

# A CRITICAL ANALYSIS OF WHETHER BEPS ACTION 1 RESOLVES ISSUES OF SOURCE TAXATION

By

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## Abstract

The digital economy and the challenges it poses to the international tax arena is a swiftly developing area. This dissertation considers the suggestions released by the OECD Pillar 1 dated January 2020 and the UN Article 12B released in August 2020.

The digital economy has evolved significantly over the last years and has changed how business operates. Digital enterprises can conduct business across borders without creating a physical presence using information and communication technology. As a result of the increased use of technology in business processes, it has been opined that the digital economy is becoming the economy.<sup>1</sup>

The challenges posed by the digital economy relate to the ease with which enterprises can conduct business in a jurisdiction without any presence. International tax rules currently require a level of presence in a country before taxes on the business profits can be levied in that jurisdiction.

There has been a significant international focus by governments and media on digital enterprises. This is due to the perception that digital companies are under-taxed and that there is a misalignment between where the value is created and where the digital enterprise is subject to tax.<sup>2</sup>

The OECD/G20 Base Erosion and Profit Shifting project (BEPS) is looking at restoring confidence in the international tax system by taxing profits where value is created. Value creation will therefore be an essential part of the BEPS initiative.<sup>3</sup>

There are different views regarding the changes to be implemented that are suggested by the OECD Task Force on the Digital Economy (TFDE). One aspect is clear, the changes will have a significant impact on the international tax system for digital enterprises.

The dissertation will explore the theories that justify taxation at source. For a tax-compliant culture to exist, it is vital that taxes raised are just.<sup>4</sup> It will be shown that the theories that justify taxation at source are relevant to the digital economy and will ensure just taxation at source. To get a clear

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<sup>1</sup> OECD OECD/G20 Base Erosion and Profit Shifting Project Addressing the Tax Challenges of the Digital Economy ACTION 1: 2015 Final Report p11

<sup>2</sup> HM Treasury, Corporate tax and the digital economy: position paper, November 2017 p2

<sup>3</sup> J. Hey, "Taxation where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative, 72 Bull. Int. Tax. 4/5(2018), Journals Articles & Papers IBFD p203 Para 1

<sup>4</sup> P. Pistone, et al., Fundamentals of Taxation: An Introduction to Tax Policy, Tax Law and Tax Administration, p4

understanding of source, the concept of source and the current concept under the international tax law, will be discussed.

The characteristics of the digital economy and its ability to conclude business in a state without creating a physical presence will be discussed. It will be shown that the characteristics are not new but merely exacerbated by the digital economy.

Since the current source concept under international tax law requires a physical presence, the proposals by the OECD Pillar 1 and the UN article 12B will be evaluated. It will be essential to establish whether these proposals address the issues raised by source taxation and the requirement of a physical presence under the Permanent establishment threshold.

It is found that the proposals do not address the source issues and are also not based on sound tax policy. The proposal will be at odds with various tax policy principles such as neutrality, equity, and simplicity. The proposals are overly complicated, and valid concerns were raised that countries might receive little or no tax.<sup>5</sup>

The changes made by BEPS action 1 pillar 2, action 3 (strengthening the CFC rule), 7 (preventing the artificial avoidance of permanent establishment), 8 to 10 (transfer pricing in line with value creation), and 13 (Country by Country Reporting) would largely address the double non-taxation of the digital economy. However; it is also recommended that the changes suggested by the TFDE should not be implemented at this stage, as not enough time has passed since the implementation of BEPS to evaluate the impact clearly.

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<sup>5</sup> P. Pistone, J.F. Pinto Nogueira & B. Andrade Rodríguez, The 2019 OECD Proposals for addressing the tax challenges of the digitalization of the economy: an assessment, *Intl. Tax Stud.* 2 (2019), *Journal Articles & Papers IBFD* (accessed 9 Oct. 2019). P13 Para 1.5

## Abbreviations

BEPS	Base erosion and profit shifting
OECD	Organization for Economic Co-Operation and Development
PE	Permanent Establishment
UN	United Nations
TFDE	OECD Task Force on Digital Economy
IP	Intellectual Property
APP	Application
B2B	Business to Business
B2C	Business to Consumer
C2C	Consumer to Consumer
R&D	Research and Development
SEP	Significant Economic Presence
WHT	Withholding Tax
DTC	Double Taxation Convention
MTC	Model Tax Convention
LRD	Limited Risk Distribution
DEMPE	Development, Enhancement, Maintenance, Protection and Exploitation
MNE	Multinational Enterprise
ADS	Automated Digital Services
UA	Unified Approach

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# Chapter 1: Introduction

## 1.1 Background

The digital economy has been high on the agenda of international tax discussions. This is due to the view that the digital economy poses significant challenges to the international tax system. The digital economy has the ability to connect billions of people, businesses, data, and processes and in doing so, create economic activity.<sup>6</sup> In addition, digital enterprises can penetrate a jurisdiction without creating a physical presence or structure the MNE to reduce or avoid taxation. These concerns are supported mainly by the perception that the amount of tax paid by the digital economy is not enough.<sup>7</sup>

Countries are free to legislate a tax under the sovereignty doctrine. The sovereignty doctrine gives the country the authority to impose taxes on individuals and companies, either resident or non-resident.<sup>8</sup> Taxes are usually based on residence or source-based tax principles. If an MNE conducts business in another state (source state), the residence state and the source state are likely to claim a part of that tax, which could lead to double taxation. Many countries have double taxation treaties in place that avoids double and non-taxation. In these treaties, an enterprise must have a significant physical presence in a country before that country acquires a taxing right over business profits.<sup>9</sup> Highly digital businesses can penetrate a country's economy without physically being present. This can be done easily by selling goods and services via a website, which is in contrast to traditional non-digital businesses that require a "brick and mortar" presence in a country to conduct business in that country.<sup>10</sup>

In 2013, the G20 tasked the OECD to address situations where multinationals structured their activities to shift profits to countries with low or no taxation. As a result, the OECD developed a 15-point plan to tackle the occurrence of "base erosion and profit shifting" (BEPS). Action 1 of that plan addressed

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<sup>6</sup> <https://www2.deloitte.com/mt/en/pages/technology/articles/mt-what-is-digital-economy>

<sup>7</sup> K. Andersson, Should We Use Value Creation or Destination as a Basis for Taxing Digital Businesses? – Krister Andersson's Comments on the 2018 Klaus Vogel Lecture Given by Professor Michael Devereux, 72 Bull. Intl. Taxn. 12 (2018), Journals IBFD (accessed 14 Oct. 2019). P684 Para 4

<sup>8</sup> L.U. Cavelti, C Jaag & T.F. Rohner, Why Corporate Taxation Should Mean Source Taxation: A Response To The OECD 's Action Against Base Erosion and Profit Shifting, 9 World Tax J. (2017), Journals IBFD

<sup>9</sup> OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241046-en> p79 para 5.2.1.1

<sup>10</sup> A. Skaar, Erosion of the Concept of Permanent Establishment: Electronic Commerce, INTERTAX, Volume 28, Issue 5, Kluwer Law International 2000

the eroding effect that the digital economy had introduced to the international tax system.<sup>11</sup> The OECD Task Force on the Digital Economy (TFDE) released a report on the 13<sup>th</sup> of February 2019 describing the proposals discussed by the Inclusive Framework.

The Inclusive Framework was established to ensure that countries, including developing economies, can participate in the implementation of BEPS initiatives.<sup>12</sup> The Inclusive Framework consists of over 135 countries.<sup>13</sup>

The question is whether the proposals by the OECD Pillar 1 and the UN Article 12B justify taxation where there is no physical presence and if it overcomes the issues raised by source taxation under the DTA.

## 1.2 Research problem

As mentioned, countries generally levy taxes based on their sovereignty to raise revenue to fund their expenditure. The sovereignty principle is a right of a country to levy a tax on the individuals and corporations within that country's territory.<sup>14</sup> The taxation of business profits on non-resident enterprises is based on source taxation. In an international setting, a sufficient link (or nexus) is required between the state and the enterprise.<sup>15</sup>

The digital economy can penetrate a market and sell goods and services without creating a taxable presence or nexus in that jurisdiction. The digital enterprise requires no physical presence in a jurisdiction, and this creates an opportunity for such digital enterprises to eliminate or reduce their tax liability in that jurisdiction. As a result, there are views that the existing international tax rules are no longer adequate.<sup>16</sup>

Pillar 1, currently under consideration, suggests an expansion of the nexus based on sales, not a physical presence in a country. The proposed change to the international tax rules will create a new nexus based on an economic presence, not a physical presence as currently defined. These proposals

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<sup>11</sup> OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. <http://dx.doi.org/10.1787/9789264202719-en> p29

<sup>12</sup> OECD BEPS Inclusive Framework on Base Erosion and Profit Shifting, [www.oecd.org/tax/beps/about/](http://www.oecd.org/tax/beps/about/)

<sup>13</sup> OECD (2018), Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

<sup>14</sup> L.U. Cavelti, C Jaag & T.F. Rohner, Why Corporate Taxation Should Mean Source Taxation: A Response To The OECD 's Action Against Base Erosion and Profit Shifting, 9 World Tax J. (2017), Journals IBFD

<sup>15</sup> C. Turley, D.G. Chamberlain & M. Petriccione, A New Dawn for the International Tax System: Evolution from past to future and what role will China play? (IBFD 2017), Books IBFD (accessed 13 Apr. 2020).– Books para 4.1.1

<sup>16</sup> Base Erosion and Profit Shifting Project Public Consultation Document ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY 13 February – 6 March 2019 page 6

will change the international tax system, especially the change to the existing permanent establishment, by allocating a portion of the business profits based on a formulaic approach.

