



The Permanent Establishment in a post BEPS world



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List of abbreviations

Art.	Article
APA	Advanced Pricing Agreement
ATR	Advanced Tax Ruling
BIT	Bulletin International Taxation
BEPS	Base Erosion and Profit Shifting
BNB	Beslissingen in Belastingzaken Nederlandse Rechtspraak
CIN	Capital Import Neutrality
CITA	Dutch Corporate Income Tax Act 1969
CEN	Capital Export Neutrality
DADT	Degree for the Avoidance of Double Taxation
DTA	Dutch Tax Authorities
EU	European Union
ETR	Effective Tax Rate
GTA	General Tax Act
HR	Supreme Court
IITA	Individual Income Tax Act
ITPJ	International Transfer Pricing Journal
LRD	Limited Risk Distributor
MAP	Mutual Agreement Procedure
MBB	Maandblad Beschouwing Belastingen
NDFR	Nederlandse Documentatie Fiscaal Recht
Nr.	Number
OECD	Organization for Economic Cooperation and Development
PE	Permanent Establishment
TDFE	Task Force on Digital Economy
TFO	Tijdschrift Fiscaal Ondernemingsrecht
UN	United Nations
VAT	Value Added Tax
WFR	Weekblad Fiscaal Recht
WTJ	World Tax Journal

1. Introduction

The 21st century started with the bursting of the internet bubble. However in 2016 we can conclude that the change in business models that has taken place over the last years proves that the internet and the evolution of information technology are more than a bubble. The increase of the number of unicorns, which are software focused startup businesses that are worth more than one billion dollars within 10 years, also shows that new businesses earn their money in different ways than enterprises did before.¹

Amongst the most successful companies of the 21th century are companies like Airbnb, Amazon, Facebook, Google, Snapchat, Uber, etc. These companies are all successfully addressing new markets in the digital economy, without owning traditional bricks and mortar businesses in their market countries. Furthermore, a significant amount of companies have entered into cloud services and the setting up of IT infrastructure and data analysis, in all of these markets is physical presence in the country of the consumer no longer necessary to conduct business activities.

Many reasons could be determined why the market share of e-commerce businesses is growing relative to the traditional business models. Apart from, or maybe even because of the reduced need for physical presence in the market country, transactions can take place in a more efficient way and are therefore less expensive than off-line transactions.² Not only the costs declined, but also the business processes themselves have become more powerful and standardized.³ The cost advantage of ‘the digital economy’ leads to an increase in the market share of the digital economy and to the detriment of the traditional businesses.

Next to the fourth industrial revolution, the 21th century has brought us also a serious debate about the role of company taxation in society. In the past years, there have been lots of discussions about tax avoidance and whether companies with extremely low Effective Tax Rates (ETR’s). Recently the Panama-leaks affair has added fuel to the debate about fairness in taxation.

The attention for tax avoidance has mainly risen as a consequence of the worldwide financial crisis, which started in 2008. The costs that governments made for the salvage of the banks made people realize that a certain number of businesses did not contribute at all to the finance of these costs, it seemed that companies have evaded to pay their fair share of taxes. By making use of loopholes or exemptions in the law, profits that were obtained by activities and sales in jurisdictions with high taxation could be transferred to tax havens with low or even no corporate income tax at all in order to artificially reduce

¹ Griffith & Primack 2015.

² OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 26.

³ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 11.

the ETR of the company. The aggressive tax planning strategies have led to a great dissatisfaction amongst civilians and resulted in initiatives from governments and supra-governmental organizations, like the OECD's (Organization for Economic Cooperation and Development) project to address Base Erosion and Profit Shifting (BEPS). These measures have been taken to ensure a balanced taxation system in the future.

Two items of the BEPS action plan are the main cause of this study, written as a part of the 2016 EUCOTAX Wintercourse project. Within groups of students from multiple countries we researched and evaluated the presence and implementation of legislation as a consequence of the final BEPS reports, which were released in October 2015.

The area under research in this study relates to both the 'digital economy' and the way 'taxation should address this properly, to enhance a neutral tax climate'. The morality of tax avoidance structures is not discussed in this thesis, instead the fundamentals of corporate income taxation are researched.

Specifically the nexus approach in a post-BEPS world is under research. A nexus approach is necessary to allocate tax jurisdiction. There needs to be a certain relationship between a country and (the profits of) a company, in order to allow that country to tax the income of the company. This topic is thus researched in the light of two BEPS actions: *Action 1 of the BEPS report about the approach to the digital economy* and *Action 7 about the prevention of the artificial avoidance of a permanent establishment*. This thesis will not focus on the artificial avoidance as such, but focuses on the need for a different nexus approach as taxation systems from the 20th century prove to be inadequate for taxing business models of the 21th century.

Current tax systems are still based on the residency of a company. Active income from business operations can only be taxed in another state than the state of residence in case of the constitution of a permanent establishment. A permanent establishment entitles the source state the taxation rights, in case the activities performed in this country meet a qualitative minimum threshold. This threshold relies mainly on physical presence, while new business characterizes itself by its mobility and reduced need for physical presence. However, if a company is physical present, this does not automatically result in a taxable presence through a permanent establishment, as proven by the recent investigation of Google's establishment in Paris by the French Tax Authorities.⁴ Even though Google performs activities in France and it addresses probably over 50 million customers in that country, it claims that no taxable presence exists through a permanent establishment.

⁴ http://www.lemonde.fr/economie/article/2016/05/24/une-vaste-perquisition-menee-dans-les-locaux-de-google-a-paris_4925428_3234.html

This example shows that it will be no surprise that the permanent establishment has been subject to criticism in literature. The threshold would be too easy to avoid and the concept would not fit with the characteristics of the current economy.

Though the changing economy has already been noted more than two decades ago,⁵ competent authorities and multilateral institutions have refrained from providing and implementing a solution. In this study the need for a new nexus approach will be discussed in the light of a theoretical and normative perspective, considering the most important solutions at the moment. In the end, the preferred approach of the OECD and the Netherlands within an international context will be evaluated.

1.1 Research question

The following research question will be answered in this thesis:

To what extent should the permanent establishment concept be modified in Dutch and international tax law, regarding the international developments influencing nexus approaches, as amongst others discussed in BEPS Action 1 and addressed by BEPS Action 7?

In order to answer this main research question, every chapter of this thesis will answer a sub question, which will eventually lead to the answer in the quest for an optimized nexus approach. The sub questions are mentioned below:

- Chapter 2 What different approaches to allocate taxation rights to tax jurisdiction exist and which one should prevail based on which underlying tax principles?*
- Chapter 3 What is the current definition of the permanent establishment in domestic and international tax law?*
- Chapter 4 What are the relevant recommendations and considerations of BEPS Action 1 and 7 and what were the incentives leading to these proposed amendments?*
- Chapter 5 What solutions have been implemented or proposed by EUCOTAX-Wintercourse participants?*
- Chapter 6 What solutions have been put forward by legislators and literature to address the need for different threshold to create taxable presence?*

⁵ Skaar 1991, p. 14-20.

1.2 Methodology

The research on which this study is based consists of two elements.

The most important one is the literature, which functioned as a source for the development of the normative framework set out in chapter two, but which has also provided me with different views on current practices and proposed alternatives to the permanent establishment, which are discussed in the fourth and sixth chapter.

The second element is the comparative law study, which is based on the research of fellow participants of the EUCOTAX Wintercourse 2016. The third chapter consists of a study of the Dutch law and jurisprudence, the fourth contains the Dutch reaction to BEPS actions 1 and 7 and in the fifth chapter the approaches from several EUCOTAX countries regarding the BEPS actions are discussed.

Based on both literature and law comparison I come to an evaluation of the proposed nexus approaches in chapter seven and make related recommendations in chapter eight. Finally, chapter nine summarizes my research in the conclusion.

1.3 Delimitation

This research should not be expected to provide an exhaustive list of developments in the digital economy, nor does it provide all variations on amendments proposed to the permanent establishment or legislative procedures relating to the taxation of the digital economy.

One of the examples, which might have added to the discussion, but was left out for above-mentioned reasons, is the CCCTB proposal by the EU. Furthermore a description of the current server PE could have been added. However, as the location of a server PE is considered to be arbitrary and not value-adding to the business, the server PE is not considered to be a solution for the current challenges regarding the permanent establishment. The scope and size of this thesis prevents me from elaborating on this issue.

An extensive study on the 'fair share' of tax nor an in-depth study of the approach of the whole BEPS discussion fall within the scope of this thesis.

The discussion on whether a subsidiary can be a permanent establishment regarding current legislation and normative concepts, or a discussion on their differences and the desirability thereof does not fall within the scope of this thesis, neither does CFC legislation.

Besides, concepts on a single tax return per company, like the unitary business approach might add value to the discussion, but are not further researched in this thesis, due to the scope and size.

For the same reason, no detailed information on profit allocation methods is given. Though transfer pricing is considered to be of major importance for this topic, its key elements are mentioned in this thesis. Profit distribution rules remain a very delicate topic, certainly when the discussion between rich and poor countries is discussed. Though this discussion is very relevant, a new view on redistribution nor an extensive study of the current situation will not be part of this thesis.

The exact consequences of the proposed changes will be significant, however a thorough analysis thereof cannot be provided due to the size of this thesis.

2 Normative framework of the permanent establishment

2.1 Introduction

In this chapter a normative framework is set out, which will be used to test the potential solutions for a modified permanent establishment in chapter seven of this thesis. The normative framework will be developed according to theoretical principles.

First the theoretical perspectives on nexus will be discussed. Paragraph 2.2 contains an analysis of the traditional nationality, residence and source principle, but also discusses the principle of origin and the destination-based principle. Considering what nexus approach should be preferred above the other, it is necessary to take relevant underlying economic and legal principles into account. These are described in the third paragraph.

