benefit, such as reduced withholding tax, is being utilized).

As currently proposed these rules will deal with some aspects of current concerns with the location of IP in low- and/or no-tax jurisdictions. If the IP is located in a high-tax jurisdiction, Pillar II will not apply.

5.7. Dealing with the characterization of transactions and income

There does not appear to be any particular targeted work in this area by the Programme of Work, but it is interesting to reflect on the impact that both Pillar I and Pillar II proposals will likely have on this issue. For instance, where income has been characterized as business profits and previously not subject to tax because of the lack of nexus to a PE, Amount A will lead to new taxing rights. The formulae used to determine the amount of the deemed income do not seem to be susceptible to this characterization. Furthermore, if the income under any of these characterizations is derived by a related entity in the multinational group that is based in a low-tax jurisdiction, the income inclusion rule should apply. Additionally, where the characterization takes the form of a deductible payment and is made to a low-tax jurisdiction's related party, the undertaxed payments rule may have application.

The 2020s compromise will necessitate further work and an in-depth examination of the consequences of the characterization of transactions. At this stage, it seems that the OECD Secretariat's Proposals provide some solutions to these difficult problems of characterization.

5.8. The failure of transfer pricing with certain MNEs and their transactions

Both Pillar I and Pillar II have components that have an impact on the challenges posed by transfer pricing. Concerning Pillar I, the profit allocation rules radically depart from the existing international tax framework in several ways. These include using formulaic calculations in an MRPS methodology and elements of formulary apportionment, allocating profits to the marketplace jurisdiction, ignoring the single-entity concept, and significant to this challenge, departing from the ALP.

How does the 2020s proposal address the challenge of transfer pricing? This can be seen in the various components as follows:

99. Id., at paras. 17-21.
100. Id., at para. 15.
101. Id., at para. 19.
102. Id., at para. 53.

- Pillar I, Amount A: as discussed in sections 5.3. and 5.4., there are two principal objectives behind Amount A, the establishment of a new nexus, together with a formulaic allocation of profit to the new taxing rights suggested for the market economy. It is the second component in particular that is relevant to this discussion. The "new" allocation of profit rules suggest that a part of the non-routine residual profit should be allocated to the market in which the product or services are consumed. Amount A can be seen as quite a radical change as the existing international tax framework, which has traditionally suggested that there is no entity to which an arm's length profit can be attributed. These traditional rules would also not identify, necessarily, any functions carried on in the market jurisdiction to which profit could be allocated. Amount A controversially suggests both the new taxing right and an amount of profit determined by way of a formula which most likely will not reflect an arm's length amount of profit.
- Pillar I, Amount B: Amount B suggests making a new fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction. Amount B, it will be remembered (*see* section 4.2.3.), emerged from practical solutions proposed by business to the original public conference on the taxation of the digital economy, and it pragmatically suggests the use of a formula or a fixed amount to determine such marketing and distribution functions. There are two major advantages to the use of Amount B – (1) it can act as a backstop to the creation of an LRD introduced into a multinational structure to avoid the application of Amount A; and (2), at the same time, it pragmatically provides for a relatively certain fixed amount of income, potentially avoiding disputes and expensive transfer pricing documentation and advice. In any event, the use of Amount B, while bearing a relationship to the determination of an arm's length amount, is likely to be a simplified formula or proxy for a more detailed calculation and so a departure from the ALP.
- Pillar I, Amount C: the final component in the proposal by the OECD Secretariat is the additional amount (Amount C). This amount gives tax administrations, primarily, but also taxpayers, the ability to "correct" the outcome arrived at through the application of Amount B in situations where Amount B has been too arbitrary and come to an unacceptable position from an arm's length perspective. Accordingly, amount C can be regarded as a retention of the ALP in certain circumstances. Some concerns have been raised that this component reopens the complexity and cost of the determination of an exact arm's length amount.
- Pillar II, the income inclusion rule: by introducing a requirement that income derived by entities within a controlled group (i.e. branches or subsidiaries that are related to the multinational parent) are taxed at a minimum rate, the international tax system would overcome the risk of transfer pricing profits to low-tax jurisdictions. Effectively, this income inclusion rule operates as a backstop to prevent the operation of profit shifting structures or transactions to reallocate profit to related parties in low- and/or no-tax jurisdictions. This is effectively a significant potential curtailment of aggressive tax planning using transfer pricing.
- Pillar II, the undertaxed payments and subject to tax rules: by imposing a withholding tax (or in the case of a double tax treaty preventing favourable tax benefits of lower withholding tax rates) or denying deductions for payments made to a related entity in a low- and/or no-tax jurisdiction the use of arm's length transfer pricing techniques to reduce taxable profits in higher-tax jurisdictions are also impacted.

The comprehensive response across a range of different areas means that the OECD Secretariat's proposal goes a significant way to counter the challenge of transfer pricing posed by the digital economy.

5.9. Tackling the inadequacy of residence-based taxation

Pillar I is primarily concerned with source-based taxation. Arguably, Pillar II is primarily concerned with residence-based taxation. The income inclusion rule operates as a type of worldwide CFC regime meaning that the incentive to incorporate a subsidiary or establish a branch in a low-tax jurisdiction is removed because any profits that were not subject to a minimum tax (for example 15%) are required to be included in the parent company's return and tax paid on a "top-up" basis. The consequence is that the income inclusion rule bolsters residence-based taxation and reduces the tax planning advantages of incorporating a subsidiary in a low-tax jurisdiction and diverting or shifting profits to it through a variety of different techniques.