An area that seems to be lacking in the discussions around the taxation of the digital economy is whether the new proposals by the OECD Pillar 1 and the UN's Article 12B are based on sound tax policy and theoretically justified. As argued by Pinto, "why" the change should be implemented, and justification of the change should be the primary consideration. The "how" it is implemented should be secondary.<sup>17</sup>

It will be pointed out in this dissertation a sound tax policy requires the taxes levied on residents and non-resident enterprises to be justified. The theories that justify the levying of a tax have been developed in literature over time, and many of these theories remain relevant today. Firstly, it will be essential to establish if these theories apply to the digital economy and if these changes align with the several fundamental tax policy canons upon which these theories rest. These tax policy cannons suggest that the tax should be neutral, efficient, effective, fair, and flexible.<sup>18</sup>

Where countries have DTA's in place, the allocative rules for source taxation of business profits require a physical presence or economic allegiance to a country. The League of Nations defined economic allegiance on a concept known as a "permanent establishment."<sup>19</sup> It is understandable why the League of nations argued for an economic presence at the time they did. During this time, production was highly valued, and due to the immobility of production at the time, production and consumption took place in the same state. The thesis will point out that the ICT revolution has made it possible to shift production to multiple jurisdictions easily.

The permanent establishment will justify business profit taxation in the source country, as the resident business will benefit from services and the use of infrastructure in the source state through its physical presence.<sup>20</sup> Historically the permanent establishment threshold was also seen as a sufficient link between the enterprise and its economic allegiance to the source state.<sup>21</sup>

The allocation of taxing rights between jurisdictions is based on the source-based principle, and one of the main justifications for source-based taxation is the benefit theory.<sup>22</sup> The benefit theory suggests that a state may levy source tax based on the benefit the digital enterprise received from

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<sup>17</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020)

<sup>18</sup> A. Nellen, Internet taxation and Principles of Good Tax Policy, San Jose State University, p12

<sup>19</sup> Ibid Para 1.2

<sup>20</sup> Ibid Para 4.1

<sup>21</sup> Ibid Para 4.3.3

<sup>22</sup> P. Pistone et al., Taxing the Digital Economy: The EU Proposals and Other Insights (P. Pistone & D. Weber eds., IBFD 2019), Books IBFD (accessed 19 October 2019). Para 3.2.1

conducting business in that state. The permanent establishment will utilise these benefits, such as fire protection, policing, and a skilled workforce in the source state through their physical presence in the country. An important question is, will the digital enterprise receive enough benefits to justify taxation in the absence of a physical presence? The digital enterprise will not utilise services such as fire protection and a skilled workforce in the source state without a permanent establishment.

Should the proposals by the OECD and the UN be accepted, the state will have to justify the taxes levied on active business profits through the state's contributions to the generation of that income (i.e., the benefit derived by the enterprise from operating in that state).

Supporters in favour of changing the allocation of active business profit taxing rights to the source country without a physical presence base this on the value created by users in the source state.<sup>23</sup> Users are therefore placed on the production side and not the consumption side of the global value chain.<sup>24</sup> This raises another question, do users create a sufficient link to justify source taxation of active business profits, and in addition, if value creation is relied upon, what is the weight placed on production factors in the global value chain at source? The thesis will also show that the weight placed on production factors of a digitised enterprise is not as highly valued as it was in the past. This is because most of the value created by a digitised enterprise is in the intangible stages, which take place in the place of residence.

In an international tax setting, the active business taxation source rules are limited by the concept of a permanent establishment. Therefore, changes to this threshold should be justified and aligned with the principles of a good tax policy.

### 1.3 Research method

The research method will be theoretical non-doctrinal research approach to get a clear understanding of the theoretical basis for current legal principles.<sup>25</sup> In evaluating whether any change to the allocation of business profit taxing rights based on a new nexus threshold is required, a qualitative research approach will be used.

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<sup>23</sup> J Kennedy, Digital Services Taxes: A Bad Idea Whose Time Should Never Come, ITIF, P4

<sup>24</sup> P. Pistone et al., Taxing the Digital Economy: The EU Proposals and Other Insights (P. Pistone & D. Weber eds., IBFD 2019), Books IBFD (accessed 19 October 2019). Para 3.3

<sup>25</sup> M. McKerchar, Philisopical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation, eJournal of Tax Research (2008) vol. 6

The analysis will be drawn from a thorough review of the literature. The literature reviewed includes books, articles, the OECD MTC and the Commentaries, UN MTC and Commentaries, OECD BEPS, and Journals.

## 1.4 Limitations

This dissertation will consider whether there is sufficient justification to levy taxes on non-resident digital enterprises in the absence of a permanent establishment. The dissertation will be limited to reviewing the proposals by the OECD Pillar 1 dated January 2020 and the UN Article 12B released in August 2020, against the theories that justify taxation and the canons of a sound tax policy.

## 1.5 Chapter structure

The chapters in the thesis will establish whether the suggestions made by the OECD and the UN Article 12B are aligned with the current understanding of source taxation and are theoretically just.

Chapter 2 will discuss the theoretical background that justifies source taxation, as well as how source is established. Finally, the features that allow the digital enterprise to penetrate a state without creating a physical presence are discussed.

The OECD is trying to solve the tax challenges posed by the digital economy. Based on what is currently known about the OECD and UN proposals, solutions to change the existing nexus rules and the allocations at source are discussed in chapter 3.

Chapter 4 will summarise the findings and conclude.

## Chapter 2: Theories justifying source taxation

### 2.1. Introduction

This chapter will establish whether the theories that justify source taxation also apply to the digital economy. To justify the allocation of taxation rights of business profits at source, it will be essential to establish if these theories also justify source taxation for the digital economy.

In theology, to "justify" means to show that what is perceived as unjust is just; this means the taking of money, time, and labour will require justification.<sup>26</sup> The justification of taxation is one of the most neglected fields of study,<sup>27</sup> however, the reasoning behind the justification that was developed over 100 years ago still seems to be relevant today.

It is not only essential to justify the existence of tax or a type of tax, but also to justify the taxes raised through the intended use of the imposed tax. Equally important is the equity (fairness) of the tax raised, and the tax policy should attempt to achieve this.<sup>28</sup>

Changes to the allocation of taxing rights between jurisdictions should be based on sound tax policy and legal rationale for the changes to be just. For a tax-compliant culture to exist, it is of importance that the taxes imposed be justified.<sup>29</sup> A tax claim could only be equitable or fair if it is justified.<sup>30</sup>

After discussing the theories that justify taxation at source, the concept of source will be analysed. A clear understanding of source will be of importance to establish the concept of source as well as why source is contained within the concept of economic allegiance. Following the concept of source, the international concept of source under the OECD will also be analysed.

Currently, source-based taxation under the international tax rules is based on the concept of a permanent establishment for active business income.<sup>31</sup> Therefore, the current source concept requires a physical presence in a state. However, the digital economy reduces the need to create a physical presence in a source state. The characteristics that enable the digital enterprise to penetrate an economy without a physical presence will be discussed. An important question to

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<sup>26</sup> K. Vogel, The Justification for Taxation: A Forgotten Question, 33 Am. J. Juris. 19 (1988) p23 Para 1

<sup>27</sup> P. Pistone, Fundamentals of Taxation: An Introduction to Tax Policy, Tax Law and Tax Administration , p4

<sup>28</sup> Ibid

<sup>29</sup> Ibid

<sup>30</sup> Ibid

<sup>31</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) Para 3.1

consider is whether the digital enterprise operates in a new way or is it merely the ease in which business is conducted in a source state without creating a physical presence?