An evaluation of which of the underlying principles are in line with the various nexus theories is given in the fourth paragraph. Considering the outcomes, I develop a preferred new nexus approach in the fifth paragraph, based on the aforementioned theories and recent statements of the OECD on value creation.

Legislation, theories and proposals mentioned in the following chapters in this thesis are based on the theories mentioned in this chapter. The normative framework developed in this chapter is used to evaluate the status quo and different alternatives for new nexus approaches in chapter seven.

2.2 Where: Nexus

In this paragraph, different nexus views on the income allocation to tax jurisdiction will be described. These theories can be found in national legislation, as well as in double tax conventions. Allocation to tax jurisdiction takes place based on various principles. Generally the nationality principle or the place of residence or a combination thereof is taken as the starting point. However, when income is ought to be derived from activities undertaken on the territory of another state, this state usually desires to tax these activities. This vision is based on the source principle, which entitles taxation rights to the jurisdiction where the source of the income is situated.

Countries do not base their tax laws on just one principle, they often choose to make use of a combination of above mentioned principles to have a balance between giving up taxation rights and harming international business.⁶ The nationality principle will be discussed in paragraph 2.2.1, the residence principle in paragraph 2.2.2 and the source principle in paragraph 2.2.3.

⁶ Van Raad 2014, p.18-19.

However, in literature not everybody agrees with the principles currently used in practice. I will discuss two principles, which have arisen from criticisms of the current system. In paragraph 2.2.4 the principle of origin will be discussed. This principle is developed as a more specific interpretation of the source principle, which could be interpreted as substance over form principle in line with the current transfer pricing regulations. Paragraph 2.2.5 describes the destination-based principle. This principle is different from the other principles, as the other principles all allocate tax jurisdiction based on the location of the supplier, while the destination-based principle takes the location of the consumer into account when attributing taxation rights.

2.2.1 Nationality principle

The nationality principle has been one of the most important principles in the earliest tax treaties.⁷ This principle however, is used to allocate taxation rights on individuals and for legal persons the incorporation principle⁸ is a similar concept. An advantage of the use of this principle is the fact that the application of the nationality principle is rather simple and effective and would result in cross-border neutrality.⁹ Nevertheless, this criterion of citizenship should not be considered as appropriate for allocation to tax jurisdiction in bilateral tax conventions, since nationality in itself does not produce income, nor enables the possession of wealth.¹⁰ Most benefits related to nationality one would initially think of, have closer alliance with the residence state and could therefore better be addressed by the residence principle. The only benefit of having a nationality, the possibility to make use of public services of embassies or trade organizations, might easier be contributed by via passport duties for persons or a registration fee or yearly for legal entities, according to Kemmeren.¹¹ This vision might be criticized as it implies a rough lump sum duty for all companies, regardless of their income. However, when the income of a company is considered as relevant factor, also the location of that income, and the relation between the business income and the state should be taken into account. Therefore different nexus principles might reflect a more desirable outcome.

⁷ See e.g. Article 1 of the Prussian-Saxonian treaty of 16 April 1869.

⁸ In the Netherlands this principle has been incorporated in Article 2 (4) Dutch CITA. For simplicity reasons I will only refer to the nationality principle, but the incorporation principle is also meant when using this term.

⁹ Schön, *BIT 4/5 (2015)*, paragraph. 1-4.

¹⁰ Kemmeren 2001, p. 28.

¹¹ Kemmeren 2001, p. 28-30.

2.2.2 Residence principle

The state of residence is most of the times considered as the most essential criteria for taxation.¹² The state of residence, the state with the *siège réel* as a basic principle is determined by the location of the principle place of management. Both in the national law and in the OECD model this principle should be determined by looking at the facts and circumstances: the places where the most important management and commercial decisions are taken that are the most relevant for the company.¹³

Reasons to use this method are the easy assessment, the audit, and the execution of obligations of the taxpayer,¹⁴ but also the direct benefit principle.¹⁵ Besides the principle of horizontal equity could be taken into account, it does not prevent the application of progressivity.¹⁶ Another benefit is that harmful tax competition by states with (close to) zero percent CIT will be mitigated.¹⁷

However, the convenience may not be the predominant argument for the allocation to a tax jurisdiction, according to Kemmeren.¹⁸ Though the globalization causes a strong increase in the quantity and complexity of international transactions, information management would provide enough possibilities to overcome this convenience argument, according to the OECD in 1998.¹⁹ Almost 20 years later the convenience argument should no longer be of decisive character for the choice of used taxation principles.

A disadvantage of this method is the fact that it does not automatically address the real value creation and the fact that the place of management is relatively easy to separate from other important business units.²⁰ Moreover, the market-circumstances of the activities in other countries and the accompanying adaptations businesses have to make are overlooked under this approach.²¹ Furthermore, residence itself does not generate profits, it is even closer to the opposite, the country where the generated wealth is consumed. Therefore the residence principle provides a basis for allocation of tax jurisdiction with

¹² Technical experts to the Financial Committee of the League of Nations 1925, p.8 and p. 18. Furthermore this principle is the basis of many tax systems in countries from all over the world.

¹³ See art. 4(1) Dutch GTA, which refers as well to Paragraph 24 OECD Commentary on article 4.

¹⁴ Kemmeren 2001, p. 31.

¹⁵ Van Raad 2014, p. 18-19.

¹⁶ Schindel & Atchabahian 2005, p. 29-30.

¹⁷ Schindel & Atchabahian 2005, p. 29-30.

¹⁸ Kemmeren 2001, P.31.

¹⁹ OECD Committee Meeting on Fiscal Affairs 1998, p 16-18.

²⁰ McLure 2000, p. 14.

²¹ Schindel & Atchabahian 2005, p. 30-33.

respect to the consumption of income or capital, instead of the taxation on value creation.²² Taxation on the consumption side of the faculty should however not be seen as unreasonable, since the environment the company in the residence state lives in, has been financed with public expenses. Therefore on both the basis of the benefit principle and the faculty principle, authorities should be authorized to tax on basis of the residence principle.

2.2.3 Source Principle

The source state principle is a concept, which grants taxation rights to the state where the income is generated. The concept embodies a lot of different sorts and types of income. The source meanings do not all address the same type of income.²³ It could enclose the state where the tangible or intangible property is located, but also the state where it is used, the state where contracts are signed, but also the state where contracts are executed and the state whose law govern the contract. Furthermore, it includes the state where payments are made, but also the state where the costs are beard.²⁴ The source state standard has been used for a large variety of situations, that it would include the origin-, territoriality- and *situs* principle.²⁵ The use of different interpretations of the source state could of course lead to misinterpretations. To distinguish different views and emphasize the importance of the causal relationship between income and origination of income, I have decided to use a more concise notion of the source principle in this thesis, which corresponds with the wordings of Kemmeren:

“a person who receives income from a person or property situated in a state has such a close relation with the state where that person or that property is physically that from this relationship an obligation to support that state is justified.”²⁶

However, this is not the only view in literature. Some of the interpretations are going more in the direction or refer to a somewhat similar concept as the principle of origin used in this thesis.²⁷ Since there tends to be a difference in the exact definition of the principle of source and there is less discussion about the definition of the principle of origin, I have chosen to support the view of Kemmeren and use the definitions he favors.

²² Kemmeren 2001, p. 32.

²³ Avery Jones 1998, p. 79.

²⁴ Kemmeren 2001, p. 33.

²⁵ Van Raad 2014, p. 19.

²⁶ Kemmeren 2001, p. 33-34.

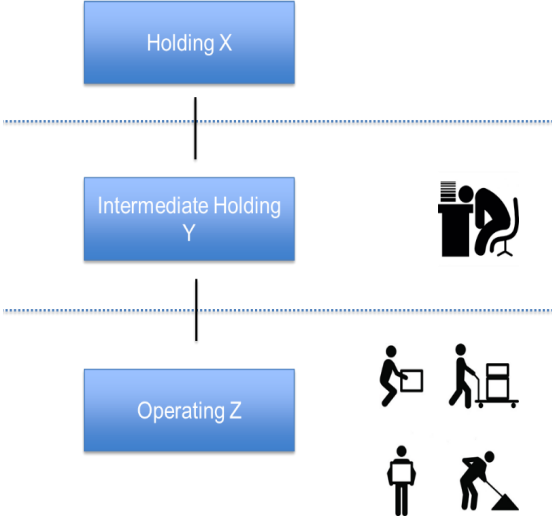
²⁷ Compare e.g. ‘Atchabahian, 28 *Bulletin for International Documentation* 309 1974, p.315, with ‘the place of the income generating activity’, Vogel, *Intertax*, 1988/8-9, p. 223.

The lack of a clear definition has not withheld Schindel and Athcabahian to list some advantages of the use of the source principle: It would be the most appropriate criterion under the sovereignty principle; the wide international acceptance of this principle; the fact that it fosters the international competition since the tax system does not interfere within competition within one market; the ease of administration since the relevant tax authority is located closer to the source of income. Furthermore, it stimulates governments to be as efficient as possible.²⁸

The state of source relates more to the location where the income is legally derived from. Due to the globalization and the increase in digitalization and tax planning, this might no longer correspond with the economic reality. Therefore the specification Kemmeren has made that will be explained in the next paragraph, is a welcome concept that fits better within the current timeframe.²⁹

2.2.4 Principle of origin

Taxation based on the principle of origin justifies taxation by a state, if the cause of the income is within the territory of that state. The causal relationship between the creation of the income and the territory of a state is prevailing under this principle, while this relationship is absent at the principle of source.³⁰ The principle of origin bases its allocation of tax jurisdiction on the economic allegiance, the direct benefit principle and the production of the wealth side of faculty. It is therefore considered as the principle that should prevail under any circumstances.³¹



An example

An intermediate holding company in country B gets proceeds from operating entity in country A and would directly distribute this income to the top-holding in country C. Under the view of the source state both A and B could be authorized to tax this income, while the principle of origin would only entitle state A to tax the income.

