International

Adapting Current International Taxation to New Business Models: Two Proposals for the European Union

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In this article, Yariv Brauner and Pasquale Pistone outline two solutions for the European Union to deal with the current problems facing international taxation: the virtual permanent establishment solution and the withholding tax solution.

1. Scope

New business models have significantly altered the way in which business is done, most importantly in no longer requiring a physical presence in market countries. In contrast, tax law still follows the traditional business models in taxing cross-border income, whereby the physical presence based concept of a permanent establishment (PE) determines the allocation of taxing powers among states. According to this concept as it currently stands, a state other than the residence state of the enterprise may only tax business income in the presence of a fixed place of business within its territory and only to the extent that income is attributable to that fixed place of business.

In line with the 1998 Ottawa declaration, the OECD has retained the requirement for a physical presence as a necessary condition for admitting the existence of a PE. This has turned the PE into a cage that prevents the market country from exercising its taxing powers on value created within its territory by the business conducted (conduct being defined by old economy standards) outside that country.

The failure to adapt international tax law to the needs of new business models has given rise to undesirable consequences. Action at the global level is urgently required to bring international tax law back into line with the objectives of fairness in the allocation of taxing powers between states and removing the existing tax biases that currently arise between the traditional economy and the new business models.

Delaying intervention will simply increase the tax wedge between such business models and permit unilateral action in the form of alternative levies on the digital economy to flourish worldwide. Such an instrument has the appeal of a quick fix, but it potentially damages international economic relationships. Consequently, countries should use it only when they are left with no other option to protect their tax sovereignty. We believe that better options exist and should be promoted, as is explained subsequently in sections 3. and 4.

In principle, it is desirable to undertake such action at the widest possible geographic level. However, in practice, the outcome of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Report on the digital economy[1] is a reliable indicator of the difficulties of realizing this outcome worldwide.

Whilst all our hopes are that the OECD will successfully aggregate consensus regarding the content of an interim report that is expected to be released by mid-2018, we suggest that action should be taken at the regional level, such as, for example, within the European Union, to facilitate the action by the OECD at the global level. The European Union has perceived the importance of addressing such problems and is currently trying to reach consensus on how action on the reform of international taxation may best deal with those issues that undermine fair allocation of taxing rights and the fundamental objectives of the internal market.

We have conducted studies and identified possible solutions that harmoniously bring new business models within the existing rules for taxing income across borders. This is desirable from a policy perspective, as it realizes a level playing field between different ways of doing business without replacing the existing tax bias with a new one. In particular, in our previous studies, we have argued for adapting the conceptual categories of international taxation to the new business models and elaborated, with a team of colleagues, two solutions that could separately operate or be combined to remove the tax bias arising from the treatment of traditional business and that of the digital economy.

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1. OECD, *Action 1 Final Report 2015 – Addressing the Tax Challenges of the Digital Economy* (OECD 2015), International Organizations' Documentation IBFD.

First, we indicated the digital (virtual) PE as being an optimal solution for adapting current tax treaties to new business models.[2] This solution would permit a move away from the concept of a physical PE and permit any state to tax business carried out by non-residents on its territory in the presence of a genuine connection with its sovereignty, such as when the business exceeds a threshold connected with the number of users in a year. We further explored the application of this solution in actual scenarios by reference to case studies.

Second, we envisaged a withholding tax to be suboptimal, but a faster reaction to the problems of adapting business taxation to the new models.[3] This solution would extend the obligation to withhold taxes in respect of all income, thereby including business income, and either be an advance, i.e. acting as a toll fee if operating in combination with the digital PE concept, or final, i.e. if operating as a standalone solution, payment of tax on business income by the market country.

Although the OECD/G20 BEPS Report on the digital economy considered such studies, it recommended none of these, nor the approaches envisaged therein.[4] We believe that this was due to the lack of a sufficient reflection and, ultimately, to the lack of consensus among the participating countries, which feared a significant loss of tax revenue or indirect effects on the operation of criteria for allocating taxing powers.