The theoretical foundations for the allocation of taxing rights between the Source and the residence countries are based on the “Benefit Principle”, “Ability to pay,” and the “economic alliance” concepts that were used by the League of Nations Economists.<sup>32</sup>

## 2.2 Benefit theory

Based on the benefit theory, the premise is that if benefits are provided to the digital enterprise in the source state, the enterprise should compensate the jurisdiction in the form of taxes.<sup>33</sup> It is regarded as the traditional theory to justify business profit taxation at Source.<sup>34</sup> Importantly; the benefit theory should not be seen as a quid pro quo for benefits provided by the state but rather as the total services provided to all taxpayers.<sup>35</sup> The benefit theory also guides countries in the international allocation of taxing rights.<sup>36</sup>

The source jurisdiction can claim a taxing right on the income earned within its borders based on the benefits provided to the digital enterprise.<sup>37</sup> These benefits can range from protective benefits, such as fire and police protection, legal protection in the form of protecting IP rights, etc., or infrastructural benefits, such as a stable environment to conduct business and provision of telecommunication services.<sup>38</sup>

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<sup>32</sup> C. Turley, D.G. Chamberlain & M. Petriccione, A New Dawn for the International Tax System: Evolution from past to future and what role will China play? (IBFD 2017), Books IBFD (accessed 13 Apr. 2020).– Books para 4.1.1

<sup>33</sup> Ibid

<sup>34</sup> The Renaissance of the Benefit Principle for the 1th Century International Tax Reform – Kluwer International Tax Blog

<sup>35</sup> P. Pistone et al., Taxing the Digital Economy: The EU Proposals and Other Insights (P. Pistone & D. Weber eds., IBFD 2019), Books IBFD (accessed 19 October 2019). Para 3.2.3

<sup>36</sup> J. Hey, Taxation where Value is Created and the OECD/G20 Base Erosion and Profit Shifting Initiative, IBFD p205 Para 2.4

<sup>37</sup> P. Pistone et al., Taxing the Digital Economy: The EU Proposals and Other Insights (P. Pistone & D. Weber eds., IBFD 2019), Books IBFD (accessed 19 October 2019). Para 3.2.1

<sup>38</sup> OECD OECD/G20 Base Erosion and Profit Shifting Project Addressing the Tax Challenges of the Digital Economy ACTION 1: 2015 Final Report p26

The question is whether the benefit principle is applicable only where the company has a physical presence in the country.<sup>39</sup> Currently, to create a link or nexus, there should be a physical presence in the country of source.<sup>40</sup>

McLure argues that to justify taxation at source, a physical presence is required.<sup>41</sup> Many of the services provided by the source jurisdiction do require a physical presence to enjoy these benefits, such as police and fire protection.<sup>42</sup> McLure argues that the source state's benefits do not seem substantial enough to justify a taxing right on business profits where there is no physical presence.<sup>43</sup>

On the other hand, benefits such as the protection of IP rights and maintaining a suitable business environment are afforded to the digital enterprise, even in the absence of a physical presence.<sup>44</sup> It will be difficult to argue that the digital enterprise does not benefit from these benefits. Therefore the benefit theory will justify a taxing right allocation to the source country. This view is confirmed by Skaar, who informs that digital enterprises benefit from the infrastructure provided by the source state and should contribute to the source state, which will be aligned to the benefit theory.<sup>45</sup>

It is important to note that the benefit principle justifies the allocation of a taxing right but does not provide the attribution of tax.<sup>46</sup> The digital enterprise benefits from the source country even without a physical presence in the source country; however, it is crucial to consider the benefits provided by the source country. For example, if value creation takes place in the residence country, it should be argued that the source country did not contribute significantly apart from the customer base.<sup>47</sup>

The benefit theory will therefore apply to the digital enterprise through the benefits provided by the source country. Therefore based on the benefits the source country provided to the digital enterprise, the allocation of a taxing right at source will be justified through the benefit principle.

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<sup>39</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) Para 2.2.2.1

<sup>40</sup> C. E. McLure, JR. Alternatives to the Concept of Permanent Establishment,“ in Report of Proceedings of the First World Tax Conference: Taxes Without Borders, 2000 World Tax Conference Report (Toronto: Canadian Tax Foundation, 2000)

<sup>41</sup> Ibid

<sup>42</sup> Ibid

<sup>43</sup> Ibid

<sup>44</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) Para 2.2.2.1

<sup>45</sup> Ibid

<sup>46</sup> C. Turley, D.G. Chamberlain & M. Petriccione, A New Dawn for the International Tax System: Evolution from past to future and what role will China play? (IBFD 2017), Books IBFD (accessed 13 Apr. 2020).– Books para 4.1.1

<sup>47</sup> Ibid 2.2.2.1

## 2.3 Value Creation

Supporters of the changes to the allocation of taxing rights for the digital economy base the justification on value creation and argue that users create this value.<sup>48</sup>

In the first paragraph of the BEPS report, it is mentioned that the current international tax rules have areas that allow for opportunities to contribute to base erosion and profit shifting and that a “bold move by policymakers to restore confidence in the system and ensure that profits are taxed where economic activities take place and **value is created**”.<sup>49</sup> The idea of value creation was introduced by the OECD as a benchmark and is an integral part of all the BEPS actions.<sup>50</sup> In the digital economy, this value is deemed to have been created by the users of that online platform.<sup>51</sup>

The idea of “value creation” was not clarified by the OECD/G20 BEPS initiative; neither were the factors defined concerning value creation. Value creation could refer to the location of sales, employees, management, or even production capacity. However, what is clear is that value creation is not where the MNE has a mere paper presence.<sup>52</sup>

A customer base or user consumption should not justify a taxing right in the source jurisdiction.<sup>53</sup> However, supporters of the value creation principle argue that the users are different from customers and should be placed on the supply side of production, arguing that users create value.<sup>54</sup> The supporters of value creation, therefore, regard the user as part of the production process in the global value chain. It will be important to consider the value created in the different stages of the GVC. In 1992 Stan Shih used the “smile curve” to illustrate the problems of IT manufacturers in Chinese Taipei.<sup>55</sup>

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<sup>48</sup> J Kennedy, Digital Services Taxes: A Bad Idea Whose Time Should Never Come, ITIF, P4

<sup>49</sup> OECD (2016), *BEPS Project Explanatory Statement: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264263437-en> p4 Para 1

<sup>50</sup> J. Hey, Taxation where Value is Created and the OECD/G20 Base Erosion and Profit Shifting Initiative, IBFD p203 Para 1

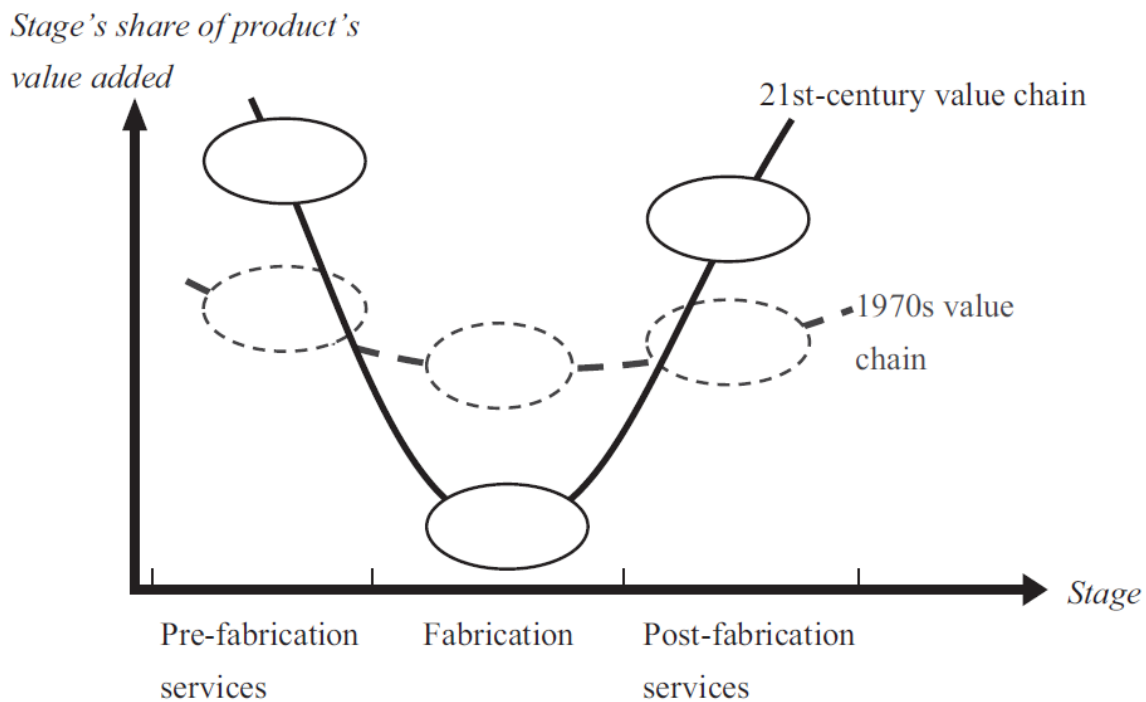
<sup>51</sup> HM Treasury, Corporate tax and the digital economy: position paper, November 2017 p8