²⁸ Schindel & Atchabahian 2005, p. 29-30.

²⁹ Hongler & Pistone 2015, p.18-19.

³⁰ Kemmeren 2001, P.35-36. and Vogel 1988, p.83

³¹ Compare Meyer 1970, p. 238-239, Klaus Vogel, *Intertax*, 1988/8-9, p. 10-11., Kemmeren 2001, p. 35-37.

2.2.5 Destination-based principle

The concepts mentioned before are based on the location of the services performed by the supply side, the origin based approach. However, other views in literature mention that there might be another approach possible, which refers to the location of the consumer, namely the destination based approach.

Instead of taxing on the basis of the location of the input factors, the jurisdiction where the output is consumed would be allocated the taxation. De Wilde states as follows:

“The observation has been made that corporate income essentially lacks geographic attributes. Income has no geographic location. The income production as the result of the interplay of firm inputs at the supply side and firm outputs at the demand side are as global as the multinational itself. This may render it somewhat pointless to search for the true source of income”³²

Solely relying on the supply side would undermine the existing of the most basic economic concept of supply and demand. The willingness of a customer to buy the product seems indeed essential for the determination of a business’s price setting, sales and therefore income. The assumption that the demand-side of the market also creates value for a business therefore seems reasonable, as no market and therefore no income would exist without a buying side.³³

2.3 Underlying principles

Though the goal of this thesis is not to describe the definition of ‘fairness in taxation’ or to test whether the principles on which taxes are levied are right, it is necessary to describe these concepts in order to create a theoretical framework to which praxis can be tested.

Therefore this paragraph describes various principles, in order to set the normative framework.

First a list of principles developed during the Ottawa Conference, of which the importance recently has been reaffirmed by the OECD³⁴ are discussed. The principles mentioned are considered to be a general set of guidelines which the tax system should satisfy. These principles form together a set of requirements which should be applicable to specific legislation. As this set of regulations is considered to be more relevant for legislation, in the second part of this paragraph a set of principles which have been based on economic and legal theories, are described, according to the extensive description of these

³² De Wilde 2015, p. 468.

³³ Musgrave 1984, p. 228-234.

³⁴ OECD, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing 2014, Annex A.2, p. 162.

principles available in literature. These principles are more suitable to describe the underlying arguments for the use of nexus approaches.

2.3.1 General principles reconfirmed during the Ottawa Conference

The OECD has performed a research on the impact of the development of information technologies, performed by the Committee on Fiscal Affairs, the outcome was a key input for the Ottawa Ministerial Conference on Electronic Commerce in 1998.³⁵ In this conference it was confirmed that also within the new economy, the traditional tax principles should apply on the new digital economy. These broadly principles are: neutrality, efficiency, certainty and simplicity, effectiveness and fairness and flexibility.³⁶ In this thesis I refer to this set of principles when testing the set of alternative solutions in chapter 7. The set as such I describe as ‘a holistic approach’. As to my opinion these principles require taxation measures to be coherent with the rest of the taxation system and the society as such. A tax system should not contain incoherent measures, it should not have too many different regulations on the same topic, and it should not be too specific. When assessing the solutions, the combined set of principles mentioned in the Ottawa Conference are therefore tested on whether they satisfy the holistic approach. The ‘fairness’ and ‘neutrality’ principle also correspond with the economic and legal principles in paragraph 2.3.2 and will be elaborated on in that paragraph.

The OECD still referred to this set of criteria for the analysis of a new tax system in the digital economy, therefore these principles, described in this paragraph are considered to be material.

1) Neutrality

The neutrality principle requires that taxpayers in similar situations carrying out similar transactions should be subject to a similar level of taxation, in order to avoid market distortions. The same principles of taxation should apply to every form of business, to the extent that the businesses are comparable. Specific features that might undermine an equal application of the principle should therefore be taken into account

2) Efficiency

Taxes should be levied in an economic efficient way, hence in any case the benefits of the reform should outweigh the transitional and implementation costs. Administration burdens for both tax payers and tax

³⁵ OECD, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing 2014, Annex A.2, p. 162.

³⁶ OECD, *Electronic Commerce: Taxation Framework Conditions*, A report by the CFA as presented to the Ministers at the OECD Ministerial Conference, ‘A Borderless World: Realising the Potential of Electronic Commerce’, 8 October 1998, paragraph 9, p. 4.

administrations should be limited, however it should be kept in mind that the influence of the information technology limits the impact of these practical constraints.

3) **Certainty and Simplicity**

Taxes should be easy to understand for taxpayers and a reduced compliance burden will limit the costs for both taxpayers and tax administrations.

4) **Effectiveness and Fairness**

Imposed taxes should represent a right and fair amount, furthermore the timing of the taxation should be right. For the assessment whether this criteria has been met, it is important to consider who will bear the ultimate tax burden and to what proportion.

In addition the tax system should be effective since a tax system, which is difficult to enforce is unlikely to meet the equity and neutrality requirements.³⁷

5) **Flexibility and sustainability**

Options of taxations should not only be evaluated on whether they address the tax challenges in the current environment in a proper manner but also to the extent that they are sufficient dynamic to adapt to future commercial and technological developments.³⁸

2.3.2 *Economic and legal principles*

In literature many different taxation grounds are described. In this context is chosen to describe the concepts which were considered to be the most important to analyze the different nexus principles. Where paragraph 2.3.1 focused on the principles applicable to specific tax measures in relation to the tax system as a whole, this paragraph focusses on the relevance and justification of the various nexus principles mentioned in paragraph 2.2.

In this paragraph, first the neutrality principle will be discussed, thereafter the benefit and the ability to pay principle will be elaborated upon and lastly the inter-nation equity theory is mentioned.

2.3.2.1 Neutrality

The neutrality notion implies that taxation should not affect business decisions, neither in a positive, nor in a negative way. It should be immaterial whether the business activities take place in an entirely

³⁷ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 134-135.

³⁸ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 134-135.

domestic manner, or in a cross-border context. Furthermore, the place of residence should not have effect on the taxation rates in the source country.³⁹

Tax neutrality could be seen as a cornerstone of European Union law. Different taxation of operators that move within the internal market of the European Union however, seem to infringe with the neutrality goal, since national tax systems in the European Union widely differ from tax rate, tax base and specific exemptions and conditions for provisions. The restrictions that tax payers face when they cross the border, would be incompatible with the fundamental freedoms, according to De Wilde.⁴⁰

'*Capital Export Neutrality*' (CEN) means that investors based in the same state pay the same amount of taxation, independent from whether they invest nationally or internationally. Hence, there is neutrality between investing domestically or globally. CEN fits best to taxation based on the residence principle. However, CEN puts companies that invest in countries with a lower tax rate in a disadvantage, with respect to local operators.

'*Capital Import Neutrality*' (CIN), means that capital funds invested in various countries should be equally taxed, regardless of the domicile of the investor. Thus, there is a neutrality between residents and non-residents, the same tax rate applies to income derived from the same source. CIN provides therefore better neutrality than CEN when taxation is based on the source of income. According to Kemmeren the CIN system would lead to the optimal allocation of production factors and this approach should therefore be prevailed.⁴¹ CIN based systems do, however, not take into account losses made abroad.

Nations generally base the decision on whether to use a CEN or CIN based tax system, on their size, structure and relation to the global economy.⁴² The Netherlands is a small country with an open and international oriented economy. The size of the Dutch market is small, therefore Dutch businesses have always been internationally active. Therefore, the CIN approach is used by the Netherlands, so Dutch enterprises can compete with local businesses.⁴³

According to De Wilde, both the CEN and the CIN approach have both its imperfections. CEN and CIN systems tend to treat inbound and outbound investments in an unequal way, resulting in a distorted market. A method combining the credit method from CEN and the exemption method from the CIN

³⁹ De Wilde 2015, p.74-76.

⁴⁰ De Wilde 2015, p.74-76.

⁴¹ Kemmeren 2001, p. 110-112.

⁴² Kemmeren 2001, p. 110-112.

⁴³ Notitie fiscaal verdragsbeleid 2011, Kamerstukken II, 2010-2011, 25 087, nr 7. P. 22.

approach, should lead to a new ‘*production factor neutrality*’ approach. This would be the only method that fully implies equal treatment of resident taxpayers and non-resident taxpayers.⁴⁴

A worldwide neutral fiscal treatment of production factors would lead to an optimal allocation of these factors, which seems to be supported by different opinions in literature.⁴⁵

2.3.2.2 Inter-individual Equity

The notion of equity within a tax system refers to both the ability to pay principle and the direct benefit principle. The ability to pay is measured in terms of level of income, wealth and consumption.⁴⁶ The direct benefit principle demands a taxation that should refer to the amount of public goods and services provided by the taxing state. The next paragraphs will elaborate on both concepts.

2.3.2.2.1 The benefit principle

This principle states that the tax burden should be distributed among taxpayers in proportion to the actual or potential level of benefit they attain from public goods and services by a state.⁴⁷ In the end of the 19th century Von Schanz made the following quote about the benefit principle:⁴⁸

“Die deduktive Betrachtung hat uns auf die wirtschaftliche Zugehörigkeit geführt und gezeigt, dass diese den Kreis der Steuerpflichtigen in einer Weise umschreibt, welche den beiden Anforderungen einer innerlich begründeten und zugleich wirksamen Abgrenzung der Steuergewalt am meisten entspricht”

The key message in these thoughts is that the tax burden should be based upon the level of economic allegiance between the state and the business. However, it might be questionable in the current economy whether an ‘effective delimitation’ does exist, or whether it is even possible. The globalization of the economy, and the digitalization have brought new challenges to the realization of the easy division by this principle.⁴⁹

⁴⁴ De Wilde 2015, p. 89-90 and p.148.