2. Quick Fixes Using Alternative Levies: A Mirage, an Effective Tool or a Punishment for the Digital Economy?

Meanwhile, the problems have not disappeared and some important reactions are occurring worldwide at the unilateral level, such as the Indian equalization levy on services[5] or the equivalent solutions adopted by other countries in the form of excise duties. We understand that this is one of the few possible options for a quick and unilateral defensive reaction that effectively protects tax sovereignty. However, when this quick fix turns into an overall tax policy standard at the global or even regional level, we believe that it may create more problems than it solves in each of the countries that apply it. For this reason, we express concern as to suitability of these types of measures to operate as quick fixes to the existing problems of adapting taxation to the requirements of the new business models.

In principle, such levies are charged on revenue rather than on income. Consequently, they create an additional layer of tax for the digital business on top of that due by the enterprise in its residence state, which ends up substituting one tax bias for another. Such levies also give rise to possible repercussions for other taxes levied on the supply of services and goods, including a potential interference with value added taxes. In addition, from the perspective of the European Union, insofar as such levies apply across borders only, they may give rise to problems of compatibility with the fundamental freedoms that could not be justified. Among others, even if such levies were applicable in a non-discriminatory manner, they would structurally produce a tax bias in the treatment of traditional and new business models, which could potentially affect the exercise of freedoms and alter competition within the internal market.

Additional legal problems may arise insofar as only a limited number of Member States (equal to at least one third of the total number of Member States) support the introduction of this type of measure using enhanced cooperation. In line with the legal requirements of article 20 of the Treaty on European Union (TEU),[6] this type of action constitutes a last resort and operates only when the objectives of cooperation cannot be attained within a reasonable period by the European Union as a whole. Enhanced cooperation is admissible to the extent that it furthers the objectives of the European Union, protects its interests and reinforces its integration process, subject to some specific limits indicated by the primary law of the European Union.

In particular, article 326 of the Treaty on the Functioning of the European Union (TFEU)[7] indicates that such cooperation should neither undermine the internal market nor constitute a barrier to trade between the Member States or distort competition between them. Article 327 of the TFEU adds that it should respect the sovereignty of the Member States not participating in enhanced cooperation.

The introduction of a quick-fix solution, applied in the form of an alternative levy by enhanced cooperation only on the revenue produced by the digital economy across borders would, in our opinion, be against all such principles and would be very difficult to reconcile with the object and purpose of enhanced cooperation. This conclusion holds at least to the extent that any alternative legal options exist to address the same type of problems, such as, in our view, the package that we are proposing in this short article, based on the measures outlined in our previous studies.

However, a fast-track solution within the European Union is desirable, insofar as it permits the pursuit of two major advantages. These are: (1) regaining fairness in the allocation of taxing powers by completing the alignment of taxing powers with value creation; and (2) removing the tax bias that currently affects competition within the internal market.

2. P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy* (1 Jan. 2015), available at https://ssrn.com/abstract=2586196.
3. Y. Brauner & A. Báez Moreno, *Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy* (2 Feb. 2015), WU Intl. Taxn. Research Paper Series No. 2015 – 14, available at https://ssrn.com/abstract=2591830.
4. It also nominally included an equalization tax option, which is similar to that ultimately adopted by India, yet such a solution is effectively identical to the withholding solution, but nominally operates outside the scope of tax treaties and the current, income tax based, international tax regime. As such, we find it inferior to the solutions suggested in this article, which operate within the current framework.
5. A.K. Lahiri Ray & S.D.P. Gautam, *Equalisation Levy*, Brookings Instn. Working Paper 02 (Jan. 2017).
6. Consolidated Version of the Treaty on European Union (TEU), OJ C 326 (2012), EU Law IBFD.
7. Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union (TFEU), OJ C 115 (2008) (as amended through 2007), EU Law IBFD.

Our preference for this type of fast-track solution leads us to suggest that the European Union should go beyond quick fixes. We do not regard quick fixes (e.g. an alternative levy on the revenue produced by the digital economy) as a mirage and appreciate their effectiveness as a defensive measure. However, we are sceptical whether the European Union should adopt them, due to their undesirable side effects outlined previously in this section. Except if this type of levy applied on an optional basis, i.e. as an alternative to the ordinary regime, which the taxpayer decides to apply, our scepticism turns into an actual doubt regarding its compatibility with EU law when we consider the effect of such measures on the internal market, its principles and the primary law of the European Union. This would even more be the case insofar as a limited number of Member States may wish to introduce such a measure despite the existence of other solutions that comply with EU law, are qualitatively better, do not move the European Union, as a block, away from the existing status quo in international taxation and may be implemented without major side effects.