<sup>52</sup> S. Morse, Value creation: A standard in search of a process @ IBFD p1 Para 3

<sup>53</sup> HM Treasury, Corporate tax and the digital economy: position paper, November 2017 p8

<sup>54</sup> P. Pistone et al., *Taxing the Digital Economy: The EU Proposals and Other Insights* (P. Pistone & D. Weber eds., IBFD 2019), Books IBFD (accessed 19 October 2019). Para 3.3

<sup>55</sup> *Interconnected Economies: Benefitting from Global value chains*, OECD 2013, *Upgrading in Global Value Chains : The Role of Knowledge based Capital*



Source: R. Baldwin, *Misthinking globalisation: twentieth-century paradigms and twentieth century challenges*, *Australian Economic History Review*, Vol 54, No 3, figure 3

The global value chain of a firm can be divided into three stages, upstream or pre-fabrication (research and development), the middle stream (fabrication), and the downstream or post-fabrication (sales and marketing).

The tangible fabrication stage contributes much less to the GVC than in 1970. The reason is that production is easily replicated and moved offshore, and it is commoditised. The pre- and post-intangible stages are not commoditised and highly valued in the GVC.<sup>56</sup> Most of the value created in the global value chain of the digital enterprise takes place in the intangible stages (pre and post-fabrication). These pre and post-intangible production stages often take place in the residence country, and very little to no value is added in the tangible fabrication stage.

When data from users in a specific jurisdiction is collected, it has no real value. This data is transferred to the headquarter company, which will run the data through various processes to extract data relevant to the organisation's business model. This data is then processed into data that is useful for analysis. After analysis of this data and patterns have been interpreted, does it only become valuable to the organization.<sup>57</sup> Corporations would use highly specialized algorithms and

<sup>56</sup> R. Baldwin, *Misthinking globalisation: twentieth century paradigms and twentieth century challenges*, *Australian Economic History Review*, Vol 54, No 3

<sup>57</sup> Marcel Olbert and Christoph Spengel, *Taxation in the digital economy – Recent Policy Developments and the Question of Value Creation ITAXS*, IBFD p13 Para 2

R&D to get the information required from the data. The data will then be sold to companies whom this data is of value to.<sup>58</sup>

Value creation is, therefore, not coherent as a theory and should not be relied upon to justify the allocation of taxing rights to source jurisdictions.<sup>59</sup> It is also important for the supporters of value creation to consider the actual value created in the source country.<sup>60</sup>

## 2.5 Neutrality

When considering the justification of taxing rights between source and residence countries, it is essential to consider economic neutrality.<sup>61</sup> The neutrality principle indicates that taxation should be neutral between digital and non-digital enterprises. Therefore, similar taxpayers should be taxed similarly. The neutrality principle states that there should not be a distortion for an investor based on the imposition of tax. If an investor has to choose between a local and international investment, that choice should not be distorted by a tax implication. This is referred to as capital export neutrality (CEN) and favours residence-based taxation.<sup>62</sup> Similarly, an investment invested in a state should not be subject to different tax rates for domestic and foreign investors. This is known as capital import neutrality (CIN), and this principle favours source-based taxation.

The following questions arise when considering neutrality,

1. Which is the preferred choice between CEN and CIN,
2. Stemming from question 1 is this choice aligned to source taxation,
3. If it is aligned to source taxation, is it also applicable to the digital economy?

Economists have held that only the CEN is consistent with efficiency, and therefore residence-based taxation is implied.<sup>63</sup> Prof. Vogel, however, argued that the source principle is best aligned to the neutrality principle.<sup>64</sup> Vogel advises that to obtain neutrality in an international setting, all the

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<sup>58</sup> K. Andersson, Should We Use Value Creation or Destination as a Basis for Taxing Digital Businesses? – Krister Andersson's Comments on the 2018 Klaus Vogel Lecture Given by Professor Michael Devereux, 72 Bull. Intl. Taxn. 12 (2018), Journals IBFD (accessed 14 Oct. 2019). P686 Para 2

<sup>59</sup> A Christians, Taxing according to value creation, 90 Tax Notes International 1379-1383 (June 18, 2018)

<sup>60</sup> The concept of value creation in the digitized economy seems to have been abandoned in the later OECD statements.

<sup>61</sup> A Christians, Taxing according to value creation, 90 Tax Notes International 1379-1383 (June 18, 2018)

<sup>62</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) Para 2.2.2.1

<sup>63</sup> Ibid

<sup>64</sup> Ibid

countries tax laws should be considered together and not favour one country over another.<sup>65</sup> This also led to the term inter-nation neutrality.<sup>66</sup> Vogel further advises that not only taxes should be considered to obtain neutrality, but also the benefits and the costs, as this is relevant to investors before making a choice.<sup>67</sup>

For example, if State A and State B taxes are at the same rate, however, the benefits of state A are more significant, an investor will in all likelihood choose state A to invest in. Therefore source taxation is aligned with inter-nation neutrality.<sup>68</sup> The answer to question 2 above is affirmative, as only source-based taxation is aligned to inter-nation neutrality. Inter-nation neutrality is also best suited for digital commerce as they conduct business across borders.

To answer question 3, the benefits referred to by Vogel should be considered. Again it is argued, as per section 2.2, that the benefits, such as the protection of IP rights and maintaining a suitable business environment are afforded to the digital enterprise, even in the absence of a physical presence.<sup>69</sup>

The neutrality principle, therefore, justifies taxation at source and applies to digital enterprises.<sup>70</sup> Importantly, any changes to the international tax system should not affect the enterprises decision to conduct business electronically or conventionally.<sup>71</sup>

## 2.6 Equity

Equity is synonymous with fairness or justness of a tax system and can be viewed in two areas.<sup>72</sup> The first is individual equity which relates to residence-based taxation and the relationship between an individual and the state. The second is inter-nation equity. Two theories are relied upon to justify taxation through equity: the “ability to pay” and the benefit theory.<sup>73</sup> Residence-based taxation

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<sup>65</sup> Ibid

<sup>66</sup> Ibid

<sup>67</sup> Ibid

<sup>68</sup> Ibid

<sup>69</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) Para 2.2.2.1

<sup>70</sup> Ibid

<sup>71</sup> Economic and Policy Aspects of Digital Services Turnover Taxes: A Literature Review, National Economics and Statistics (NES), PWC

<sup>72</sup> 14. K. Vogel, “Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part I)” (1988) 8-9 Intertax

<sup>73</sup> N H Kaufman, “Fairness and the taxation of international income.” Law and Policy in International Business, v 29, no.2, 1998, pp. 145-203. Gale Academic OneFile.

through individual equity can be justified based on the fact that residents with similar ability to pay should have the same tax implications in a country regardless of the source of that income.<sup>74</sup>

Mills' view on individual equity is that "a tax is equitable only if the tax law levies an equal sacrifice on all citizens."<sup>75</sup> This refers to the amount of tax paid by the individual to their government and is referred to as inter-individual equity.<sup>76</sup> Although the principle refers to individuals, it is ultimately applicable to the shareholders of the digital enterprise in the resident state.

Vogel argues that taxpayers receiving foreign income should not only be compared to taxpayers in their residence country but also to taxpayers in the source country in terms of legitimacy and uses the benefit theory to support this.<sup>77</sup> Furthermore, Vogel argues that equality in the source country will not be achieved if the rate of taxation in the residence country is higher than in the source country. Under Vogel's argument, equity favours source-based taxation.<sup>78</sup>

Therefore, source-based taxation can be justified based on individual equity. Taxpayers engaged in traditional or digital commerce business should be treated the same to be equitable.

## 2.7 Inter-nation Equity

Professor Musgrave identified inter-nation equity, which relates to the distribution of taxing rights amongst jurisdictions. Inter-nation equity refers to income a digital enterprise receives in a specific jurisdiction (country A) for concluding business in another jurisdiction (Country B) and whether it justifies that jurisdiction (country B) to withhold some of that income.