⁴⁵ De Wilde, *NTR Beschouwingen* 2015/10, paragraph 3.3 and Kemmeren 2001, p. 110-112.

⁴⁶ Schindel & Atchabahian 2005, p. 31.

⁴⁷ Schindel & Atchabahian 2005, p. 33.

⁴⁸ G. von Schanz, *Zur Frage der Steuerpflicht* p. 434 (Finanzarchiv 1892). Direct translation: “The deductive consideration has taken us to the economic allegiance and showed that it delimitates the circle of taxpayers in a way that in most cases corresponds to both the requirements of an internally founded and meanwhile effective delimitation of the [exercise] of the power to tax”.

⁴⁹ Roxan 2012, paragraph 2-4 and Schön, *WTJ 2009/1*, p. 75.

Though the direct benefit in terms of education, infrastructure, a legal system, etc., might be hard to measure, it does not mean that this principle should be discarded.⁵⁰ The benefit could be perceived both directly (e.g., the use of public transportation), or indirectly (e.g., the legal framework that enforces creditors to pay). Indirect profit from legal systems, resulting in the enforcement of payments and the protection of property rights, or use the (digital) infrastructure and profiting from energy supply and waste recycling are perceived to be relevant benefits to take into account.⁵¹

2.3.2.2.2 Ability to pay

The ability to pay principle, or faculty principle, consists of two main elements, horizontal equity and vertical equity. Horizontal equity suggests that taxpayers who find oneself in the same circumstances should be taxed similarly. Vertical equity is a normative concept with no unambiguous definition, but the idea behind the concept is that people with a higher income pay more taxes. This could either be based on a progressive or a proportional tax system.⁵²

2.3.2.3 Inter-nation equity

Equity could also refer to inter-nation equity, the concept addresses the allocation of national gains and losses in an international context and aims to ensure that each single country receives an equitable share of tax revenues from cross-border transactions.⁵³

Example:

If an investor resident in country A invests in country B, there are negative consequences for country A based on two factors. Country B, the source country will tax the income earned on the investment, and the residence country face a revenue loss because it could allow a credit relief for the tax paid in the source country. The second effect depends on the tax levied by the source state and the application of the relief.⁵⁴

In literature, the inter-nation equity concept is described in both a legal approach and an axiological approach.⁵⁵ The legal approach focuses on the distribution of the ‘competence to tax’,⁵⁶ while the

⁵⁰ De Wilde 2015, p. 68.

⁵¹ D. Pinto, *BIT (60) 2007*, p. 267.

⁵² OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 31.

⁵³ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. p. 31.

⁵⁴ The Netherlands uses the object exemption as of 2012, and therefore does not give a tax credit anymore.

⁵⁵ Peters 2013, p.83.

⁵⁶ Kaufman, *Law and Policy in international business 1997-1998/29*, p.202

justification for this distribution is referred to as the proper division of the tax base among countries.⁵⁷ Some even refer to the term ‘fair distribution’⁵⁸

Vogel interprets this principle as an argument for allocating the right to tax to the source state, as the state where the business income is produced, directly provides the economic opportunities for the profit generating activities.⁵⁹ Also, Smit confirms that the source principle is in line with the inter-nation equity, taking the benefit-principle as a starting point.⁶⁰

Peters brings forward that the interpretation of the inter-nation equity principle is blurred by globalization. State-society interaction has changed and therefore there might be no straight-forward interpretation possible.⁶¹

With special regards to e-commerce, the OECD reacts to the fair distribution of the tax base as follows:

*“[...] achieve a fair sharing of the tax base from electronic commerce between countries and to avoid double taxation and unintentional non taxation”*⁶²

2.4 Evaluation of the different nexus approaches

In paragraph 2.2, five nexus principles have been discussed: the nationality principle, the residence principle, the source principle and the origin principle. These nexus will be evaluated according to the underlying principles as described in paragraph 2.3.

First the different nexus approaches will be tested on whether they satisfy the requirements for the inter-nation principle, thereafter benefit principle and the ability to pay principle will be discussed and thereafter the neutrality principle will be regarded. In addition to these principles, also a specific BEPS paragraph is included that evaluates the possibilities for avoidance under each nexus approach.

It must be noted that in the assessment of the nexus approaches it is considered that both a method from the supply side of the economy and the market side should preferably be taken into account.

⁵⁷ Avi-Yonah 2000, p. 1616.

⁵⁸ Jeffery 1999, p. 11.

⁵⁹ Vogel, *Intertax* (16) 1988/11, p. 398.

⁶⁰ Smit 2012, p.99.

⁶¹ Peters 2013, p. 90.

⁶² OECD, *The Impact of the Communications Revolution on the Application of ‘Place of Effective Management’ as a Tie-Breaker Rule*, Discussion Draft, 2001, p. 228.

2.4.1 Inter-nation equity

When evaluating the references made to inter-nation equity in literature and by the OECD, the goal of this principle is to ensure a fair distribution of tax base between countries. Considering the preference of the OECD for a substance over form approach as expressed in the recent BEPS reports, in combination with their statement that income tax should be levied in the state where value creation takes place,⁶³ the discussion on inter-nation equity is getting intertwined with the discussion on value creation.

Therefore the different nexus approaches will be evaluated upon their correspondence with value creation.

Regarding the nationality and residence principle, it is clearly explained that these activities do not relate to value creation. As the income generated from activities performed in another state is considered to be created in that other state, the inter-nation equity condition is not met. Though the source principle initially adheres to the location where the activity is undertaken, the current source principle has been considered as a form over substance provision, which thus still relies on contracts regarding the constitution of taxable presence.

As explained in paragraph 2.2.4 under the source principal currently legal contracts are considered to be of more importance than real economic activities, while the principle of origin attributes more value to the undertaken economic activities. As such, I consider the origin principle to be a more substance over form approach of the source principle, and therefore I consider it to be more in line with the value creation criteria. The origin principle should thus be prevailed over the source principle.

However, it must be added that I adhere to a broadened interpretation of the principle of origin, which does not create a necessity for the presence of significant people functions. Significant people functions are considered to be of importance in the value creation process, however, not essential.

Regarding the value creation on the consumer side of the market, in paragraph 2.2.5 comments have been made that both parties on the market, the demand side and the supply side, should be taken into account when determining the value drivers of the company, as on the market place no transactions exist, and therefore no income can be created if there is only demand, but no supply of a product and vice versa. A correlation between the input and output in terms of profit of an enterprise is thus not determinable ex ante.⁶⁴ The height of the income and thus of the profit depends on the market, therefore the influence of the consumers on the value of a company cannot be denied.

⁶³ OECD 2013, *Action Plan on Base Erosion and Profit Shifting*, p. 10.

⁶⁴ Hines Jr., *54 European Economic Review 108 (2010, Nr. 1)*, p. 108-120

2.4.2 Benefit

The nationality principle and the residence principle do not acknowledge the activities and business conducted by companies in other countries. These principles are thus not in line with the negative benefit principle, stating that a state should not be allowed to tax if there is no benefit in that country. The source principle is more in line with the benefit principle, as tax jurisdiction is allocated to the state where the company undertakes activities, however this might not always be the case due to the broad definition, which includes form over substance. The origin principle is more in line with substance over form and should therefore be prevailed.

The destination principle is also in line with the benefit as the taxes are only levied to the extent that sales take place on the territory of the country and to the extent the business benefits from the services of the government in the market state.

Though the benefit in case of no physical presence of the company in the country might be questioned, these benefits certainly exist. Relevant benefits in this context are the profit from legal systems, resulting in the enforcement of payments and the protection of property rights, or the use of (digital) infrastructure and profiting from energy supply and waste recycling.⁶⁵

2.4.3 Ability to pay

The nationality principle and the residence principle would be able to take into account the total situation of a taxpayer, including profits and losses made worldwide. They are therefore considered to be in line with the ability to pay principle. The source principle and the principle of origin and destination only tax locally and therefore only take fragments of the situation of the subject into account. They are therefore considered to be less in line with the ability to pay principle.⁶⁶

Furthermore the ability to pay principle also implies that taxation should not be based on sales, but that the tax base should take into account the costs made, to the extent that these are businesslike.

Regarding the destination based principle, some raise the question whether this automatically means that gross sales are taxed in a system like the current VAT (Value Added Tax) system. However, this criticism does not acknowledge the fact that VAT is based upon gross payments, while a destination based income tax also takes into account relevant costs. Furthermore, the value added taxes are levied at the level of the consumer, while a destination based income tax would levy taxes at the level of the

⁶⁵ D. Pinto, *BIT(60) 2007*, p. 267.

⁶⁶ To bring the last mentioned principles in line, a shift towards a unitary business approach would reduce the infringement of this principle. An extensive analysis on the exact impact lies, however, not in the scope of this thesis.

business. Besides, the income tax mitigates the tax difference between non-domestic and domestic production, thus enhancing equal competition.

2.4.4 Neutrality

First the neutrality principle as it is considered in literature will be evaluated. Second, as this study is based on the BEPS action plan, I consider it to be relevant to examine the possibilities for tax avoidance, which relate to the discrepancies in neutrality. Therefore subparagraphs on tax competition and avoidance are included.

2.4.4.1 Neutrality as discussed in literature

CEN puts companies that invest in countries with a lower tax rate in a disadvantage, with respect to local operators. This approach, used by the nationality and residence principle, is considered to harm globalization of business significantly, as activities abroad are taxed at a different rate than local operators and should therefore not be favored.

CIN based systems, like systems based on the principle of source or origin, do provide an equal treatment between non-resident and resident companies, however they do not take losses made abroad into account.

Production factor neutrality guaranteed by a system fully based on the destination based income taxation, would not disturb competition and provides thus total neutrality.