Similarly, if deductible payments are made from the parent jurisdiction to a related entity based in a low-tax jurisdiction, the undertaxed payment rule or the subject to tax rule could apply. This would mean that either the payment would not be deductible or there would be withholding tax imposed (even overriding the reduced rates in a double tax agreement).

5.10. Influencing competition by states

The creation of a new taxing nexus and the allocation of taxing rights to the market or the source country might be viewed in one way as a fundamental change to the international tax framework, which is largely about the taxation of highly digitalized businesses and the vanishing ability of the source state to tax business income generated in their jurisdiction (the first challenge described in this chapter). Pillar I focuses on this issue. It may also be possible to regard this potential change to the international tax framework through the lens of tax competition. Some multinationals based in highly developed countries have currently, or previously, structured their affairs to pay virtually no tax in the source jurisdiction, and little, in their residence jurisdiction. Consequently, recent domestic legislative amendments in the United States have improved the position of that country to impose a tax on their multinationals doing business overseas.[103]

Looking at the proposed changes in Pillar I through the lens of consistency in taxation between source and residence countries, and between consumer states and developing countries as opposed to highly digitalized and developed countries with significant MNEs, the proposed response in this Pillar can be seen as one addressing tax competition. That is perhaps a surprising conclusion, as, superficially, the changes have everything to do with the allocation of taxing rights and nothing to do with tax competition per se. It is just that the allocation of taxing rights under the existing regime favours certain highly digitalized and developed jurisdictions and not others, and the response proposed by the OECD Secretariat seeks to address that imbalance.

In the case of the proposed changes in Pillar II, it is possible to see the challenge of tax competition addressed more directly. The income inclusion rule, which is designed to eliminate the advantages of incorporating a subsidiary in a low-tax jurisdiction (or operating a branch in that jurisdiction), has the effect of bolstering the parent jurisdiction's residence-based taxation. It would be expected that this situation would reduce the opportunity for countries to offer low-tax or incentive-based regimes to attract profit and investment shifting through the operation of tax competition. A multinational may not see the same advantage in operating part of their international group through a low-tax jurisdiction if they are obliged to pay away some of the advantage gained through the structure to their parent jurisdiction by way of a "top-up" tax.

This position is also a valid proposition for the second set of rules in Pillar II. The undertaxed payments rule and the subject to tax rules are designed to discourage payments made to related entities in low-tax jurisdictions by either disallowing the deduction or imposing withholding tax. A classic example involves a multinational establishing a special-purpose subsidiary to hold IP and then paying deductible royalties to that entity that would enjoy both a deduction in the (high-tax) parent company or operating subsidiaries whilst the royalty income was subject to low or no tax in the subsidiary. If the deduction is disallowed, or withholding tax is imposed then the benefits of the structure are largely eroded. The utilization of such entities is likely to diminish as does the prospect of international tax competition.

5.11. Some other perspectives

This article is not intended to be a critique of the OECD Secretariat's programme of work and its resultant two Pillars. Others have written with that objective in mind, pointing out areas of concern and, on occasion, omissions.[104] The focus of this article is to test whether the 2020s compromise deals adequately with the problems identified, which leads us to the last concluding part of this study.

6. Conclusions

This article has examined the response proposed by the OECD Secretariat to the challenges to the international tax framework proposed by the digital economy. The challenges are very different. Some challenges, such as the allocation of taxing rights and the taxable nexus, are relatively recent taxation consequences arising from the enormous success of the digitalization of the economy and the massive business advantages that occur from phenomena such as the network effect, the use of data, the role of users and the ability of a business to identify customer needs and the value of the customer to the business. Other challenges, such as some issues in tax competition and transfer pricing, are more generic and long-standing. Many of the broader challenges are addressed by Pillar II in its broad-brush remedies against base erosion and profit shifting – a backstop to the more specific actions detailed in the 15-point Action Plan adopted by the OECD at the end of the first BEPS round.

The overriding impression is that it is difficult to address the specific challenges posed by the digital economy without reference to the broader issues. Accordingly, the proposals need to be as broad as they currently are in being able to deal with issues broader than those posed specifically by the digital economy.

The various proposals in Pillar I are the most far-reaching international tax reforms for 100 years. Why are they seen as being so radical? There are three major reasons (at least) why this is so:

(1) They revise the allocation of taxing rights: some of the proposals allocate more taxing rights to the market or user jurisdictions. The OECD/Inclusive Framework suggests that this reallocation of taxing rights reflects situations where value is created by business activity through participation in the user or market jurisdiction that is currently not recognized in the existing rules.[105] This position is controversial, as the market has not traditionally been seen as a sufficient link to

103. US: An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. no. 115-97, 115 Cong. The law is more commonly known as the Tax Cuts and Jobs Act1 (TCJA), was enacted in December 2017.