Vogel argues that inter-nation equity favours taxation at source. Vogel again based this on the benefit theory and argues that the income would not have been produced without the benefits provided by the source state.<sup>79</sup> Vogel also notes that in the absence of a permanent establishment, there will not be a right to claim tax on business profits.<sup>80</sup> States have, however, claimed a taxing

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<sup>74</sup> F. Souza de Man, Chapter 4: The UN Model Convention in Taxation of Services in Treaties between Developed and Developing Countries – A Proposal for New Guidelines (IBFD 2017), Books IBFD (accessed 13 Apr. 2020) Para1.2.1.2.3

<sup>75</sup> K. Vogel, The Justification for Taxation: A Forgotten Question, 33 Am. J. Juris. 19 (1988) p28

<sup>76</sup> N H Kaufman, "Fairness and the taxation of international income." Law and Policy in International Business, v 29, no.2, 1998, pp. 145-203. Gale Academic OneFile.

<sup>77</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) Para 2.2.2.1

<sup>78</sup> *ibid*

<sup>79</sup> K. Vogel, "Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part I)" (1988) 8-9 Intertax, pp. 216, 223

<sup>80</sup> *Ibid* p401

right based on the sales within their jurisdiction, reasoning that the sales would not have taken place if it was not for the market (benefits) they provide.<sup>81</sup> To this, Vogel advises that inter-nation equity should be considered whether there is a permanent establishment or not. It is reasonable to conclude that the source states benefits do contribute to sales.<sup>82</sup>

To justify inter-nation equity, such a claim from (Country B) could be because the source state should withhold tax based on the “benefit” the resident digital enterprise of country A has received in Country B and the cost of services and public goods.<sup>83</sup> Inter-nation equity will be achieved through the benefit principle.<sup>84</sup> Inter-nation equity justifies taxation at source and will also apply to electronic commerce.

## 2.8 Concept of Source

The theories discussed justify taxation at source and it is clear that it also applies to the digital economy. It will be important to have a clear understanding of the concept of source.

Source taxation, as stated by Vogel, is unambiguous only in what it excludes; taxation based on source differs from taxation based on residence.<sup>85</sup> The residence country is usually where the digital enterprise is situated, managed, or controlled.

Vogel further states that source refers to “a state that in some way or other is connected to the production of the income in question, to the state where value is added to a good.”<sup>86</sup> This indicates that value must be added to the goods or services sold in that country, and therefore implies a connection with that country.

When a country imposes tax on source basis (on a non-resident who produced income in the country), it could lead to a situation of double taxation. This will be due to the resident country that might also claim a portion of that tax. International tax law has tried to solve this double taxation since the beginning of the 20<sup>th</sup> century.<sup>87</sup>

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<sup>81</sup> Ibid p400

<sup>82</sup> Ibid p401

<sup>83</sup> K. Brooks Inter-Nation Equity: The development of an Important but Underappreciated International Tax Value. Dalhousie University p22 Para 3

<sup>84</sup> P. Hongler, Justice in International Tax Law Para 11.3.1

<sup>85</sup> K. Vogel, “Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part I)” (1988) 8-9 Intertax, pp. 216, 223

<sup>86</sup> Ibid

<sup>87</sup> L.U. Cavelti, C Jaag & T.F. Rohner, Why Corporate Taxation Should Mean Source Taxation: A Response To The OECD ‘s Action Against Base Erosion and Profit Shifting, 9 World Tax J. (2017), Journals IBFD

The four economists in 1921 adopted a concept of “economic allegiance” to find a solution for double taxation. The report indicated that “all corporeal wealth, including immovable and tangible movables, except money, jewellery, furniture and the like, is to be generally assigned to the place of origin or source, while all intangible wealth, except the property value of mortgages, is generally assigned to domicile or residence.”<sup>88</sup> Interestingly the four economists also noted that in the determination of source, human and material resources are important to establish economic allegiance.<sup>89</sup>

To determine source, the economic allegiance or economic location of the income is essential. This also led to the 1927 Draft convention by the League of nations that based taxation at source on a concept known as “permanent establishment,” which is still found in double taxation agreements today.<sup>90</sup>

Understandably, the four economists argued in favour of an economic allegiance at the time they did. In 1927 production, labour and capital were immobile and took place in the residence country.<sup>91</sup> During this time, business relied mostly on manufacturing tangible goods and had a fixed location, such as factory machines for example.<sup>92</sup>

Baldwin explains that during this time, globalisation was in the “first unbundling”.<sup>93</sup> The steam revolution made it possible for production to take place in one geographical location and consumption in another during the first unbundling.<sup>94</sup> However, the complexity of production still ensured that production activities remained in the same geographical location to lower the cost associated with complex production.<sup>95</sup> This was due to the high cost and lack of profitability in moving products across borders.<sup>96</sup>

Production and consumption, therefore, mostly took place in the same state. This is similar to how businesses operated before the first unbundling and steam revolution as well, in as much as production and consumption took place in the same geographical location.

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<sup>88</sup> M. B. Carroll, *Prevention of International Double Taxation and Fiscal Evasion. Two Decades of Progress under the League of Nations* (1939) p13

<sup>89</sup> D. Pinto, *E-Commerce and Source-Based Income Taxation*, Books IBFD (Accessed 24 Mar. 2020) Para 3.3

<sup>90</sup> *Ibid*

<sup>91</sup> *Ibid*

<sup>92</sup> *Ibid*

<sup>93</sup> R. Baldwin, *Misthinking globalisation: twentieth century paradigms and twentieth century challenges*, *Australian Economic History Review*, Vol 54, No 3

<sup>94</sup> *Ibid*

<sup>95</sup> *Ibid*

<sup>96</sup> R Baldwin & S Evenett, *Value creation and trade in 21<sup>st</sup> century manufacturing*, *Journal of regional science*, Vol 55, No 1, 2015 p31

The “second unbundling” that took place in the 1980s was made possible by the ICT revolution.<sup>97</sup> In contrast with the first unbundling, the ICT revolution ensured that the production complexities could be managed across borders and production can occur in another or multiple geographical locations.<sup>98</sup> The feasibility and profitability of separating production and consumption in different jurisdictions result from the ICT revolution.

Even though there have been significant changes in globalisation and the way digital MNEs can operate since the time the four economists argued for an economic allegiance, the allocative rules for “Source” in an international setting are still based on a connection or a genuine link between the income and the jurisdiction.<sup>99</sup> The link is an economic allegiance to the country of source through a permanent establishment, either by a physical presence or via an agent as a representative.<sup>100</sup>

Should the digital enterprise conduct business in a source country through a permanent establishment, the active business income will be subject to source taxation. This will be achieved by either a physical or a representative presence in the source country.

## 2.9 The international Concept of Source under double tax agreements

### 2.9.1 Article 7

As mentioned, the source country will be entitled to tax the business income at source if there is a permanent establishment. This taxation at source is justified because a physical presence will indicate an economic allegiance to the source country.<sup>101</sup> Therefore, the concept of a permanent establishment will be of importance to analyse why the digital enterprise might not be subject to taxation of business profits at source under the current concept.

Article 7 sets the Permanent establishment as the threshold for the contracting state to tax. The Article states that the profits derived by a company will only be taxable in the contracting state

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<sup>97</sup> Ibid

<sup>98</sup> Ibid

<sup>99</sup> C. Turley, D.G. Chamberlain & M. Petriccione, A New Dawn for the International Tax System: Evolution from past to future and what role will China play? (IBFD 2017), Books IBFD (accessed 13 Apr. 2020).– Books para 4.1.1

<sup>100</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) p3.4

<sup>101</sup> Ibid Para 4.3.3

unless that company is conducting business in another contracting state through a permanent establishment.<sup>102</sup>

### 2.9.2 Article 5

Article 5 of the OECD states that “fixed place of business through which the business of an enterprise is wholly or partly carried on”<sup>103</sup>

Therefore, to be liable for taxation in a contracting state, it must be a “place of business” and have a certain degree of permanence to it “fixed”. The business must also be carried on through this place, either wholly or partly.

When considering a fixed place, it must be from a geographical perspective.<sup>104</sup> Computer equipment such as a server could create a permanent establishment for the enterprise. For this to be the case, the equipment must be at a certain location for a sufficient period of time.<sup>105</sup> However, the system software and data used by that server will not create a “place of business,” for example, a website used on the server.<sup>106</sup>

To constitute a place of business, there is no legal or formal right required to use the facilities or installation, it could either be owned, leased, rented, or even at the enterprise's disposal.<sup>107</sup> Should the digital enterprise operate computer equipment automatically without personnel to operate and carry on the business, the equipment itself will create a business that is wholly or partly carried on through that place.<sup>108</sup>

### 2.9.3 Exclusions to Article 5

Should the enterprise have a fixed place through which this business is conducted, the exclusions will eliminate such a business from a permanent establishment. The digital enterprise will not have a permanent establishment if the activities performed are regarded as preparatory or auxiliary.