2.4.4.2 Tax competition

For a balanced international tax system it is important that no harmful competition between jurisdictions exists, which enables specific companies to get an advantageous tax treatment relative to their competitors. This does not mean that competition between countries is a bad thing in itself, it might even be argued that through tax competition, governments are stimulated to spend their budget more efficiently.

Though the recent measures by the OECD's BEPS project and the stronger focus of the EU on taxation in the form of directives, state-aid cases and the renewed CCCTB proposal will limit the freedom of tax jurisdictions to define their taxation regulations, it is agreed that countries are still entitled to define their own CIT rates. Recent EU State Aid developments are focused on the tax base applied. If a further harmonization in tax base would be accomplished, a strengthened competition on the CIT rates is

inevitable. However, a rat race to the bottom should be prevented, as this will result in a ‘sitting duck’ tax, where the immovable and economic less favored will contribute mainly to the treasury.⁶⁷

When looking at practice, one could observe that countries, which are competing to attract businesses, incorporate special regimes to lower the tax burden for this company. Regarding the fact that the share of distance sales increases, as physical presence is no longer a main condition to conduct business in a country, it must be noted that optimal production factor allocation is no longer guaranteed if certain countries lower their tax rates significantly. Other countries could only follow, otherwise they would lose all their mobile businesses.

Tax competition is considered to limit the neutrality of the principle of origin. A destination based approach would provide a higher neutrality, as differences in tax rates would apply to the same extent to competitors.

2.4.4.3 Avoidance opportunities

Both the nationality principle and the residence principle are considered to provide substantial possibilities to avoid taxation. The place where a business is incorporated has generally no relationship with its economic activities, and therefore opens abuse opportunities. The residence of the company is determined by the place of principal management. Though the place where the company is managed from seems to be a reliable reference point, in practice this approach relies purely on ceremonial events, such as the place where the board of directors meet. Facilitated by the globalized world and the digital economy, misuse of these criteria is thus considered to be well possible.⁶⁸

The principle of source and the principle of origin seem to relate more to the real economic activity. As discussed, the latter to a greater extent than the first-mentioned. As will be discussed in paragraph 7.2 the current interpretation of the source principle in international tax law leaves more room for improvement.

Indeed, especially well-educated staff is considered to be relatively mobile in this globalized 21st century.⁶⁹ Especially with the increase of distance sales, this concern for abuse on the supply side is considered to be substantial.

Concerning the abuse opportunities regarding destination based taxation, some mention that ‘shifting the final consumer’ to a low tax jurisdiction would make is also considered to be a risk in this nexus

⁶⁷ Van der Geld, TFO 2008/182, p. 182-191.

⁶⁸ de Wilde 2015, p. 317-320.

⁶⁹ In the Netherlands the 30% ruling which offers a reduction in wage taxes only applies on high-paid jobs. The existence of such rulings, together with tax provisions on deductions for international school fees prove the mobility of people functions.

approach. Though for the most situations the location of the consumer seems to be out of the influence of the company, Grubert argues that an unrelated distributor could be used to evade taxes.⁷⁰ Avi-Yonah puts as a contra argument that it would be not businesslike to shift all the responsibility to a third party distributor.⁷¹ Furthermore he notes that people functions can be shifted to low tax states as well.⁷²

2.4.5 Summary

The evaluations of each nexus approach according to the criteria set out above are schematically summarized in the table below. As can be interpreted, an ideal nexus approach to allocate the entitlement to tax to jurisdictions would be based on both the origin principle and the destination principle, as they both seem to fit best with the criteria. In paragraph 2.5 a proposal for a new nexus approach is made, based on components of these two nexus principles.

	Value Creation (Inter-nation Equity)	Benefit	Ability to Pay	Neutrality	Avoidance
Nationality	-	-	++	CEN	-
Residence	-	-	++	CEN	-
Source	+	+	-	CIN	+
*Origin	++	++	-	CIN	++
*Destination	++	++	-	Production factor neutrality	++

2.5 Nexus 2.0: A new view on value creation

As can be concluded from the last paragraph, two nexus approaches are favored. The choice for these two principles can mainly be explained by a new view on value creation.

⁷⁰ Grubert 2015, 69 *New York University Tax Law Review* 43, p .50.

⁷¹ Avi-Yonah 2013, p. 2-3.

⁷² Avi-Yonah 2013, p. 2-3.

I adhere to the vision of the OECD, that income tax should be levied in the state where value creation takes place.⁷³ According to me however, value creating activities do not necessarily have to be performed in the source state by the supply side of the market.

The underlying thought of determining a right nexus factor is that taxation should be levied as close as possible to the geographic source of the income. However, in many situations it is not entirely clear where the value creation takes place.⁷⁴ Transfer pricing is addressing the profit allocation based on the functions, risks and assets. It concludes mainly who produced the profit, but not the geographical location of the profit.⁷⁵ Profit does not have geographical characteristics according to McIntyre.⁷⁶ However, when it is not entirely clear from which geographical location the profit originates, it is best to get as close to that location as possible.

The current transfer pricing systems relying on the arm's length principle is based on the assumption that the functions performed by the enterprise are a 'recipe' automatically leading to profit, since no profit is allocated to the market in which the products are sold. The fact that current OECD Transfer pricing guidelines do not recognize the market side of the economy as a value creating factor is criticized in literature.⁷⁷ In formulary apportionment, an alternative to the current arm's length principle, a significant amount of profit is allocated to the destination state.

The importance of the consumer in the value creation of course differs per market and product sector. Paul Oosterhuis states that:

*"This is particularly true for consumer products where much of the value lies in consumer preferences and brand awareness, both items of value that typically inhere in the market country and not in the location of product development activities or in the parent's country of residence."*⁷⁸

Another argument for the inclusion of the destination state is the atomization and the digitalization, which reduces the need for human activities and increases the value creation in the destination state through data collection. As the need to conduct business via human presence decreases, this should not be a decisive criterion to establish taxable presence.

⁷³ OECD 2013, *Action Plan on Base Erosion and Profit Shifting*, p. 10.

⁷⁴ De Wilde, *NTFR Beschouwingen 2015/10*, paragraph 2.2.

⁷⁵ De Wilde, *NTFR Beschouwingen 2015/10*, paragraph 2.2.

⁷⁶ McIntyre 2003, p. 253.

⁷⁷ Sheppard 2014, p. 75, De Wilde, *NTFR Beschouwingen 2015/10*, paragraph 2.2.

⁷⁸ Oosterhuis 2013, p. 2.

Thus, a combination between a nexus approach based on destination and a nexus approach based on the supply side should be used, being the destination based approach and the principle of origin.

For the supply side, the locations where assets are held, labor takes place and risks are managed should be leading to create taxable presence, whereas a logical measuring factor for the destination state would be turnover.

When further referring to value creation in this thesis, I mean value creation in a broad sense, including the value creation on the demand side of the economy.

In chapter 8 I will make more specific recommendations to both the OECD and the Netherlands for implementing the favored nexus approach, based on the findings described in the following chapters.

2.6 Conclusion

The sub question that has been addressed in this chapter is:

What different approaches to allocate taxation rights to tax jurisdiction exist and which one should prevail based on which underlying tax principles?

Three different principles could be derived from the traditional views on the allocation of taxation; the nationality principle and the domicile principle, which cause unlimited right to tax income based on the formal location of the business and the source principle which grants a limited right to tax income to the source state. Next to the methods used in practice the origin principle exists, a method which favors the importance of substance over form. Furthermore there exists a destination-based principle which acknowledges taxation rights to the state where the consumer resides.

It has been argued that tax jurisdiction should be allocated both to the location the supply-side and to the market country. As selection criteria for the best nexus approach, the conformity of the nexus approaches with neutrality, ability to pay, benefit and value creation criteria were taken into account.

The origin principle is considered to be the best method to determine nexus on the supply side of the market, notwithstanding the fact that the decisive need for human activity for the creation of value is argued, as this criteria directly conflicts with the theory that the market country also needs to be taken into account when allocating profits.

Combining the principle of origin with the destination based approach would lead to a new nexus factor presence test, based on the existing transfer pricing factors and the sales in a country.

3 Permanent Establishment Concept in Dutch and International Tax Law

3.1 Introduction

As explained in the introduction, the PE is used to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates, or whether the country of residence should be entitled to tax these cross border profits. In this chapter the qualitative threshold limiting taxation at source defined by the PE concept is described from a national perspective in an international context. In paragraph 3.2 the general outline and the differences between inbound and outbound cases is described, thereafter the definition of the PE is split up into three parts: the fixed place PE (paragraph 3.3), the project PE (paragraph 3.4) and the agency PE (paragraph 3.6). Exempted situations are described in paragraph 3.5, the sequence of this paragraphs reflects the sequence of the paragraphs of the corresponding article of the OECD Model Convention. Paragraph 3.7 describes some deviations of the PE definition in Dutch treaties and paragraph 3.8 describes fiscal risk management with regards to the PE. Paragraph 3.9 summarizes this chapter, which has initially been written for the purposes of the EUCOTAX Wintercourse.

3.2 The PE concept in inbound and outbound cases

The concept of a permanent establishment could be applicable on different sorts of taxes: wage tax,⁷⁹ personal income tax,⁸⁰ value added tax and also the corporate income tax. According to Boers, Vermeulen and Wisman, the definition of the PE in the other areas of Dutch tax law is not substantially different, all existing differences originate from the nature and objective of the specific laws. However, when assuming the value of case law with respect to the PE concept for Dutch wage tax purposes for interpretation of the PE rule in CIT circumstances, a cautious approach is necessary.⁸¹ Due to its nature, the focus of this thesis will be on the PE concept in the Dutch Corporate Income Tax Act 1969 act.