We do have such a solution in mind or, in fact, a combination of two solutions. These are the virtual PE and a withholding tax, which can either operate separately, with the virtual PE being, in our opinion, the optimal solution in qualitative terms, or be combined.

In sections 3. and 4., this short article develops some technical ideas to adapt our previous studies and to give technical support to the initiative of the Estonian Presidency on the taxation of the digital economy. In this context, we also address two additional issues regarding each of the two proposed measures, i.e. those relating to compatibility with EU law and those arising from relationships with third countries.

3. The Virtual PE

A PE is a fixed place of business through which an enterprise exercises its activity on the territory of a contracting state other than that in which it is resident. When this concept was first developed, a PE constituted a reliable proxy for a fair allocation of taxing powers on business income, as a stable physical presence was considered to be indispensable for the stable exercise of business on the territory of another country.

Consequently, the object and purpose of the PE clause in article 5 of the OECD Model[8] presents a structural connection with the requirement of physical presence. It is, therefore, no surprise that the additions made to the Commentary on Article 5 of the OECD Model (2003)[9] recall such a requirement to exclude the fact that e-commerce could give rise to a PE in the absence of a tangible piece of the enterprise being on the territory of a country.

The exponential growth of the digital economy and the liberalization of trade and capital movement, especially between the most industrialized nations and within the European Union, have gradually taken advantage of this interpretation of the concept of a PE to carry on business without an actual physical presence on the territory of the country where business products are sold. In this respect, the PE has changed from being a fairness tool into an obstacle preventing the levying of taxes on business income by the market country. Two factors have increased the unfairness of this context.

First, new business models involve final customers in value creation using various tools that permit businesses to better target their products at potential customers by interacting with them and their preferences. Second, the possibility to sell products at distance has allowed business to operate from low-tax jurisdictions and to compete with the traditional physical economy that is often subject to a higher tax burden in the market country.

This situation has two major consequences. First, it contributes to boosting the digital economy with a considerable and perfectly legitimate tax savings. Second, it gives rise to a significant effect on the allocation of taxing powers among states. Low-tax jurisdictions have seen their share of revenue increasing because of higher exports and high-tax jurisdictions partially lost their right to exercise the taxing power compared to what would otherwise be the case in the traditional economy.

In our original proposal, we suggested the introduction of a new paragraph into article 5 of the OECD Model that would specifically address the extension to the concept of a PE to deem its existence only in the presence of a threshold based on the number of users and turnover within a given period. This solution could represent a more transparent change to the boundaries of the PE and could now also be channelled through a corresponding amendment to the OECD "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (2016) (Multilateral Convention, or MLI).[10]

However, insofar as it is currently not possible to realize global consensus in this respect, we consider that alternative options could permit the European Union to realize an equivalent result from the perspective of removing the existing tax bias between the traditional and the digital economies. Consequently, we suggest an intervention at the level of interpretation, which could be implemented rather quickly and would not require any renegotiation of existing tax treaties.

Such an intervention essentially consists of interpreting the concept of a fixed place of business in article 5 of the OECD Model as not only including cases of physical presence, but also those of virtual presence of an enterprise on its territory. The latter could be determined in line with some criteria that take into account the number of users established on the territory of the country with which an enterprise has successfully concluded business contracts, the duration of the presence of the enterprise on the territory of the country and the overall revenue derived.

8. *OECD Model Tax Convention on Income and on Capital* art. 5 (26 July 2014), Models IBFD.
9. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 5*, para. 42.1 et seq. (28 Jan. 2003), Models IBFD.
10. *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (24 Nov. 2016), Treaties IBFD [hereinafter: the MLI].

As there are significant differences between countries, their geographical dimensions, the size of their economies, the number of inhabitants and other persons legally established on their territory, we suggest that the criteria based on the number of users and the overall revenue are determined in a flexible way. With regard to the first criterion, one could take into account the overall number of established individuals and companies. With regard to the second, it would appear to be advisable to establish ratios with GDP and the overall revenue collected.

In addition, in order to avoid an excessive fragmentation of the taxable base, we envisage that the application of the virtual PE should take place along the lines of a de minimis threshold. This could operate with a similar function to that which a construction PE has in article 5(3) of the OECD Model and be based on the three criteria previously indicated in this section.