104. *See*, for instance, the work of the IBFD's Task Force on the Digital Economy: P. Pistone et al., *The OECD Public Consultation Document "Secretariat Proposal for a 'Unified Approach' under Pillar One": An Assessment*, 74 Bull. Intl. Taxn. 1 (2020), Journal Articles & Papers IBFD; and by the same authors, *The OECD Public Consultation Document "Global Anti-Base Erosion (GloBE) Proposal – Pillar Two": An Assessment*, 74 Bull. Intl. Taxn. 2 (2020), Journal Articles & Papers IBFD; *see also* U. Schreiber, *Remarks on the Future Prospects of the OECD/G20 Programme of Work – Profit Allocation (Pillar One) and Minimum Taxation (Pillar Two)*, 74 Bull. Intl. Taxn. 6 (2020), Journal Articles & Papers IBFD, and B.J. Arnold, *The Evolution of Controlled Foreign Corporation Rules and Beyond*, 73 Bull. Intl. Taxn. 12 (2019), Journal Articles & Papers IBFD.

105. OECD, *Public Consultation Document: 'Unified Approach' Under Pillar One*, *supra* n. 45, at p. 2.

create a nexus for taxation.[106] The factors involved in the production of income associated with supply, rather than demand (obviously linked to the market), have historically been the factors where income has been located.

(2) They override the limitation on taxing rights determined by reference to a physical presence (of a person or situs): this situation has generally been accepted as a cornerstone of the current rules, with the definition of a PE having a long-standing history dating back to the 1920s compromise. An increasing number of countries have voiced their dissatisfaction because of the failure of:

> the existing profit allocation and nexus rules [to] take into account the increasing ability of businesses, in certain situations, to participate in the economic life of a jurisdiction without an associated or meaningful physical presence.[107]

(3) They challenge the ALP: the vulnerability of the international corporate tax system is ascribed, in part, to "limitations of the arm's length principle" in a report to the Executive Board of the International Monetary Fund (the "IMF Report").[108] Some of the proposals in the IMF Report require a reconsideration of the current transfer pricing rules as they relate to non-routine returns, and other proposals would require modifications going beyond non-routine returns. These suggestions, "in all cases,... would lead to solutions that go beyond the arm's length principle".[109]

No one is underestimating the difficulty of this task. This situation arises because, first, as discussed in section 1.4., the OECD/Inclusive Framework are trying to revisit some long-standing and fundamental tenets of the international tax system. The existing system, for all its faults, has had a remarkably long tenure. The new solution reflects a balance between precision and practicality (remembering the wide gulf of capabilities between the largest and most developed countries and the smallest and developing countries) with a sound conceptual and logical economic basis. The rules should neither result in taxation where there is no economic profit nor result in double taxation.[110] In short, dealing with the corporate tax implications of digitalization and new business models is potentially such a fundamental change in the tax system, that it has been described as "highly contentious, politically and intellectually".[111]

Given the fundamental nature of these proposed changes, it is perhaps surprising that other potential options have not been more thoroughly explored. In particular, a shift in a more fundamental way to formulary apportionment, for example,[112] or even more wholeheartedly embracing destination-based taxation. Perhaps political compromise evolves from an existing architecture rather than a totally new blueprint plan.

The 1920s compromise was forged in the context of the significant worldwide deficits which had arisen as a result of the First World War. There was a common need to forge an international agreement to prevent the evils of double taxation. The 2020s compromise might be forged on the anvil of the Great Lockdown as countries collectively struggle to deal with the challenges and problems exposed by the burgeoning digital economy.

106. OECD, *Consultation Addressing the Tax Challenges of the Digitalisation of the Economy*, *supra* n. 69, at p. 8.
107. OECD, *Programme of Work for the Tax Challenges Arising from the Digitalisation of the Economy*, *supra* n. 38, at para. 11.
108. IMF, *Corporate Taxation in the Global Economy* (IMF 2019).
109. OECD, *Digitalisation of the Economy – Policy Note*, *supra* n. 66, at p. 2, as approved by Inclusive Framework on BEPS.
110. Id., at p. 3.
111. IMF, *supra* n. 108, at p. 14.
112. Thank you to Professor Kerrie Sadiq for her comments as discussant on this paper in the seminar series held by Melbourne Law School on 27 August 2020.

OECD/International

Dick Molenaar and Harald Grams***

Influencer Income and Tax Treaties: A Response

The authors respond to the article written by Savvas Kostikidis on the taxation of influencers' income that appeared in the June 2020 issue of the *Bulletin for International Taxation*. The authors advance their solution to the problem, which would include the abolition of article 17 of the OECD Model.

"*Much Ado about Nothing*" – William Shakespeare (1600)

1. Introduction

"Influencer Income and Tax Treaties" by Savvas Kostikidis (2020)[1] is a very interesting article and invites a reaction. It discusses whether modern influencers may be identified as entertainers under article 17 of the OECD Model[2] and demonstrates that this special provision makes the taxation of cross-border entertainment very complicated. Problems arise not only with the definition, but also with the apportionment of income, which entertainers and sportspersons have but ordinary persons and companies do not. The article states the reasons that the OECD gave in 2014 for keeping this special provision in the OECD Model (2014),[3] and adds that reading between the lines suggests that article 17 is based on the benefit principle, which would mean that states want a share of the earnings of famous persons on their territory.