⁷⁹ For wages taxes, the determination of the permanent is relevant to determine whether there is a withholding agent. The notion of the permanent establishment is mentioned in art. 6 (2) Wage Tax, but is not further explained. It solely states that the presence of a permanent establishment in the Netherlands, which is used for the conduct of business, profession or other activity, leads to the formal existence of a withholding agent. Furthermore two examples of possible permanent establishments are given: activities for a continuous period of at least 30 days in, on or above Dutch territorial waters and the intermediary activities for the benefit of those who gain full employment in the Netherlands.

⁸⁰ In article 7(2) of the individual income tax act incorporates the object of taxation for foreign taxpayers. Profits from permanent establishments located in the Netherlands are included in the tax base, but it lacks a definition of what activities fall within the scope of a permanent establishment. Though no description is given, two specific supplements of permanent establishments are given. The first determines that all activities of limited time from artists or sportsmen made on Dutch territory establishes a permanent establishment. The second states that all income from (rights on) immovable property located in the Netherlands, and rights related to natural resources are taxable in the Netherlands.

⁸¹ Boers, Vermeulen & Wisman 2015, p.11 See additionally e.g. paragraph 2 (12) – 2 (15) of the Conclusion of Advocate-General IJink to the Supreme Court, 28 March 2001, nr. 33 490, BNB 2001/239.

Therefore only case law relevant for Corporate Income Tax purposes will be treated within this paper. Case law plays an important role in the development of the PE concept in the Netherlands, since the explanation of the PE concept in national law is limited.

In national law reference is made to the definition of the PE concept in both outbound and inbound situations. For inbound cases the question is whether a foreign company has a permanent establishment in the Netherlands, while for outbound cases the question is whether an enterprise with its residence in the Netherlands has a permanent establishment abroad.

The interpretation of PE concepts in inbound and outbound settings tends to be different in legislation and therefore both situations will be discussed separately.

3.2.1 Inbound cases

The object of taxation for non-resident corporations is mentioned in articles 17 and 17a CITA (Dutch Corporate Income Tax Act). Profits from businesses in the Netherlands proceeding from permanent establishments located in the Netherlands have been included in paragraph 3 sub a) of art. 17 CITA. However, the Netherlands has also included income from other sources than a permanent establishment to the taxable base in the Netherlands. Other business activities leading to taxable presence in the Netherlands, in addition to the permanent establishment, have been listed in article 17a CITA. No reference is made to the PE concept, so the legislator has intended to include the following activities as an object leading to tax liability in the Netherlands for foreign companies, apart from the income from permanent establishments.

Article 17a includes specific activities, which lead to taxable presence in the Netherlands:

- a) Immovable property located in the Netherlands, including rights thereon and rights related to the exploitation of natural resources located in the Netherlands;
- b) Rights to the shares of profits of an enterprise whose management is located in the Netherlands, unless the rights constitute a mere portfolio shareholding;
- c) Debt claims on a Dutch company if the beneficial owner of the debt claim has a substantial shareholding ($\geq 5\%$) in that company;
- d) Services provided as a member of the board of directors/supervisory board of a resident entity, even if the powers of the members are restricted to the company's establishments abroad;
- e) Business activities in respect of the exploration for/or natural resources for a period of at least 30 consecutive days or for a total period of 30 days within 12 months.

Above-mentioned activities are not serving as an explanation of the definition of a permanent establishment, these paragraphs give an expansion to a taxable business conducted in the Netherlands.

The PE concept is thus only mentioned in art. 17 CITA tax, but no explanation for the purposes of inbound cases can be found within the law.

It can thus be concluded that the sole use of legislation to determine the definition of a permanent establishment for inbound cases does not provide satisfying answers. In literature, for the explanation of the definition of the permanent establishment, often reference is made to the case law of the Dutch courts. For the comprehension of the Dutch PE concept, jurisprudence is thus the crucial factor, due to the absence of a description of the concept in domestic law. The relevance of the OECD model and the commentary thereon will be discussed more in detail in paragraph 2.2.3.

3.2.2 Outbound cases

In outbound situations the Netherlands would judge on a situation on another territory whether there is a PE established or not. For these situations there are two different situations: a distinction can be made between cases in which there is a bilateral tax treaty with the other country and situations where there is no bilateral tax treaty applicable. When a bilateral tax treaty is present, the PE definition of the treaty is applicable and therefore no specific PE definition in national law applies to this situation.⁸²

However, when there is no bilateral tax treaty concluded, there are two articles that might be relevant. Article 15f for purposes of the CIT, and article 2 of the DADT (Degree for the Avoidance of Double Taxation) for other purposes, like the Individual Income Tax Act (IITA). Article 15f CITA has been introduced in 2012, when the object exemption for PE results was incorporated in Dutch tax law.⁸³ At the same time the definition of article 2 DADT has been updated to bring the national law into an agreement with the standard treaty and bilateral treaties. Both Dutch articles are almost identical to, and embody the same definition of a PE as the OECD describes in article 5 of the model convention.⁸⁴

Though both article 15f CITA and article 2 DADT provide material equality between the PE concept in national law and the OECD model, at least are intended to, according to the minister of Finance,⁸⁵ a total equivalence based on the law is absent.

When comparing the PE definition in the OECD model with the definition given in art. 15f CITA and art. 2 DADT, some dissimilarities can be noted. The Netherlands has not only merged paragraphs 1 and 3 of the OECD Model, but has also omitted paragraph 2 and 7 of article 5 of the Model treaty. Another

⁸² Kamerstukken II, 2011/12, 33003, 3, p. 97.

⁸³ Art. XXI of the *Verzamelbesluit 2012 of 22 december 2011, Stb. 2011, 677*.

⁸⁴ For the sake of simplicity, from now on I will only mention 15f CITA, if not explicitly mentioned otherwise, the information will have the exact same relevance for article 2 DADT.

⁸⁵ MvT, *Kamerstukken II 2011/12, 33 003, nr. 3, blz. 97*.

small difference lies in the definition of the agency PE. In the Dutch law an agency PE could only be established by a person or a company, while the term ‘person’, further explained in article 3 (1-a) OECD standard treaty also includes ‘any other body of persons’.

This could have consequences for the condition that the ‘person’ habitually exercises the authority to conclude contracts. If this person would not qualify as an individual, but would in the context of a cooperation (body) with other persons, there would be a different application of the Dutch article 15f and the OECD model article 5.

For outbound cases situations where there is a bilateral tax convention concluded, the text of the treaty is followed. For outbound cases in non-treaty situations however, article 15f CITA is relevant.

3.2.3 Comparability between outbound and inbound cases

For inbound cases a definition in domestic law is absent. Since there is a clear definition on the situation for outbound cases, mainly initiated by international law, the question whether the international concept could be used to interpret national cases as well, could be posed.

The answer to this question is not unambiguous. Both in case law and literature different views exist. In BNB 1974/172 the Supreme Court decided that the OECD Model should not be interpreted as a decisive for the interpretation of the national PE definition in the unilateral decree.⁸⁶ However, in BNB 1982/60, the Supreme Court decided that the definition in national law could be explained by the OECD model. However, only to the extent that this provision would fit in the system of Dutch law.⁸⁷ Though BNB 1982/60 was about a wage law case, by the wordings that were used it could be interpreted that this provision would also be suitable for interpretations on different laws.

The editors of the NDFR⁸⁸ and Pijl⁸⁹ support the view that when a treaty is applicable, the definition of the double tax treaty would normally be directly applicable to domestic law.

However, Van Raad,⁹⁰ Pötgens and Bellingwout,⁹¹ are of the opinion that the international permanent establishment concept is not directly relevant for domestic cases.

⁸⁶ HR 3 april 1974, nr 17 259, BNB 1974/172.

⁸⁷ HR 17 oktober 1980, nr. 1.574/1.980, BNB 1982/60.

⁸⁸ NDFR Commentary, Income tax act, Wet IB 2001, art. 7.2, paragraph. 2.4.

⁸⁹ Pijl, *WFR* 2004/792, paragraph 4.2.

⁹⁰ Van Raad, comments to: HR 9 december 1998, nr. 32.709, *BNB* 1999/267.

⁹¹ Pötgens & Bellingwout, *WFR* 2012/654, paragraph 2.3.2.

Several authors have mentioned that it would be recommended to adopt one uniform permanent establishment concept in domestic tax law to enhance clarity.⁹² Since such a uniform concept has not been implemented (yet), the interpretation of the permanent establishment concept is based on case law by the Dutch Supreme Courts and various lower courts.

Three different types of Permanent Establishments could be distinguished: The fixed place PE, the agency PE and the construction PE. In the next paragraphs all provisions will be discussed.

3.3 The fixed place PE

The fixed place PE, the general PE, is a fixed place of business through which the business of an enterprise is wholly or partly carried on. To determine whether a fixed place PE is present, several criteria have to be met. These criteria correspond in big lines with the criteria that the OECD has set, but different applications have been given by the Dutch Supreme Court. The main focus will be on the Dutch specifications of the different criteria, but when ought necessary some relevant parts of the OECD interpretation are given.⁹³ To meet the standards of a fixed place PE, the activities performed should pass several tests in order to be qualified as such. The tests that have to be met are the *situs* test, the *locus* test, the *tempus* test, the *ius* test and the business activity test. They will be described in following subparagraphs.

3.3.1 *Situs test – There has to be a place of business*

OECD Commentary: Any physical object that could be suitable for business activities might be a qualifying place of business. This criterion should be perceived as a wide concept, according to the OECD commentary.⁹⁴

Dutch case law: No specific cases that describe this criteria could be found in Dutch case law. In general this test could not be considered to be the most important one, since the following tests already provide a limitation on ‘real place of business’.

3.3.2 *The place has to be fixed*

The term ‘fixed’ has to be explained in two ways, it means a fixed geographical location (the *locus* test), and a fixed duration of the activities (the *tempus* test).