The implementation of this solution within the European Union should take place in three steps, which are closely connected with each other. First, the Member States should issue an authentic interpretation of the concept of a PE that considers a physical presence as unnecessary to have a fixed place of business. Second, the Member States should sign an agreement in which they formally declare their intention to interpret and apply their tax treaties in line with such a concept. Third, the Member States should make an observation to the relevant paragraphs of the Commentary on Article 5 of the OECD Model (2014),[11] which are affected by this interpretation.

In line with the principle of subsidiarity, we do not regard the issuing of an EU directive as strictly indispensable for successfully implementing the adaptation of the concept of a PE to this new interpretative standard. The main reason for this is that tax treaties currently regulate this area. Consequently, an EU Multilateral Protocol would suffice to change this interpretation.

The text of the core clause to be included in the EU Multilateral Protocol could read as follows:

> The fixed place of business shall be deemed to exist also when the enterprise carries out business in the other Contracting State without a physical presence on the territory of such State. This situation includes cases in which the enterprise regularly concludes contracts with users in such Contracting State for an amount that exceeds XXX in a given year.

We think that it is unnecessary to provide additional specifications on the content of this clause, as the merits of this fast-track solution should be to quickly create consensus being a simple solution that harmoniously incorporates the new business models in traditional categories that would only require a few additional adaptations in respect of the methods for allocating tax on income.

In our view, the EU Multilateral Protocol should constitute part of the *acquis* of the European Union, along the same lines that have characterized the binding international tax coordination produced by the EU Arbitration Convention (90/436).[12] From a structural perspective the EU Multilateral Protocol would be very similar to the MLI, as it flanks the existing tax treaties in order to remove the potential effect that the existing tax bias between the traditional economy and the new business models has on the internal market.

The effects of the EU Multilateral Protocol within the European Union could operate immediately after Member States sign, ratify and implement it. Consequently, the Member States would have to interpret all their tax treaties on the basis of the new standard to comply with the content of the EU Multilateral Protocol. As a result, all of the rules applicable to a physical PE would automatically apply to the broader concept of a PE, which would also include the virtual PE, following the signature, ratification and implementation of the EU Multilateral Protocol.

In the tax treaties between Member States, the main consequence of this shift of taxing powers from the residence state of the enterprise to the residence state of the virtual PE would be a shift in tax revenue towards market countries and those in which the business activities were exercised without an actual physical presence. However, this shift could, in our opinion, re-establish fairness in the allocation of taxing powers among countries. Consequently, any Member State that opposed this shift would have to bear the responsibility towards the public opinion of countering a reform that would resolve the abnormal past increase in the national revenue of some Member States caused by the inadequacy of the existing international tax rules to apply to the new business models. By bringing these Member States into line with the concept of value creation, this new allocation of taxing powers would better reflect the reality of new business models and would remove the tax distortions within the internal market caused by the physical requirement connected with a PE. Tax treaties with non-Member States could give rise to additional issues, unless the non-Member States decided to adjust the boundaries of a PE in a way that also includes the concept of a virtual PE.

In principle, in executing the EU Multilateral Protocol, the contracting Member State would widen the interpretation of the concept of a PE in a way that, when acting as the source state, it could attribute a larger portion of the income to a PE than that which would currently result along the lines of the concept of physical presence of a PE. As this would be an interpretative change operating prospectively and would be combined with a corresponding observation on article 5 of the OECD Model, we do not consider this would represent a violation of the *pacta sunt servanda* principle enshrined in article 26 of the Vienna Convention on the Law of Treaties (the "Vienna Convention") (1969).[13] Insofar as the other non-EU contracting state has an ex ante knowledge of this new standard for interpreting the PE concept, it would be in a position to decide what measures it should take in that respect.

The effect would also be, in substance, less distortive than that of an alternative levy. This would be particularly visible in the opposite situation, i.e. that of a contracting resident Member State. In such circumstances, if the non-EU contracting state taxes income in line with

11. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 5*, para. 42.1 et seq. (26 July 2014), Models IBFD.
12. Convention 90/436/EEC of 23 July 1990 on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (as amended through 2008), EU Law IBFD [hereinafter: the Arbitration Convention (90/436)].
13. *Vienna Convention on the Law of Treaties* (23 May 1969), Treaties IBFD.

the concept of a virtual PE, the contracting Member State would be in a position to give relief for international double taxation on business income. However, if the non-EU contracting state were to exclude the existence of a PE, the contracting Member State could counter possible unintended cases of double non-taxation. In particular, for such a purpose, the Member State should exercise its sovereignty and apply defensive measures that could go as far as subordinating relief to a subject-to-tax clause.