Influencers arose with social media and derive their attention from digital communication. This makes them an interesting case study in asking how the taxation of entertainment relates to initiatives for the taxation of the digital economy. States are starting to impose source taxation, even when digital companies do not have a permanent establishment (PE). The OECD has taken the initiative in coming up with a Unified Approach for the taxation of digital companies, and the UN has tried to cover this situation with an extension to the UN Model.[4] In this article, the authors will compare both worlds and discuss what they can learn from each other to avoid tax obstacles and double taxation.

2. Influencers and Article 17 of the OECD Model

The first topic is whether influencers fit within the scope of the term "entertainers" in article 17 of the OECD Model. Kostikidis came to that conclusion and gave his considerations, but the present authors have some remarks.

The current title of article 17 of the OECD Model favours Kostikidis. In the OECD Model (2014), this header changed from "Artistes" to "Entertainers", and the OECD itself acknowledged in its Report of 26 June 2014 (OECD Report (2014)) that the term "entertainer" is broader than the term "artiste".[5] But strangely enough, the OECD did not give examples to justify that change and kept the descriptions in the text of article 17(1) of the OECD Model (2014) and in the Commentary on Article 17 of the OECD Model (2014)[6] the same as before. However, these examples are still about "old-fashioned" performing artistes, such as stage performers, film actors, actors in a commercial and musicians, and sportspersons, such as runners, jumpers, swimmers, golfers, jockeys, footballers, cricketers, tennis players and racing drivers. In addition, the examples cover billiards, snooker, chess and bridge players. Unfortunately, the Commentary on Article 17 (2014) was not extended to encompass new types of entertainment, such as influencers,[7] YouTubers and bloggers,[8] or new sports, such as esports.[9]

The authors have doubts as to whether Kostikidis is correct in concluding that influencers should fall within the scope of article 17 of the OECD Model. As he says in his article,[10] an influencer mainly promotes products or goods for others, which means that the real entertainment character is only secondary. This may be different for YouTubers, vloggers and bloggers, who are aiming their messages at their audience in order to create a following and are not primarily promoting goods and services for others, as influencers do. With this in mind, an influencer is more like a model, in respect of which the OECD has stated in the Commentary on Article 17 (2014)[11] that presenting clothes during a fashion show or photo session falls outside the scope of article 17 of the OECD Model. But the same Commentary also gives "actors in a commercial" as an example of entertainers falling under article 17 of the

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1. S. Kostikidis, *Influencer Income and Tax Treaties*, 74 Bull. Intl. Taxn. 6 (2020), Journal Articles & Papers IBFD.
2. Most recently, *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Treaties & Models IBFD.
3. *OECD Model Tax Convention on Income and on Capital* (26 July 2014), Treaties & Models IBFD.
4. *UN Model Double Taxation Convention between Developed and Developing Countries* (1 Jan. 2017), Treaties & Models IBFD.
5. OECD, *Issues related to Article 17 of the OECD Model Tax Convention* para. 31 (OECD 2014).
6. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 17* paras 3, 4 and 6 (26 July 2014), Treaties & Models IBFD.
7. *See* D. Busemann & G. Gilson, *Unsicherheiten über Abzugsteuern nack §50a EstG bei der Zusammenarbeit mit Influencern*, DStR 42/2019.
8. *See* R. Homuth, *Einkünfte X.0: Blogger, Influencer, YouTuber & Co.*, NWB (26/2018).
9. S. van Overbeek & D. Molenaar, *The Emergence of Esports*, 73 Bull. Intl. Taxn. 2 (2019), Journal Articles & Papers IBFD.
10. Kostikidis, *supra* n. 1, at sec. 1.1.
11. Para. 3 *OECD Model: Commentary on Article 17* (2014).

OECD Model.[12] In the end, the Commentary on Article 17 (2014) recognizes that there are also mixed situations, and that seems to be applicable to such social media actors as YouTubers, bloggers, vloggers and influencers.[13] Most of them have advertising, from which they derive income, based around their entertaining films and posts, but some are aiming their activities primarily at promoting products and services, while others have their own independent stories to tell.

In his article,[14] Kostikidis extensively discusses the personal scope of article 17 of the OECD Model, in which he also looks at the position of other models. It may be acknowledged that some states have expressed positions against this part of the Commentary on Article 17 (2014), including Argentina, Brazil, India[15] and Malaysia,[16] and that it is difficult to distinguish this situation in practical cases, but the authors believe that the OECD approach to models is the correct one to follow, and that promoting goods or services does not fall under the definition of entertainment. But as already mentioned in this section, it is hard to distinguish this activity from the example of an actor in a commercial, who is regarded as an entertainer under article 17 of the OECD Model. It would be good if the OECD would update the Commentary on Article 17 of the OECD Model (2017).[17]

3. The Benefit Principle

The next topic of Kostikidis' article for consideration is his statement that the inclusion of article 17 of the OECD Model is also based on the benefit principle. This would mean that tax revenue was one of the reasons why the OECD and its member countries wanted special taxing rules for entertainers and sportspersons.