⁹² Van Raad, *WFR* 1992/1352, paragraph 2. And Pötgens & Bellingwout, *WFR* 2012/654, paragraph 2.3.2. and Stevens, *TFO* 2012/119, paragraph 3.1.

⁹³ As mentioned before, the goal of this paper is not to display an exhaustive definition of the PE concept according to the OECD.

⁹⁴ Paragraph 4.2-4.5 OECD Commentary on article 5.

3.3.2.1 Locus test – The place of business must be located in a certain territorial area

To pass this test, the place of business should be sufficiently fixed at a certain geographical location. However, a place of business can thus be considered as a fixed, even though it is movable.⁹⁵ In case law a circus tent was qualified as a permanent establishment, because it served as a center of the business, despite changing from geographical location.⁹⁶

A temporary use of the territory, meaning that the geographical location is not nailed into the ground but flexible, should thus not prevent the qualification as a PE according to the Dutch Supreme Court. Apart from circus tents, also boats could therefore be recognized as a PE, as long as the other PE tests are passed. Ships moving mainly in the territorial waters of the Netherlands were considered to form a permanent establishment.⁹⁷ For outbound cases however, the Supreme Court decided that no permanent establishment was present in Egypt⁹⁸ or Libya.⁹⁹

On the other hand, when a derrick, anchored to the seabed, navigates frequently to territorial waters from other countries, it is not considered to be fixed.

Furthermore the permanence requirements should be met by single activities, a set of multiple temporary locations in the same jurisdiction, which would on itself not qualify, do not qualify either as a set of various locations, if the activities are performed consecutively.¹⁰⁰

3.3.2.2 Tempus test – the use of the place of business must last for a certain period of time

OECD Commentary: According to the OECD commentary and the view of Skaar, in general a minimum period of 6 months should be enough to pass the tempus test.¹⁰¹ Whether this is the exact minimum remains also unclear in further discussions by the OECD.¹⁰²

Reasons of the OECD not to set a hard minimum time frame, is that such a time frame would not take into account the different businesses models.

⁹⁵ Hof Den Haag 10 september 1990, nr. 4287/87, BNB 1992/51.

⁹⁶ HR 13 oktober 1954, nr. 11.908, BNB 1954/336.

⁹⁷ HR, 2 October 1996, nr. 31 135, BNB 1996/358.

⁹⁸ HR 3 april 1974, nr. 17 259, BNB 1974/172.

⁹⁹ HR 22 January 197, nr. 17 537 BNB 1975/66.

¹⁰⁰ HR, 15 June 1955, nr. 12 369, BNB 1955/2773.

¹⁰¹ Paragraph 4.2-4.5 OECD Commentary on article 6 and Skaar 1991, p 220-222 and p. 226.

¹⁰² OECD Model Tax Convention: Revised proposals concerning the interpretation and application of article 5 (permanent establishment), 19 October 2012- 31 January 2013.

Dutch case law: In the ‘*artificial eyes*’ case, the Dutch Supreme Court judged that the rent of different hotel rooms for only a limited amount of time would not be sufficient.¹⁰³ Three months would neither be enough, according to the Dutch court in the *Boorplatformarrest 1990 (drilling rig decision)*¹⁰⁴. Periods of ‘a few’ months¹⁰⁵ and even half a year¹⁰⁶ would not form enough substance for taxable presence according to the Supreme Court. In other cases a minimum length of 4.5 up till 9 months would be sufficient to pass the tempus test.¹⁰⁷ The Supreme Court has mentioned that the intended duration of the activities is decisive and is even prevailed over the actual time spent by the taxpayer.

A movable place of business seems to pass the test if the aggregated time spent on the territory of a state is deemed to be sufficient. Simultaneous use of different fixed places on different locations in one jurisdiction can be aggregated as well, while the consecutive use of different places of business cannot be aggregated and would therefore not qualify as a permanent establishment.¹⁰⁸ However, Boers, Vermeulen and Wisman are of the opinion that no clarity exists on whether the simultaneous or consecutively use should be aggregated or not.¹⁰⁹

It can be concluded that a case-by-case analysis is necessary and the facts and circumstances will play an important role in assessing whether the time spent on the specific activities on Dutch territory is enough to qualify as a PE.

3.3.3 The business of the enterprise has to be wholly or partly carried on by the fixed place of business

3.3.3.1 Ius test – The taxpayer must have a certain right of use over the fixed place of business and

Dutch case law: The Ius test is fulfilled in the Netherlands if the place is at disposal of the enterprise. Ius test does not require ownership of the fixed place, the rental would also qualify as an object which is at the disposal of the enterprise. If there is no legal ownership or formal rental, a PE can also be deemed to exist if the fixed place would be available *de facto*.¹¹⁰

¹⁰³ HR 15 June 1955, nr. 12 369 (BNB/277).

¹⁰⁴ Hof ‘s Gravenhage 10 September 1990, nr 4. 4287/87, (BNB 1992/51).

¹⁰⁵ HR 22 January 197, nr. 17 537 (BNB 1975/66).

¹⁰⁶ HR 24 march 1976, nr 17 812 (BNB 1976/121).

¹⁰⁷ Van den Berg 2009, p. 469.

¹⁰⁸ Van den Berg 2009, p. 469. Referring to Hof Den Haag 10 september 1990, nr. 4287/87, BNB 1992/51 and HR 24 maart 1976, nr. 17.812, BNB 1976/121.

¹⁰⁹ Boers, Vermeulen & Wisman 2015, p. 19.

¹¹⁰ See for example HR 24 march 1976, nr 17 812 (BNB 1976/121).

The room in the house of an employee through which activities for a foreign enterprise are performed would not meet these criteria, since the place is not at disposal of the enterprise.¹¹¹ The same counts for a hotel room, which was decided upon in BNB 1955/277.¹¹² The court of Leeuwarden has decided that the fact that the enterprise does not have access to the fixed place at certain moments does not prevent a permanent establishment to exist.¹¹³

3.3.3.2 Business activity test – The activities must be performed through the fixed place of business.

Dutch case law: When activities, even only of administrative nature take place from the fixed place, a permanent establishment can be deemed to be available.¹¹⁴

Additionally, the place of business should be equipped for the exercise of the specific business. This criterion would prevent the establishment of a permanent establishment in case a businessman would travel from hotel to hotel, since the hotel rooms are nor at the disposal of the business and neither equipped for the business.¹¹⁵ Furthermore, Dutch court decision states that it is not necessary that the foreign enterprise carries on the business itself, but that the business carried on by joint ventures could be attributed to such foreign enterprise.¹¹⁶

3.3.4 *OECD model Article 5 (2)*

Though the OECD model paragraph 2 offers a list of possible fixed place PEs, the Netherlands has decided not to take over this paragraph of the OECD convention because it would not be significant enough and just states a non-exhausting list of examples.¹¹⁷ Every case should be tested individually to the criteria set under the other paragraphs, independent from what example is used in the OECD model.¹¹⁸ The Supreme Court has confirmed the Dutch approach and judged that one of the examples, a place of management, does not necessarily lead to the establishment of a Permanent Establishment if the criteria of the fixed place PE are not met.¹¹⁹

¹¹¹ HR 13 March 1957, nr. 13 096, BNB 1957/144.

¹¹² HR 15 June 1955, nr. 12 369 (BNB 1955/277).

¹¹³ Hof Leeuwarden 12 August 1988, nr. 440/68, FED 1988/710.

¹¹⁴ HR 7 March 1956, BNB 1956/123, VN 1956, at 212.

¹¹⁵ HR 15 June 1955, nr. 12 369 (BNB 1955/277).

¹¹⁶ Van den Berg 2009, p.471.

¹¹⁷ MvT, *Kamerstukken II* 2011/12, 33 003, nr. 3, blz. 97.

¹¹⁸ Van Raad 2014, p. 217.

¹¹⁹ HR 9 December 1998, nr. 32 709, BNB 1999/267.

3.4 The project PE

The project PE, also known as a temporary or installation PE, addresses construction or installation activities, which last longer than 12¹²⁰ months. The situation for inbound and outbound cases seem to differ significantly.

3.4.1 *Inbound*

For inbound situations, the project PE would not be relevant, since no national law exists for building and construction permanent establishments. In the comments to case BNB 1999/267, the leading opinion of Van Raad is that a PE is only deemed to exist if the criteria for a fixed place PE are met, hence the project PE would not exist on its own.¹²¹

3.4.2 *Outbound situations*

For outbound situations however, the project PE has been included in the PE concept, and should therefore be interpreted according to the OECD commentary and relevant jurisprudence.¹²²

According to the general interpretation of the OECD model, the twelve months criterion for building sites and construction or installation projects is an extension of paragraph 1.¹²³ This means that the cumulative criteria for the fixed place PE do not cover the installation PE.¹²⁴ The Supreme Court has confirmed that the project PE is a fictitious PE for the purposes of a Double Tax Treaty and the DADT, meaning that the criteria for the fixed place are irrelevant for this type of PE.¹²⁵

There does not seem to be 100% clarity on what activities exactly fall under the scope of ‘construction sites’.¹²⁶ Dredging activities,¹²⁷ planning and supervision as a preparation of construction activities,¹²⁸ while geological and geophysical research activities would not fall under the scope of a PE.¹²⁹

¹²⁰ The period of 12 months is standard under the OECD model and the Dutch policy, however other states have preferences for shorter periods.

¹²¹ Van Raad, comments to: HR 9 december 1998, nr. 32.709, *BNB* 1999/267.

¹²² Boers, Vermeulen & Wisman 2015, p.19.

¹²³ Vogel 1997, art 5 at m. nr. 72.

¹²⁴ Paragraph 16 and 17 OECD Commentary on article 5.