The concept of a virtual PE could also require a corresponding adaptation of the criteria currently used for allocating taxing powers between the head office and a PE. As the OECD Transfer Pricing Guidelines[14] recommend using the method that best reflects the needs for each type of business, in line with the recommendation contained in our previous study, in the presence of the virtual PE, we suggest using the profit-split method with some adaptation. Such an adaptation should relate the replacement of the risk-taking function and the geographical presence of assets with other criteria, which could include the revenue from the contracts concluded in the country of the virtual PE and others that more closely correspond to the dynamics of the new business models.

Finally, the interpretative solution of the virtual PE would have, in our view, three important advantages. First, it would permit a rather quick implementation, as it would act at the level of interpretation and would not require the renegotiation of tax treaties. Second, it would significantly reduce the tax bias between traditional business and the digital economy by bringing them both within the same conceptual framework. This would be particularly important to avoid possible tax biases and additional problems relating to the different treatment of different types of business within the internal market. Third, it would provide an effective solution that would overcome the existing problems that prevent the market country from exercising its sovereignty over business activities exercised at distance on its territory in the absence of a physical presence. We also consider that this solution would prevent the development of further unilateral reactions based on the concept of the alternative levies, which would move this form of business income away from the patterns currently included in the OECD Model that would be difficult to abolish once introduced.

For these reasons, the introduction of a virtual PE concept into EU law would be a constructive step forward and an effective global action to bring international tax categories and concept back into line with the business models. It would also represent a friendly development in cooperation with the OECD, as it would essentially preserve the OECD PE standard and facilitate OECD action to realize a possible expansion of this solution at a later time. Finally, it would not prevent the European Union from applying this solution in a context of formulary apportionment, provided, of course, that the factors along which the formula applies were amended in a way that would take into account the different features of the new business models connected with the digital economy.

4. The Withholding Tax Solution

The withholding solution would complement the virtual PE solution based on a few realistic assumptions. First, and most importantly, similar to the outcome of the OECD/G20 BEPS Project, it is possible that too few of participating states would be able to agree on the premises of a virtual PE solution. In particular, disagreement could arise from too many states fearing that they would be losers under that solution or simply due to the uncertainty that such a solution would present in their view.

Second, it is reasonable to assume that all Member States would agree that something must be done now. This is because some of them have already undertaken unilateral actions and others are ready to do so in the immediate future if international action were to stall.

Third, the primary concern giving rise to unilateral action concerns base erosion. This challenge has been addressed, but clearly not fully resolved by the OECD/G20 BEPS Project. It does not, for example, address the views of such countries that market based value creation should result in the allocation of taxing rights. To put it simpler, these countries are protesting against the diminishing of source taxation in the international tax regime.

Fourth, much of the difficulty in taxing the digital economy relates to definitional issues, which are themselves translated into questionable anti-abuse mechanisms. This is so as, while all states agree that the digital economy cannot be ring-fenced, the current solutions all rely on particular treatments for income generated by the digital economy, thereby resulting in circular reasoning that is difficult to resolve.

Fifth, much of the debate regarding the taxation of the digital economy is at the maximal state, i.e. an all-or-nothing solution to all digital economy solutions. This, for many reasons, including the complexity and the diversity of the digital economy, is very difficult to devise, and, therefore, more focused solutions should be discussed as well.

Sixth, the focus of the debate is on the most salient issues and not on the most pressing ones, i.e. the taxation of "hot" topics, such as Uber drivers and buyers on Amazon, while a large majority of the digital economy and essentially all of the base erosion involves business-to-business ("B2B") transactions.

Consequently, we have thought of a solution for right here, right now, and this is a solution that would deal with the concerns of all of the parties, but, at the same time, could be implementable within the framework of the current international tax regime and would be flexible enough to accommodate any expected developments, including future better coordination among states on solutions, such as the virtual PE. Our proposal is also quite simple.

14. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), International Organizations' Documentation IBFD.

We propose the design of a standard 10%[15] final withholding tax on all base-eroding business payments to registered non-residents, with specific, again standard, exemptions to payees who decide to register to be taxed under a net taxation scheme.[16] The net taxation scheme could also be a nexus-based solution or an elective scheme to avoid the withholding tax proposed here. The proposal would depend on a reliable, quick, cheap and automatically shared registration system shared by, at least, the major economies, such as the BEPS countries.

It can immediately be observed that there would be no separate treatment for the digital economy and, therefore, no need for definitions. However, at the same time, this solution would respect all of the existing rules on which countries currently agree. They are reflected in what would now be exemptions from the withholding tax, such as employment income, which is typically subject to a unique withholding regime itself that can easily be preserved, dividends, interest and royalties, etc., the latter being covered by both domestic laws and treaty provisions, and regular business outlays, such as material, rents, and services performed by people on the ground that would be exempt and would qualify for deductions if viewed as bona fide in the same way that they are under the current rules. Only those non-covered deductions that are not accompanied by an income inclusion, which, therefore, we would regard as base eroding, would be subject to the proposed withholding tax.

Implementation should be quite simple as well. A taxpayer that wished to deduct a payment would have to present a “code”, either for an exemption or a different applicable rule, or for a payee registered to be taxed on a net basis.

In the absence of such a code, the payer would have to withhold. They would withhold 10% if they could identify the payee and, if they were unable to do so, a higher rate, say 15%, of withholding tax would be required. This higher rate could also apply mandatorily to payees in, or owned by, low- or no-tax jurisdictions. States could choose to provide an option for taxpayers to file a return for a refund of the increased portion in defined circumstances.

It should be noted that this tax would effectively resolve the base erosion problem and most of the digital economy taxation issues. At the very least, it would create a significant incentive for non-cooperating states to increase their efforts in such a direction.

The proposal acknowledges that business-to-consumer (B2C) transactions are different. These would initially be exempt as non-base eroding, but this does not resolve the issue of the diminished jurisdiction to tax of market economies. First, the withholding tax should change, at least, some of the politics and alliances in the context of this debate, there creating better opportunities for cooperation that could result more collaborative solutions, such as the virtual PE. However, even in the absence such collaboration, the withholding tax solution could be extended to payments effected through regulated financial institutions, primarily banks and credit card companies that must operate in each market jurisdiction under the licence and control of the domestic government. In that way, the operation of the tax would not be conceptually different from VAT and, therefore, similar issues could arise and similar solutions could be applied. This should be particularly direct, in technical, if not in political terms, in the European Union where VAT is already advanced and harmonized. Again, payees should be able to register to be taxed under any net taxation scheme, thereby exempting them from the withholding tax. Consumer-to-consumer (C2C) transactions, except for marginal cases, such as barter transactions, are not technically different from B2C transactions and, therefore, would not necessitate a distinct taxing scheme.

To sum up, the withholding tax solution would be a flexible, immediate solution to the most acute challenges of the digital economy. It is a solution that would avoid critical technical problems and would work in the direction of better cooperation between states to arrive at collaborative solutions, even if, at present, such a solution has not yet presented itself. It could also become an implementation mechanism for a virtual PE solution, if one were to be agreed on by a sufficient number of the Member States.

The solution would operate within the framework of the current international tax regime and would, therefore, not represent a departure that could risk weakening of the fundamental premises of this regime. It would require some pragmatic steps, all of which are essentially similar to those proposed by us in the context of the virtual PE solution mentioned in section 3. Withholding taxation is universally considered to be an acceptable form of taxation at source in lieu of net income taxation, as long as it is proportional and reasonably similar to the equivalent net income tax. Consequently, although a withholding tax would represent a departure from typical taxation of business income under articles 5 and 7 of the OECD Model, and probably also article 12, which is, in effect, a business tax article already employing a withholding tax mechanism, it would not be contradictory to these provisions and would, therefore, available for an interpretation strategy of the kind we proposed in section 3. for the virtual PE solution.