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<sup>102</sup> OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing. [http://dx.doi.org/10.1787/mtc\\_cond-2017-en](http://dx.doi.org/10.1787/mtc_cond-2017-en) p31

<sup>103</sup> Ibid

<sup>104</sup> Fundamentals of International Tax Planning edited by Raffaele Russo p40 Para 2

<sup>105</sup> OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing. [http://dx.doi.org/10.1787/mtc\\_cond-2017-en](http://dx.doi.org/10.1787/mtc_cond-2017-en) p152 Para 123

<sup>106</sup> Ibid

<sup>107</sup> Ibid p118 Para 10

<sup>108</sup> [2008] 19 SOT 257 (Delhi) in the ITAT Delhi Bench 'B' Galileo International Inc. vs Deputy Commissioner of Income-tax, Non-Resident Circle, New Delhi

Activities of this nature can be carried out at a fixed place of business and contribute to the overall productivity of the business, but if these services so performed are remote from the actual realisation of profits and challenging to allocate profit to these activities and fixed place, it will be considered to be preparatory and auxiliary functions to the enterprise.<sup>109</sup>

Whether a particular activity is of a preparatory or auxiliary nature will have to be established on its own merits and the facts and circumstances of each case. Nevertheless, it is accepted that a fixed place that carries on activities that are identical to the purpose of the whole enterprise cannot be of a preparatory or auxiliary nature.<sup>110</sup>

## 2.10 Digital enterprise characteristics

Notably, the digital enterprise has a reduced need for physical presence in a country, and this is due to the highly mobile nature in which business is conducted. This will impact the way source is currently defined under the permanent establishment threshold.<sup>111</sup>

Tax laws rest on two principles which are territoriality and enforceability.<sup>112</sup> Both of these principles will be impacted by the digital economy due to mobility and the reduced need for physical presence in a jurisdiction.

To ascertain whether the digital business models are different from the more traditional brick-and-mortar business model, some of the characteristics of the digital enterprise will be discussed. It will be essential to isolate some of the salient features in a digital business model. These features are cross-jurisdictional scale without mass, the importance of intangible assets, and the importance of data.<sup>113</sup>

### 2.10.1 Cross-Jurisdictional scale without mass

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<sup>109</sup> OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing. [http://dx.doi.org/10.1787/mtc\\_cond-2017-en](http://dx.doi.org/10.1787/mtc_cond-2017-en) Para 23 of the OECD Commentary on article 5

<sup>110</sup> Ibid p133 Para 59

<sup>111</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) p3.5

<sup>112</sup> Ibid para 3.5.1

<sup>113</sup> OECD (2018), Tax Challenges Arising from Digitalisation – Interim report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD p51

With the increase in digitalisation, companies can now trade across the globe easier and faster than before. In addition, digital businesses can be involved in the economic life of a country without having a physical presence in that country, and by doing so, creating a “scale without mass”.<sup>114</sup>

This is due to the highly mobile nature of the digital business intangibles, users, and functions. A digital enterprise has a decreased need for local personnel and can select the location of its servers and other resources.<sup>115</sup> In addition, the mobile nature of the digital economy affords it the opportunity to choose where to move production.

Production is easily replicated and can be reproduced in another state.<sup>116</sup> In contrast to production, intangibles such as R&D cannot be replicated, and a heavy reliance is placed on R&D to stay competitive internationally. It is crucial to consider the value added to the different stages of the GVC. It was shown that the most value is allocated to the intangibles in the global value chain.

The way the digital economy operates is not new. Traditional brick-and-mortar companies have been operating and selling products across borders for a significant time and operated very similarly to the digital companies. One example of this would be the so-called “catalog sales”. This was a technique used to market the company’s products across borders and states. A printed catalogue of the company’s products will be sent to potential customers, who were often also targeted by mailing lists, together with price and order information. The order would be placed either by return mail or telephone with payment, and the goods were then delivered via post.

### 2.10.2 Reliance on intangible assets

Digital companies have a substantial reliance on intangible property such as intellectual property, for example, the algorithms and software that support the core functions of their business.

Intangible assets are an essential part of the digital business and a fundamental part of value contribution to the digital enterprises GVC.

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<sup>114</sup> Ibid P51 Para 151

<sup>115</sup> Ibid p64

<sup>116</sup> R. Baldwin, *Mistaking globalisation: twentieth century paradigms and twentieth century challenges*, *Australian Economic History Review*, Vol 54, No 3

### 2.10.3 Data user participation and their synergies with IP

An integral part of digital business models is the gathering and use of data collected from users and customers. The larger the data, the more valuable it will be as a direct result of the information obtained from the data. This information is used to target a specific advertisement to a specific user group, making it much more effective and valuable. Data has become a precious commodity in the digital economy. Data collection, however, is not new, customer feedback, as an example has been critical to traditional business for many years.<sup>117</sup>

This data can be used to improve business operations, marketing, or products. This will also lead to a significant value creator for the business.<sup>118</sup> There is a distinction between two types of user participation, active and passive user participation.

Active user participation involves the user uploading videos to YouTube, posting comments on Facebook, or rating an experience on the website. From this, the user would be actively creating content on the platform.<sup>119</sup>

Passive participation takes place without the active involvement of the user, primarily through cookies of the browsing history, the type of device that the user uses to browse the internet or use the App, and even the user's location.

The data gathered by active and passive users will be collected in its raw form, and the enterprise will extract the data relevant to the business model. This data can be used as a value driver in the business model or sold to a third party once processed in the residence state.

Customer feedback is important and has been for many more traditional businesses,<sup>120</sup> and is not new. However, the way digital enterprises collect data and the volume is new.

## 2.11 Conclusion

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<sup>117</sup> J Kennedy, Digital Services Taxes: A Bad Idea Whose Time Should Never Come, ITIF, P9

<sup>118</sup> OECD (2018), Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.  
<http://dx.doi.org/10.1787/9789264293083-en> p28 p53 Para 142

<sup>119</sup> Ibid p55 Para 147

<sup>120</sup> J Kennedy, Digital Services Taxes: A Bad Idea Whose Time Should Never Come, ITIF, P9

This chapter argued that the theories justifying taxation at source apply to the digital economy. Therefore, these theories and tax principles should continue to be used to ensure that taxation at source is just for digital enterprises.

As discussed, the concept of source-based taxation is based on a link between the digital enterprise and the source jurisdiction for taxation to be justified on business profits. This link is the connection between the benefit the digital enterprise received from the source jurisdiction through an economic allegiance and is based on a permanent establishment. Without a permanent establishment, it could be argued that the digital enterprise would not enjoy enough benefits to justify taxation at source.<sup>121</sup>

At the time, the four economists argued for an economic allegiance, which led to a permanent establishment, production, and consumption mostly took place in the same jurisdiction (the resident state). Multinational enterprises during this time also relied on tangible assets, such as machines and equipment.<sup>122</sup> The digital economy heavily relies on intangible assets, and the production stages can easily be moved to different locations. To establish the profit attribution to the various stages of production, the smile curve should be considered. It was shown that the smile curve has deepened, and as a result, the intangibles are highly rewarded in the GVC. The profits are therefore justifiably moved to the location of the intangibles, which is the residence state.

The current international definition of a permanent establishment was discussed to understand the requirements that should be present to constitute a permanent establishment. The definition of the permanent establishment was based on the OECD's definition. For a source country to exercise a taxing right, there should be a presence in that country. The presence in the source country could be by way of physical or representative presence.

It was also shown that the digital business models are not unique in how they conduct business, however, the volume in which business is concluded, and the ease of penetrating a jurisdiction without a physical presence is unique. This lack of a physical presence in the source country will lead to the minimum threshold of a permanent establishment not being achieved. Without a physical presence, the digital enterprise would not be subject to tax on business profits at source under the current international tax rules.

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<sup>121</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) p4.1

<sup>122</sup> Mastering the IP Life Cycle from a legal, tax and accounting perspective – Grasping the Intangibles – Part 1: Setting the Scene – Chapter 1: Increasing the Importance of IP Rights



## Chapter 3: Pillar One, UN proposal and the theoretical application

### 3.1 Introduction

This chapter will give an overview of the proposals and establish whether the proposals by the OECD Pillar One and the UN Article 12B are aligned to the way source rules are currently defined and theoretically justified.

The tax challenges due to the digital economy, and its ability to reduce the need for physical presence in a country, have been under the spotlight globally. The OECD is trying to find a longterm solution to these challenges, which includes new nexus rules and extending the taxing rights at source. It was established that the current source rules require a physical presence in the jurisdiction to justify taxation at source. This chapter will set out to establish if the suggested changes to the allocation rules at source align with the concept of source. In addition, it would be essential to also establish if an economic allegiance, based on a physical presence threshold, exists at source based on the proposals by the OECD and the UN.