This is an interesting suggestion, but it is not to be found in the OECD Report (2014) or in other publications, such as the OECD Report (1987).[18] The benefit principle can be found in the literature, but only in Sandler (2008), who wanted to broaden the scope of article 17 of the OECD Model to all well-known persons, including speakers, former politicians giving lectures and others, and defended this with the argument that it would be fairer to tax all well-known persons at source and that this could result in a valuable amount of tax revenue for source states.[19] Later, another Canadian, Arnold (2011), supported this new approach,[20] but it did not make it into the OECD recommendations.

But even when it is not mentioned officially, it is still possible to imagine that states do not want well-known entertainers and sportspersons to leave their territory without paying a contribution to their budget. In general, taxing rights are based on the use of public facilities, such as having a PE in another state[21] or going as an employee for a longer period to another state.[22] For short-term visits, the use of public facilities is normally considered to be so negligible that it seems more reasonable to allocate the taxing right to the residence state.

But the main reason behind article 17 of the OECD Model has remained anti-avoidance, because top entertainers and sportspersons tend to move to tax havens with no or low taxation, which has led to the view that there should be a source tax in the state of work. This is confirmed in the OECD Report (2014), which is discussed further in section 5.

For the benefit principle to apply, it is important to know how much of the tax revenue from visiting entertainers and sportspersons should be payable to a state. Unfortunately, not much information is available, but in 2019 the Minister of Finance in Belgium had to answer parliamentary questions on this point.[23] He provided the list of tax earnings (per year in euro) shown in Table 1.

Table 1 – Tax revenue derived by Belgium from entertainers and sportspersons, 2014-2018

Year	Entertainers (EUR)	Sportspersons (EUR)	Total revenue (EUR)
2014	14,783,534	2,438,895	17,222,429
2015	14,732,761	3,535,922	18,268,683
2016	15,989,872	3,393,602	19,383,474
2017	17,572,315	4,423,913	21,996,228
2018	16,675,645	4,209,088	20,884,733

The most lucrative year was 2017, bringing EUR 22 million in revenue from the source withholding tax. Belgium had 11.3 million citizens in 2017 and is an open and active state with many performances and sports events, which implies that the tax revenue can be extrapolated to many other states (*see* Table 2).

12. Id.
13. Id.
14. Kostikidis, *supra* n. 1, at sec. 2.2.3.
15. Para. 8 Positions on *OECD Model: Commentary on Article 17* (2014).
16. Id., at para. 5.
17. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 17* paras 3, 4 and 6 (21 Nov. 2017), Treaties & Models IBFD.
18. OECD, *The Taxation of Income derived from Entertainment, Artistic and Sporting Activities – Report: adopted on 27 March 1987* (OECD 1987), Primary Sources IBFD.
19. D. Sandler, *Artistes and Sportsmen (Article 17 OECD Model Convention)*, in *Source versus Residence – Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives* pp. 215-246 (M. Lang ed., Wolters Kluwer 2008).
20. B.J. Arnold, *The Taxation of Income from Services under Tax Treaties: Cleaning Up the Mess*, 65 Bull. Intl. Taxn. 2 (2011), Journal Articles & Papers IBFD.
21. Art. 7 *OECD Model* (2017).
22. Id., at art. 15.
23. Answers of 8 August 2019 from the Belgian Minister of Finance, Alexander De Croo, to Parliamentary Questions from Servais Verherstraeten. The figures come from a special tax form that Belgian promoters of performances and sports events have to complete before they present the withholding tax for payment to the Belgian tax authorities. The tax rate is 18% of the earnings, while non-resident entertainers and sportspersons have the right to deduct their expenses in advance, but only after approval by the Belgian tax authorities (*Voorafgaand Akkoord*). Since 2009, these non-resident entertainers and sportspersons have also had the right to file a normal tax return in a subsequent year, but there is no information on how many tax refunds have been paid out under that procedure.

Table 2 – Extrapolated tax revenue from entertainers and sportspersons for other states, derived from the Belgian example			
State	**Citizens (millions)**	**Tax rate (%)**	**Estimated tax revenue (millions (EUR))**
Australia	25.5	29	80.0
Austria	8.9	20	19.3
Canada	37.6	15	61.0
Denmark	5.8	-	11.3[a]
France	67.0	15	108.7
Germany	83.0	15.825	142.1
Ireland	4.9	-	9.5[a]
Netherlands	17.3	-	33.7[a]
Sweden	10.2	15	16.5
United Kingdom	66.7	20	144.3
United States	325.1	30	1,054.9

a This estimate of tax revenue is only theoretical, as this country does not have a source withholding tax for non-resident entertainers and sportspersons.

The possibility of deducting expenses in advance or filing tax returns in a subsequent year is not taken into account here. This is very often the case in Australia, Germany, the United Kingdom and the United States, so the real figures regarding tax revenue will be lower than given for these states. But altogether, these figures are not impressive and do not support the position that states want to retain article 17 of the OECD Model (and in their bilateral tax treaties) because of the tax revenue.

In addition, the total tax revenue in each state will fall considerably because of the tax credits (or exemptions) for resident entertainers and sportspersons engaging in foreign performances and sporting events. This will equalize the tax earnings from non-residents, so that, on balance, no real tax revenue will remain for a state. This means that not including the equivalent of article 17 of the OECD Model in a bilateral tax treaty would result in the same tax result for states as now.