Similarly to the virtual PE solution, at the EU law level, we also propose to establish a single EU Multilateral Protocol that would reflect the strategy for the single market and would potentially be a step toward a more comprehensive, universal solution, hopefully led by an EU example. This solution would already be compatible with expected reforms in the business tax rules, including the European Commission’s Common Consolidated Corporate Tax Base (CCCTB) or Common Corporate Tax Base (CCTB) proposals and any reform in the spirit of formulary taxation within or outside the European Union.

15. The exact rate is unimportant, as it need only be sufficiently low to avoid distortion and high enough to incentivize avoiding it, and sufficiently high to be meaningful on its own.
16. This mechanism is familiar to many and is similar to that adopted by many countries for foreign investors in real estate.

5. Conclusions

This article argues for immediate action to establish a level playing field between the tax treatment of income derived within the framework of new business models and of the traditional models across the borders. The lack of a global consensus on the proposed solutions has unduly deferred the introduction of a common standard, thereby giving rise to significant distortions worldwide and in the European Union, from which multinational enterprises (MNEs) have benefitted in particular.

In this scenario, some states have already taken action with the introduction of defensive measures in the form of alternative levies that are an effective form of protecting their national tax sovereignty with regard to the value creation generated in their territory. Such levies may constitute an additional tax burden, at least, to the extent that they apply to revenue and are, therefore, ineligible, under existing tax treaties, for relief against taxes on income.

Such measures may be depicted as quick fixes to the existing problems of international taxation connected with the treatment of the digital economy. However, they may also potentially harm global digital players in an unnecessary way and give rise to negative effects on the economy of smaller countries. For all of these reasons, we do not consider them to be a suitable approach to the international tax problems connected with the digital economy.

Under the political impulse of the Estonian Presidency of the EU Council, the reform of international taxation in respect of the digital economy is now high on the agenda of tax integration of the European Union. We consider that this would be an important opportunity to give the European Union the role of forerunner in the modernization of international taxation. This could give rise to positive effects from the perspective of removing some of the existing tax distortions within the internal market. It could also complement the action that the OECD has started with BEPS Action 1 and the technical measures that are envisaged in its technical report, but which cannot yet be implemented due to the absence of sufficient consensus among the participating states.

In line with these criteria, we believe that the reform of international taxation should incorporate the treatment of the digital economy into the existing rules, rather than creating additional rules that depart from such rules and replace the existing tax bias across the borders with a different one. For this reason, this article has proposed adapting to the framework of the European Union two solutions based on the concept of the virtual PE and the broader application of withholding taxes, which we have developed in our earlier studies together with our colleagues.

We are still convinced that the virtual PE would be the qualitatively best solution to adapt the existing categories and concepts of international taxation to the new business models connected with the digital economy. The virtual PE is a simple solution that we have outlined in this article through a different approach compared to that previously indicated. We believe that a switch to the virtual PE could be implemented with a mere intervention at the interpretative level, by deeming that the concept of fixed place of business could also include cases of digital presence on the market of a country. Consequently, a country could establish a tax nexus with business exercised on its territory, despite the physical absence of business from it, to the extent that a significant number of contracts were concluded with users from that country in a given year.

The virtual PE solution should be implemented by means of an EU Multilateral Protocol, which would deprive the Member States of their tax prerogatives at the national level, but would align them in a simple way with the need for international tax coordination at EU level. This solution could also require a corresponding adjustment in the methods for allocating income to the different business models connected with the digital economy. However, in our opinion, this adaptation would not completely deviate from the framework advanced in the OECD Transfer Pricing Guidelines. In addition, we believe that the virtual PE could operate within a scenario of formulary apportionment, should the European Union or some of its Member States decide, in the future, to make progress on the front of the CC(C)TB project(s).

The second solution envisaged in this article is an extension of withholding taxes. This solution could be even simpler than that based on the virtual PE or could be a mechanism for implementing the latter solution in the form of a toll fee for tax collection, or even a first stage towards implementation of a widely supported virtual PE solution.

In our view, such measures and the identification of the steps to implement them within the European Union demonstrate that a simple and inclusive solution to the international tax problems of the digital economy is now possible. Our two proposed solutions would, therefore, be better in line with the legal framework of the European Union and enhance the consistency in the tax treatment of traditional and new business models.

Now is the time for action and it is for the Member States and decision-makers not to hesitate in pursuing this long-awaited reform of international taxation. This, in our opinion, could also help the OECD to increase its chances of success in advancing international tax coordination at the global level in the near future.