In the report released in 2015 on BEPS action 1, issues were discussed that go beyond the BEPS action points. These issues were Nexus, Data, and Characterization. The TFDE did further work on these issues and released a report in 2018 on the ‘tax challenges arising from the digitalisation.’<sup>123</sup> In the 2018 report, various options to address some of the broader challenges were analysed, namely Changes to the existing Permanent establishment threshold based on a “Significant Economic Presence” (SEP), implementing a WHT (Withholding Tax) on some digital transactions, and a separate equalisation levy.<sup>124</sup>

Following the 2018 report by the TFDE, an update on the work was released in February 2019, where several proposals were given that could form part of a long-term solution to the broader tax challenges created by the digital economy. The proposals were grouped into two pillars: pillar 1

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<sup>123</sup> Base Erosion and Profit Shifting project public consultation document Addressing the tax challenges of the digitalisation of the economy 13 February – 1 March 2019 p7 Para 6

<sup>124</sup> OECD (2018), Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264293083-en> p134 Para 344

focused on the taxing rights and a change to the allocation and nexus rules, and pillar two aimed at business MNEs that shift profits to entities that are subject to low taxation.<sup>125</sup>

Pillar 1 consisted of three proposals, “user participation”, “marketing intangibles,” and “SEP (Significant economic presence)”. More recently, the OECD published a “Unified approach” in October 2019 under pillar 1.

Pillar 1 would expand the nexus and create a taxing right in jurisdictions based on sustained and significant involvement. On the other hand, the UN proposal will also create a taxing right where the income arises and does not require a physical presence in that country.

In cross border income-generating activities, the source concept, should be considered. The allocation of taxing rights at source is defined through the economic allegiance principle, which led to the permanent establishment. The benefit theory will justify taxes imposed on multinational companies in a jurisdiction based on the premise that those companies enjoyed the benefit of exploiting those states' political, legal, and economic framework through the utilisation of public goods. The public goods utilised through a PE, such as labour and infrastructural resources, will justify source taxation.<sup>126</sup> However, the question remains whether taxation at source would be justified in the absence of a physical presence, as these public goods will not be significantly utilised. The benefit principle is one of the principles that underlie the international tax regime.<sup>127</sup> The benefit principle allocates a theoretical taxing right on where the value was created. This implies that if a source country adds value to a product, it should be compensated for the contribution.

### 3.2 The OECD Pillar one and the UN proposals

Pillar one will give the market jurisdiction a taxing right over the multinational group's residual profit. This will be done by creating new nexus and profit allocation rules. These new nexus rules will be based on “sustained and significant involvement” in a state.<sup>128</sup>

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<sup>125</sup> A.S. Samari, The OECD Secretariat Proposal for a “Unified Approach” under Pillar One: Strengths and Weaknesses of the New and Revised Nexus and Profit Allocation Rules, 27 Intl. Transfer Pricing J. 2 (2020), Journal Articles & Papers IBFD (accessed 15 May 2020).

<sup>126</sup>C. Turley, D.G. Chamberlain & M. Petriccione, A New Dawn for the International Tax System: Evolution from past to future and what role will China play? (IBFD 2017), Books IBFD (accessed 13 Apr. 2020). para 4.1.1

<sup>127</sup> R. S. Avi-Yonah international taxation of electronic commerce, 52 Tax L p509 Para 2

<sup>128</sup> Ibid

Calculating the allocation of the profits is based on a formulaic approach. The group's profits will first be calculated. Then routine activities are approximated based on an agreed level of profitability, which is done by possibly applying a fixed percentage to the industry. The split of the calculated non-routine profits between the market jurisdictions will be the next step, and finally, the calculated amount will be allocated to each jurisdiction. It is also suggested that sales be used as an allocation key.<sup>129</sup>

This approach will cover automated digital service enterprises as well as consumer-facing businesses and exclude sellers of raw materials and commodities.<sup>130</sup> Certain thresholds will also be applied. The first would be a gross revenue threshold and the second an “in-scope” revenue that is less than a certain threshold.<sup>131</sup>

The nexus will be based on an economic presence in a state and will no longer require a physical presence linked to a permanent establishment in a jurisdiction.<sup>132</sup>

The UN Tax committee drafted and released the proposal on the 6<sup>th</sup> of August 2020. The new Article 12B is comparable with articles 10 and 11 (dividend and interest).<sup>133</sup> The country where the income is generated or source country will receive the taxing rights regardless if the enterprise has a permanent establishment.

The new proposed Article that will be added to the UN model will tax automated digital service enterprises at Source. This will be done either by a withholding rate on gross income or on net income, which will be based on a formula.

The Automated digital service MNE can choose whether to be taxed on gross income or net income. The net income would apportion 30% of the MNE’s ADS to the countries where that income arose.<sup>134</sup>

Automated digital services will include, Online advertising services, Online intermediation platform services, social media services, digital content services, cloud computing services, sale of user data, and online teaching services.

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<sup>129</sup> Secretariat Proposal for a “Unified Approach” under Pillar One Public consultation document OECD p13

<sup>130</sup> OECD 2020, 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, p11

<sup>131</sup> Ibid

<sup>132</sup> A.S. Samari, The OECD Secretariat Proposal for a “Unified Approach” under Pillar One: Strengths and Weaknesses of the New and Revised Nexus and Profit Allocation Rules, 27 Intl. Transfer Pricing J. 2 (2020), Journal Articles & Papers IBFD (accessed 15 May 2020).

<sup>133</sup> R. Rawal, Taxation of Digitalized Economy – Proposed UN Solution, 26 Asia-Pac. Tax Bull. 3 (2020), Journal Articles & Papers (accessed 21 August 2020).

<sup>134</sup> Website, <https://mnetax.com/un-committee-proposes-new-model-treaty-provision-altering-taxation-of-automated-digital-services-39609>

Similarly to the OECD proposal, the nexus will be based on an economic presence and not a physical presence currently required for taxation at source through a permanent establishment.

It was established that the benefit principle justifies taxation at the source through a permanent establishment. This is due to the utilisation of goods through a physical presence. Therefore, the question remains: Is source taxation theoretically justified based on an economic presence and not a physical presence in the current way in which source is defined?<sup>135</sup>

### 3.3 Theoretical application to source

The theories discussed in chapter 2 justifies source taxation, and should continue to apply to the digital economy. These theories support taxation at source as just if the non-resident company has an “economic allegiance” to that source state. Economic allegiance was defined by the League of nations as the place where human and material resources are used.<sup>136</sup> Economic allegiance is the guiding principle, and it led to the permanent establishment, which requires a physical presence.<sup>137</sup>

The permanent establishment threshold makes sense on at least two points.<sup>138</sup> Firstly, the permanent establishment will make it easier to enforce and collect taxation due to the permanent establishments' assets being situated in that country.<sup>139</sup> Secondly, the permanent establishment indicates an economic allegiance to the source country. Physical presence in the source country is regarded as sufficient evidence that an MNE receives significant benefits.<sup>140</sup>

The benefit theory will justify taxation through these benefits received. These benefits can range from fire protection and skilled labour. The question was, does the MNE utilise these benefits without a permanent establishment? It would be difficult to argue that the digital business benefited enough, in the lack of a physical presence, to justify source taxation through the benefit theory.<sup>141</sup>

The proposals by the OECD pillar one and the UN article 12B will create a new nexus based on a formulaic approach. The nexus will be based on an economic nexus and not only on a physical

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<sup>135</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) Para 1.2

<sup>136</sup> Ibid Para 3.4

<sup>137</sup> Ibid

<sup>138</sup> Ibid 4.3.2

<sup>139</sup> Ibid 4.5

<sup>140</sup> Ibid

<sup>141</sup> Ibid Para 4.1

presence nexus.<sup>142</sup> This new nexus will move away from the traditional allocation of taxing rights at source, which is based on a geographical location. Source taxation must be seen as a justification and limitation to tax, not as an allocation principle.<sup>143</sup>

The rules that govern the source-based principle require a physical presence. A permanent establishment is needed to create a sufficient link for an economic allegiance to a state. It is therefore opined that the proposals by the OECD and the UN will not be in line with the concept of source in international law under the permanent establishment.

Vogel has advised that source taxation could point to where *value* was added to goods or service.<sup>144</sup> As discussed, value creation could justify taxation at source through the benefit principle. The OECD has noted the role of the users in creating value in digital enterprises and advised “profits are taxed where economic activities generating the profits are performed, and where value is created”.<sup>145</sup> Value creation is, therefore, at the core of the BEPS initiative.<sup>146</sup> To establish the value created in the different parts of the global value chain of the digital multinational enterprise, the smile curve was utilised.