4. Complicated Apportionments

A large part of Kostikidis' article[24] is devoted to the vertical and horizontal apportionment of the income of influencers. The present authors believe he is right to consider this a complex matter, and experience in practice every day the difficulties of these apportionments. It is hard to allocate the taxing right for different income elements, especially when the text of article 17 of the OECD Model specifies that this taxing right applies only to "income derived by a resident of a state as an entertainer or sportsperson from his personal activities as such in the other state". When the work is done in one state but the income is derived from another state, it is not easy for states to determine and use the taxing right. In addition, the income can be divided into different types, such as with models in Germany, who are partially paid for their appearance and partly for their personality rights.[25] And unequal treatment can arise from article 17 of the OECD Model, as with Kostikidis' example of the German opera choir singer working as an employee in Switzerland, who is not entitled to the exemption method (under article 15) but, rather, to the tax credit method (under article 17) in Germany.[26]

The conclusion that may be derived from these apportionments is that article 17 of the OECD Model makes the international taxation of entertainers and sportspersons very complicated and gives rise to the risk of double or excessive taxation or even double non-taxation. It leads to high administrative expenses, not only for (i) the entertainers and sportspersons and (ii) the organizers of the performances and sports events, but also for (iii) the tax authorities in the source state (when levying the source tax and allowing deductions for expenses and tax returns) and (iv) the tax authorities in the residence state (when applying the correct tax credit or exemption).

5. Why We Do Not Need Article 17 of the OECD Model

In his article,[27] Kostikidis mentions the three reasons why the OECD decided not to remove article 17 of the OECD Model (2014) but instead to retain it. These three reasons are:

– residence taxation should not be assumed, given the difficulty of obtaining the relevant information;
– article 17 of the OECD Model permits the taxation of a number of high-income earners who can easily move their residence to low-tax jurisdictions; and
– source taxation of the income covered by article 17 can be administered relatively easily.

These reasons are not realistic or convincing, because:

– currently, the relevant information can easily be obtained by the residence state, as past performance dates can be found on the Internet, payments are almost always done via banks and states are improving their exchange of information.[28]

– low-tax jurisdictions normally do not have tax treaties, which means that article 17 of the OECD Model does not have any effect on tax treaties. To counteract the move to tax havens, states only need to have a unilateral source withholding tax on outgoing income. Why, for example, would Germany need to have the equivalent of article 17 of the OECD

24. Kostikidis, *supra* n. 1, at secs 2. and 3.

25. DE: *Bundesfinanzmisterium* (Federal Ministry of Finance), 9 January 2009, IV C 3, BStBl 2009 I, p. 362.

26. This also happened with a Swedish football player in the Netherlands, who received a share of the transfer fee from his previous Swedish club/employer, but received only the tax credit (from article 17 of the *OECD Model*) and not the exemption method (from article 15) in the Netherlands. This is strange, because he was undoubtedly an employee. *See* the decision of the Netherlands *Hoge Raad* (Supreme Court, HR) in NL: HR, 7 May 2010, Case 08/02054, BNB 2010/245, Case Law IBFD.

27. Kostikidis, *supra* n. 1.

28. The residence state could also obtain the right to undersign the form for source tax exemption, which would provide information about foreign income, just as with the exemption application procedure for royalties. This suggestion was previously made in H. Grams, *Artist Taxation: Art. 17 of the OECD Model Treaty – A Relic of Primeval Tax Times?*, 27 Intertax 5, p. 189 (1999).

Model in a tax treaty with France, the Netherlands, the United Kingdom and similar states? Those states are clearly not low-tax jurisdictions. This situation is easy to administer, but why only for entertainers and sportspersons? The same argument is not used for other sources of income, such as those derived by the self-employed, as well as royalties, dividends, employment income and pensions. Moreover, source taxation makes it more complicated because the income must also be reported in the residence state, where the elimination of double taxation should be achieved.

On this basis, the conclusion must be that the reasoning behind article 17 of the OECD Model is wrong. Article 17 of the OECD Model is not needed in the modern world, where influencers, YouTubers, vloggers and bloggers are the new entertainers. Life would be much easier without such a disturbing tax provision.

6. Possible Restrictions in the Commentary on Article 17

The good news from the OECD Report (2014) was that the OECD also offered some new options for restricting the scope of article 17 of the OECD Model. These were mentioned only in the Commentary on Article 17 (2017), which make them not so strong, and now that six years have passed it would be very helpful to promote these restrictions to the text of article 17 of the OECD Model itself. We note these options below:

- employees:[29] states can agree in their bilateral tax treaties to exclude employees from article 17 of the OECD Model. This would mean that article 15 of the OECD Model would prevail over article 17, so that article 15(2) for posted workers would also apply to entertainers and sportspersons. The three justifications for article 17 of the OECD Model (*see* section 5.) do not seem to apply to employees.[30]
- expenses and income tax returns:[31] it can also be included that expenses should be deductible at source and normal tax returns should be fileable in a subsequent year. Within the European Union, this is already obligatory after the *Gerritse* (Case C-234/01),[32] *Scorpio* (Case C-290/04)[33] and *Centro Equestre* (Case C-345/04)[34] decisions. Australia, the United Kingdom and the United States have already had these options for many years in their national legislation. This seems to be a straightforward element for new tax treaties.
- minimum threshold:[35] with a minimum threshold, smaller and medium-sized entertainers and sportspersons in terms of income can be spared the complicated taxation that follows from article 17 of the OECD Model. The OECD has taken this over from article 16 of the US Model,[36] but gives 15,000 International Monetary Fund (IMF) Drawing Rights (approximately, EUR 18,000) per person per year as an example, whereas the United States has increased the threshold to USD 30,000 (approximately EUR 25,500) per person per year in the US Model (2016).[37]
- public funds:[38] approximately two out of three tax treaties already have an exception for subsidized entertainers and sportspersons. The definition that they should be wholly or mainly funded from public sources requires more than a 50% subsidy, which, in practice, is very high.[39]
- limited approach of article 17(2) of the OECD Model:[40] some states have expressed that in their tax treaties they will only apply the limited approach of article 17(2), as it was when the second paragraph of article 17 was introduced in the OECD Model (1977).[41] This means that only payments to associated parties fall within the scope of article 17(2) of the OECD Model, and that is a very helpful restriction for many entertainment companies and sports teams.[42]

However, unfortunately, these restrictions will not help influencers and other social media stars very much, and the same is true for other individual entertainers and sportspersons.

7. Taxing the Digital Economy

In addition to Kostikidis' article, we want to make a connection with taxing the digital economy. Not just because influencers and other social media stars communicate by digital means, but also because both article 17 of the OECD Model and taxing the digital economy set aside the main international principle of a PE in taxing companies (and the self-employed) in the source state, and replace it with the use of the services by consumers in the source state (consumer-facing businesses). It also openly brings forward the benefit principle as one of the justifications for source taxation.

29. Para. 2 *OECD Model: Commentary on Article 17* (2017).
30. This would also take away the unfair difference between the tax credit method used in article 17 of the *OECD Model* (2017) and the exemption method employed in article 15, as discussed in section 4. and footnote 18 of this article.
31. Para. 10 *OECD Model: Commentary on Article 17* (2017).
32. DE: ECJ, 12 June 2003, Case C-234/01, *Arnoud Gerritse v. Finanzamt Neukölln-Nord*, Case Law IBFD.
33. DE: ECJ, 3 Oct. 2006, Case C-290/04, *FKP Scorpio Konzertproduktionen GmbH v. Finanzamt Hamburg-Eimsbüttel*, Case Law IBFD.
34. DE: ECJ, 15 Feb. 2007, Case C-345/04, *Centro Equestre da Lezíria Grande Lda v. Bundesamt für Finanzen*, Case Law IBFD.
35. Paras 10.1-10.4 *OECD Model: Commentary on Article 17* (2017).
36. *United States Model Income Tax Convention* (17 Feb. 2016), Treaties & Models IBFD.
37. But the OECD also provides the option to make the threshold variable, following the GDP index, which is very good for long-running tax treaties.
38. Para. 14 *OECD Model: Commentary on Article 17* (2017).
39. *See* D. Molenaar & H. Grams, *Article 17(3) for Artistes and Sportsmen: Much More than an Exception*, 40 Intertax 4 (2012).
40. Para. 16 *OECD Model: Commentary on Article 17* (2017).
41. *OECD Model Tax Convention on Income and on Capital* (11 Apr. 1977), Treaties & Models IBFD.
42. Canada, Switzerland and the United States have made this reservation with regard to article 17 of the *OECD Model* (2017) in paragraph 16 of the *OECD Model: Commentary on Article 14* (2017). The United States also mentions this restriction in article 16(2) of the *US Model* (2016). *See also* D. Molenaar & H. Grams, *Rent-A-Star – The Purpose of Art. 17(2) of the OECD Model*, 56 Bull. Intl. Fiscal Docn. 10 (2002), Journal Articles & Papers IBFD.

Taxing the digital economy is a result of the OECD/G20 Base Erosion and Profit Shifting (BEPS) programme, which was successfully coordinated by the OECD and has led to many recommendations, including proposals for changes in bilateral tax treaties, implemented by way of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (3 June 2017) (the Multilateral Instrument (2017)).[43] This has required so much energy and focus on the part of the OECD that taxing the digital economy was not directly followed up. Some states have become anxious, because they were concerned about very large international digital companies, mainly from the United States but some of them Chinese, collecting income from their territory that they could not tax because of the lack of a PE.[44] This situation has caused some states to announce unilateral source-withholding taxes of between 1.5% and 7.5%,[45] even when, under the relevant tax treaties, it is unclear whether a digital enterprise in its residence state would be entitled to a tax credit or exemption. This entails a realistic risk of double taxation.

The tax problems of both entertainers and/or sportspersons and the digital companies are comparable: the definition of personal scope, apportionment of income, deductibility of expenses, the risk of double or excessive taxation and high administrative expenses. These problems hit, in income terms, the small and medium-sized much harder than the big players, who will have the budget to employ good advisers who can help them avoid double taxation.

The OECD has taken the initiative and come up with a proposal for a Unified Approach with Pillars I and II.[46] Briefly, Pillar I proposes that states in which digital companies are selling their content will decide together what the total worldwide profit of that digital company has been, how that will be divided between these states and how the residence state will eliminate double taxation. This coordinated approach will be led by the tax authorities of the residence state. With Pillar II, the OECD wants to arrive at a minimum corporation tax rate, so that competition between states with very low tax rates and artificial tax structures, with the resulting transfer of profits to such low-tax jurisdictions, will be avoided.