The smile curve has “deepened” from 1970 to the 21<sup>st</sup> century. This shows that value is added during the intangible R&D and marketing stages, and the tangible production stage is not as highly valued as assumed. The intangible assets, often situated in the residence state, are indicative that taxation is taking place where value is created in the resident state.

Apart from the theoretical justification and issues with source allocation, it would also be important to consider whether the proposals align with a good tax policy based on equity, neutrality, and fairness.

Equity is a fundamental part of a tax policy, and it was shown that businesses should all be treated equally. To achieve equity, a traditional business should have the same tax treatment as digital enterprises. The proposals by the OECD and UN suggest ring-fencing automated digital service enterprises as well as consumer-facing businesses and applying a threshold that suggests businesses

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<sup>142</sup> D. Pinto, Exclusive Source or Residence-Based Taxation. Is a New and Simpler World Tax Order Possible? Bulletin for International Taxation July 2007.

<sup>143</sup> P. Hongler, Justice in International Tax Law Para 11.5.3

<sup>144</sup> K Vogel, Worldwide vs source taxation of income – A review and re-evaluation of arguments (Part1)

<sup>145</sup> Explanatory statement to the Multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting p1

<sup>146</sup> J. Hey, “Taxation where Value is Created” and the OECD/G20 Base Erosion and Profit Shifting Initiative, 72 Bull. Int. Tax. 4/5(2018), Journals Articles & Papers IBFD

will not all have the same rules. This will not endorse inter-nation equity.<sup>147</sup> This could lead to unequal treatment of enterprises and lead to a situation where enterprises choose between digital and non-digital advertising based on tax implications.<sup>148</sup>

The proposals might also be at odds with the neutrality principle, as the enterprise might base decisions on digital or traditional activities. Again, this will be due to the different treatment between digital and more traditional activities.

It is therefore clear that the proposals will not only be at odds with the concept of the source principle but will also not be justified based on the benefit principle and sound tax policy. It should also be considered where value is added in the GVC to establish the benefit the digital enterprise received from the source state.

### 3.4 Conclusion

This chapter has shown that the suggestions by the OECD and the UN are based on an economic presence and not on a physical presence. Currently, a permanent establishment is required as a threshold. The question raised was whether the formulaic approach creating a nexus in the absence of a permanent establishment is just and aligned to the way taxation at source is defined.

It was shown that the justification of allocating taxation at source should be through the benefit principle. Vogel advised that source taxation should point to where value was added at source, thereby creating a benefit to the enterprise.<sup>149</sup> The benefit theory will not only justify taxation at source but will also lead to inter-nation equity.<sup>150</sup> It was shown that the value-added through the GVC takes place mainly in the intangible stages at the residence state and that production is not as highly rewarded.

For the allocation of taxing rights to be just under the benefit theory, a link is required between the income producing activity and the benefit received from the host jurisdiction. The current

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<sup>147</sup> 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 (accessed 18 May 2020).

<sup>148</sup> Economic and Policy Aspects of Digital Services Turnover Taxes: A Literature Review, National Economics and Statistics (NES), PWC

<sup>149</sup> K Vogel, Worldwide vs source taxation of income – A review and re-evaluation of arguments (Part1)

<sup>150</sup> J. Hey, “Taxation where Value is Created” and the OECD/G20 Base Erosion and Profit Shifting Initiative, 72 Bull. Int. Tax. 4/5(2018), Journals Articles & Papers IBFD p203 Para 1

requirement for such a link to exist within the source country is based on the permanent establishment concept.

Pillar one and the UN recommendations will not change the concept of source. However, it does suggest a change in the allocation of taxing rights at source. This change in the distribution of taxing rights is at odds with the current concept of source. The concept of source based on a permanent establishment is not new and has been established in treaties for over a century. Therefore, any changes to this concept will be significant and will change a concept that was implemented for a considerable amount of time.

The proposals will ring-fence certain digital enterprises and will also be at odds with inter-nation equity and are therefore not aligned to good tax policy. Moreover, neutrality will also not be achieved, as different enterprises will be treated differently.

## Chapter 4: Conclusion

With the digital economy expanding and the traditional business moving towards digitalization, there has been a need to reconsider the current principles of international tax to address the tax challenges raised by digital enterprises, as there is a belief that digital companies have the potential to create double non-taxation. As a result, there has been significant movement in the international tax arena, with BEPS action 3 (strengthening the CFC rule), 7 (preventing the artificial avoidance of permanent establishment), 8 to 10 (transfer pricing in line with value creation), and 13 (Country by Country Reporting).

In 2019 an updated report was released containing two proposals. Pillar 1 suggests a change in the profit allocation and nexus rules, and pillar two aims at enterprises that shift profits to low tax jurisdictions. Pillar 1 suggested that taxing rights be allocated to the source jurisdiction, despite the absence of a permanent establishment. An agreement was also reached in principle on the 31<sup>st</sup> of August 2021 on the two-pillar solution to address the tax challenges.

For taxation to be justified in a jurisdiction, it should be based on a sound legal principle and good tax policy. It was shown that the theories that justify taxation at source are also applicable to the digital economy. To justify the taxation at source, a clear understanding of source is required. The League of Nations historically defined source as the place where human and material resources are used.<sup>151</sup> When the four-economist argued for an economic allegiance, an enterprise's production, assets, and labour were relatively immovable and took place in the same geographical location. The economic allegiance, which led to the permanent establishment, was based on this assumption.<sup>152</sup> Production factors at the time were also highly rewarded in the allocation of profit.

The utilization of human and material resources is the link that creates an “economic allegiance” to the source country. Economic allegiance is a guiding principle in establishing source, and the League of Nations defined source under the concept of a permanent establishment.<sup>153</sup>

To allocate taxing rights at source, a physical presence through a permanent establishment is required. A Physical presence is also necessary to justify taxation at source through the benefit

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<sup>151</sup> 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 (accessed 18 May 2020).

<sup>152</sup> D. Pinto, E-Commerce and Source-Based Income Taxation, Books IBFD (Accessed 24 Mar. 2020) Para 3.3

<sup>153</sup> *ibid*

principle. Arguably, without a physical presence, the digital enterprise would not benefit from the source country enough to justify taxation based on the benefit principle.<sup>154</sup>

The OECD Pillar 1 and UN Article 12B suggest a change to the allocation of source. The allocation of source will be based on an economic presence and not a physical presence. It is clear that the proposals are at odds with the way source rules under a DTA are currently applied. The theoretical justification for taxation at source will also be at odds with the proposal based on the benefit principle.

There is an argument that the taxes levied on business profits without a permanent establishment are justified as income should be taxed where value is created.<sup>155</sup> They argue that users create this value by “producing” and not consuming. However, the “Smile Curve” clearly indicated that the production factors are not as highly rewarded in the allocation of profits as it was before the second unbundling. Digital enterprises operate differently from traditional businesses, and the IP is where value is created. This is often situated in the residence country.

Users do not create value, the digital enterprise creates the value.<sup>156</sup> Further, the collection of data does not create value, only when the data is processed does it become valuable, and the collection of data should not be the justification for a change in the tax treatment of digital MNE’s.<sup>157</sup>

The OECD has also noted that the digital economy should not be ring-fenced. This does not seem to be the case when the proposals are considered. Business and activities will be ring-fenced based on specific criteria. The proposals will be at odds with various tax policy principles set out by the OTTAWA tax principles. These principles guide governments in evaluating tax and apply to electronic commerce.<sup>158</sup> The proposals based on a threshold could lead to unequal treatment between MNE’s below and above the threshold and will be at odds with the equity principle.<sup>159</sup>

The proposals cannot be theoretically justified, aligned to the way source is currently defined, or based on good tax policy.

There are different views on whether digital business models should create changes to the international tax rules. Of the 137 members of the inclusive framework, there are three different views. The first view is that there is a misalignment between where the profits are taxed and where

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<sup>154</sup> Ibid Para 4.1

<sup>155</sup> J Kennedy, Digital Services Taxes: A Bad Idea Whose Time Should Never Come, ITIF, P4

<sup>156</sup> Ibid P1

<sup>157</sup> Ibid

<sup>158</sup> Economic and Policy Aspects of Digital Services Turnover Taxes: A Literature Review, National Economics and Statistics (NES), PWC

<sup>159</sup> Ibid

the value is created. The second view is that there are challenges to the effectiveness of the existing tax rules due to the change in the economy as a result of digitalisation. Finally, the third view is that the BEPS package has addressed the concerns raised by the digital economy regarding double non-taxation.<sup>160</sup>

The Pillar one proposal by the OECD does not seem widely accepted, and the changes to the existing nexus requirements will not have the desired effect.<sup>161</sup> Therefore, the author believes that the Pillar 1 and UN Article 12B proposals are not aligned to the international concept of source and not based on sound tax policy.

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