The Unified Approach is still very much under discussion, but entertainment and sports taxation can learn from some of its elements:

– A high minimum threshold: there seems to be a consensus that a high minimum threshold for digital services taxes (DSTs) would be reasonable. This would avoid the situation of small and medium-sized digital companies also having to undertake complicated administrative work. The proposal is a minimum turnover of EUR 750 million worldwide and EUR 50 million turnover per state.
– This approach is comparable to that which the United States already has for entertainers and sportspersons with its threshold in article 16(1) of the US Model, and as applied in its tax treaties. But the OECD mentions the threshold only in the Commentary on Article 17 of the OECD Model (2017) and should upgrade this to the text of article 17 of the OECD Model itself, after which all states could start to use this threshold in their tax treaties. The same applies to article 17 of the UN Model. The threshold could even be set at a higher level in order to be more effective, as proposed in the OECD Unified Approach for digital companies.
– A low source withholding tax: the rates of DSTs vary from 1.5% to 7.5% on gross income, while entertainers and sportspersons face a 15% to 30% tax on gross income at source. A lower rate would remove the risk of double taxation.
– Coordination between tax authorities: this would also help entertainers and sportspersons performing worldwide, because it would reduce their administrative expenses arising from different procedures in every state and would certify the tax credit in the resident state.

The UN has also come up with a new proposal for the taxation of digital companies, through which it wishes to add a new article 12B to the UN Model.[47] There is no threshold in this proposal, but there is an easier method of calculating how much turnover or profit should be allocated to the states where a company is active. There will be more discussion in time as to whether this alternative will be adopted by states.

8. Conclusions

The taxation of influencer income is an interesting topic, and its discussion was initiated by the article by Savvas Kostikidis in the June 2020 issue of the *Bulletin for International Taxation*.[48] The present article offers a response, in which the authors have expressed their doubts as to whether influencers would fall within the personal scope of article 17 of the OECD Model as entertainers and sportspersons. Hopefully they would not, because, otherwise, they would enter into a problematic world of the apportionment of income, taxation at source and the elimination of double or excessive taxation in their residence state. Unfortunately, article 17 of the OECD Model gives rise to tax problems and high administrative expenses; nevertheless, the OECD and its member countries decided in the OECD Model (2014) to retain

43. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (7 June 2017), Treaties & Models IBFD.
44. Examples include Alibaba, Apple, Facebook, Google, Netflix and Spotify.
45. Examples of unilateral digital service taxes (DSTs) are Austria 5%, Belgium 3%, France 3%, Hungary 7.5%, Poland 1.5%, Spain 3%, Turkey 7.5% and the United Kingdom 2%, all on gross earnings without deduction of expenses.
46. OECD, *Secretariat Proposal for a "Unified Approach" under Pillar One* (OECD 2019).
47. UN Committee of Experts on International Cooperation in Tax Matters, 21 July 2020.
48. Kostikidis, *supra* n. 1.

the article, even though the three reasons given for this are neither realistic nor fair (*see* section 5.).

It may be that states wanted to keep the article because they believe they could profit from the tax revenue to be derived from well-known entertainers and sportspersons performing on their territory, but the figures from Belgium show that this tax revenue is very low (*see* section 3.). And such income falls almost to nil when the tax credits for residents with foreign performance income are brought into the same calculation. "Much ado about nothing", as William Shakespeare wrote around 1600.

The comparison with taxing the digital economy may place the taxation of entertainers and sportspersons in another perspective. In this new era of business, states seem to have given up on the principle of a PE and the use of public facilities in the allocation of the taxing right, and, instead, have made a connection with the use of the digital services in their territory. The taxation of entertainers and sportspersons can learn from this regime, with its high minimum threshold, small and medium-sized entities not being caught by the system, low source withholding tax rates and coordination between tax authorities with bigger tours or events to avoid double taxation. And perhaps that regime could be implemented for entertainers and sportspersons with the same Multilateral Instrument as is intended for the new taxing rules for digital companies.

If influencers do not fall under article 17 of the OECD Model, then it is likely that article 7 of the OECD Model or article 14 of the UN Model would apply to them, as self-employed earners. Royalties could fall under article 12 of the OECD Model and the UN Model, while, following the discussion on the digital economy, article 12B of the UN Model might apply to everything. Only in circumstances of genuine employment would article 15 of the OECD Model and the UN Model apply.

9. Postscript: Virtual Influencers

The tax situation of the virtual influencer Esther Olofsson (Instagram: esther.olofsson) is different. She seems to go around in Rotterdam, Netherlands. She is smart, clever, good-looking and goes to new and trendy places, while also promoting existing products and events. But the distinction from other influencers is that she does not exist in reality, as she is the creation of Maarten Reijgensberger of the RauwCC communication agency. The foreign income derived from her activities will not be for her but for the communications agency, and these will clearly be business profits under article 7 of the OECD Model and the UN Model. But this is just a single case to be noted, because a virtual influencer such as Esther Olofsson is still an exception in the growing world of human influencers.

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