¹²⁵ HR 4 februari 1970, nr. 16 305, *BNB* 1970/71 and HR 9 December 1998, nr 32 709 *BNB* 1999/267.

¹²⁶ Van den Berg 2009, p.473.

¹²⁷ HR 23-01-1974, nr. 17 237 *BNB* 1986/100.

¹²⁸ However, if these activities would be separated from the actual construction activities, no PE would be recognized according to HR 9 december 1998, nr. 32.709, *BNB* 1999/267.

¹²⁹ Hof Den Haag 4 April 1987, nr. 2169/85, *FED* 1988/560.

Though the aim of the Dutch authorities is to set a minimum threshold of twelve months for the project PE,¹³⁰ the minimum period of twelve months is reduced in several bilateral treaties with developing countries, see paragraph 3.7.1.

3.5 Exemptions

Within the OECD model an explicit enumeration of the criteria, which lead to the existence of a Permanent Establishment, and an exhaustive list of the specific exemptions is given. Paragraph 4 of the OECD model states that activities with a preparatory or auxiliary character are exempted, regardless of the size of these activities. In Dutch law such an exemption does not exist for inbound cases, and neither jurisprudence provides for a similar provision.

Inbound situations

In BNB 1974/172 the Supreme Court decided that the specific activity exemptions of the OECD model were not relevant for the domestic definition.¹³¹ Also in the comments to BNB 1999/267, Van Raad argued that the specific activity exemptions do not apply on inbound cases.¹³²

Boers, Vermeulen and Wisman do not directly agree with van Raad, and state that it is unclear whether the specific activity exemptions are part of the domestic concept.¹³³

Outbound situations

However since the adoption of article 15f (2) CITA and the changes to article 2 (2) DADT, the same specific activities exemptions as under article 5 (4) OECD model apply. In the article, several situations have been enumerated which should be exempted from the PE concept. Some specific activities are mentioned, like the storage of goods solely used for the purpose of storage, display or delivery, or the collection of data for the enterprise. The last two letters however mention activities that have a preparatory or auxiliary character. The determination of the concept preparatory or auxiliary fully depends on the particular business. The significance of the activities within the business and the relative added value they yield should be identified. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits.¹³⁴ The goal of the exemptions

¹³⁰ Notitie fiscaal verdragsbeleid 2011, Kamerstukken II, 2010-2011, 25 087, nr 7. P. 40.

¹³¹ HR 3 april 1974, nr 17 259, BNB 1974/172.

¹³² Van Raad, comments to: HR 9 december 1998, nr. 32.709, BNB 1999/267.

¹³³ Boers, Vermeulen & Wisman 2015, p.11.

¹³⁴ Paragraph 24 OECD commentary on article 5.

is to encourage international trade,¹³⁵ and to prevent administrative complexities for the matter of profit allocation.¹³⁶ However, the OECD has reconsidered their view in BEPS action 7, which will be further discussed in chapter 7.

In domestic law it is thus not entirely clear to what extent the exceptions are relevant for inbound situations.¹³⁷ However, in case law the relevance of the exclusions in outbound situations has been confirmed.¹³⁸

3.6 The agency PE

The agency PE is a special provision for agents. It has the following four conditions in the Netherlands:

3.6.1 The representative is dependent on the business he represents

When the agent is independent and acts in the ordinary course of his business there will be no presence of a PE.¹³⁹ When the activities do not fall in the ordinary course of the business however, a PE might exist.¹⁴⁰ The Supreme Court has judged that a representative can act independent and in the ordinary course his business for certain activities and could be dependent for other activities.¹⁴¹ The Supreme Court stated that territorial restrictions and the restriction of the representative's authorization to a period of three years did not preclude a determination that a permanent representative existed.¹⁴²

To determine the dependency of an agent, both legal and economic dependency are essential. Legal dependency is deemed to exist when the agent is bound by detailed instructions and is subject to supervision, while economic dependency refers to the entrepreneurial risk that is borne by the representative.¹⁴³

One of the factors, which determines the economic dependency is the amount of principals that a commissionaire works for.¹⁴⁴ A commissionaire working for 58 different insurance companies was

¹³⁵ Paragraph 21 OECD Commentary on article 5.

¹³⁶ Paragraph 23 OECD Commentary on article 5.

¹³⁷ Boers, Vermeulen & Wisman 2015, p. 17.

¹³⁸ HR 26 January 2000, 33 434 (BNB 2000/159).

¹³⁹ This is described in article 15f(4) CITA and article 2(4)DADT of national law, and article 5 (6) of the OECD model.

¹⁴⁰ HR 13 January 1971. 1971, nr. 16 445, BNB 1971/43.

¹⁴¹ HR 15 June 1988, nr. 24 881, BNB 1988/258 (noot van Brunschot), V-N 1988 blz 2283.

¹⁴² See HR 20 June 1978, nr. 1106/761 BNB 1979/190 and HR 21 April 1971, HR 21 april 1971, nr 16 528, BNB 1971/110.

¹⁴³ Boers, Vermeulen & Wisman 2015, p. 17.

¹⁴⁴ HR 15 June 1988, nr. 24 881, BNB 1988/258.

deemed to have sufficient principals to assess the agent as 'independent'.¹⁴⁵ However, in centralized business models, there are many cases with only one principal. Whether such an agent would directly lead to the existence of a PE remains to be seen, according to Oosterhoff and Tiele.¹⁴⁶ In various industries non-exclusive agents or changing distributors might be common practice and could indicate the prevention of the existence of a PE.

In the Netherlands, an agent who fulfills the instructions of the principal is not automatically deemed to be dependent on that principal,¹⁴⁷

In general, important factors that influence the degree of economic dependency of a Dutch entity are: the responsibility for its own entrepreneurial activities and the bearing of the associated risks in this regard; the remuneration model of the agent and the performance of activities on the account of the agent himself.

3.6.2 The agent has to have the permanent authorization to conclude contracts in name of the foreign enterprise

The authorization to conclude contracts in the name of the foreign enterprise can be general and comprehensive,¹⁴⁸ though a more specific authority for a set of limited activities can also lead to the recognition of a PE.¹⁴⁹ Leading is the fact that the agent has the authority to bind the foreign enterprise to business activities in the Netherlands.¹⁵⁰ According to the Dutch Supreme Court,¹⁵¹ a formal authorization to perform these activities is not necessary. In practice there are no specific conditions on the bandwidth of the authorization, it will always be restricted in a way. The main criterion is that the commissionaire has enough power to conclude binding arrangements for the company in the other country.¹⁵²

¹⁴⁵ See Hof Amsterdam 5 maart 1991, nr. 1455/90, FED 1993/876. In this case another important fact was that the activities performed by the agent were common business activities.

¹⁴⁶ Oosterhoff & Tiele, *ITPJ* (17) 2010/6. P 430-433.

¹⁴⁷ Compare Daniëls, in his annotation to Court of The Hague 25 June 1986, FED 1987/296 and Van Raad 1990, P. 3-7.p

¹⁴⁸ HR 17 may 1961, nr. 14 448, BNB 1961/196.

¹⁴⁹ Court of Amsterdam, 20 June 1978, nr 1106/761, HR 20 June 1978, nr. 1106/761 BNB 1979/190 and HR 28 May 2001, nr 33, 33 490, BNB 2001/239.

¹⁵⁰ Court of Amsterdam, 11 December 1995, 948/80, V-N 1986, at 1942.

¹⁵¹ See e.g. Hof Arnhem 9 March 1990, nr. 43/1985, V-N 1990 2597 and Court of Appeal of Amsterdam, 20 June 1978, BNB 1979/190.

¹⁵² See HR 17 May 1961, nr 14 458, BNB 1961/196 and Hof Amsterdam 11 December 1985, nr 948/80, V-N 1986, blz. 1942.

The need to conclude contracts in the exact same name of the principal is neither mandatory to constitute a permanent establishment.¹⁵³ The economic reality is thus considered to be more important than the legal form, a permanent establishment can be deemed to exist if the customer, based on facts and circumstances, knows to what entity he is bound.¹⁵⁴ In literature there are different views on the meaning of ‘binding on’, which is argued to be the real definition of concluding contracts ‘in the name of’. Some are of the opinion that a commissionaire always concludes contracts in the name of his own enterprise and therefore does not create a direct relationship between the customer and the principal. Others state the economic risk of the commissionaire is normally located at the principal, since he acts for the account of the principal. This view is supported by art. 7:421 of the Dutch Civil Code, which states that in specific circumstances (i.e. bankruptcy of a commissionaire), the principal is the one who is ultimately bound to the customers of the commissionaire.¹⁵⁵

In general the Dutch practice seems to place substance over form in the assessment of these criteria.

3.6.3 The agent has to make us of the authorization to conclude contracts regularly

The Ministry of Finance has published a decree in which they refer to the habitual exercise of the authority to conclude contracts. Both the frequency (e.g. the number of times) and the permanence (the duration of the activities) are relevant in the assessment.¹⁵⁶ Real quantitative guidance on these statements seems not to exist. The frequency of the conclusion is depends on the characteristics of the specific business and the specific contracts and thus a minimum amount is not set.¹⁵⁷ According to Van Raad it should be more often than in one single case,¹⁵⁸ but it remains unclear in his overview if this is the bottom. The permanence test could be met if the activities of the commissionaire last for several years, according to the Secretary of State.¹⁵⁹

In general no exact criteria can be perceived in the Netherlands; specific case law on this item is absent, therefore the nature of the business and the facts and circumstances should be the criteria for this test.¹⁶⁰

¹⁵³ HR 20 November 1940 B.7250.

¹⁵⁴ Oosterhoff & Tiele, *ITPJ* (17) 2010/6. P. 430-433.

¹⁵⁵ Oosterhoff & Tiele, *ITPJ* (17) 2010/6. P. 430-433.

¹⁵⁶ Decree of 16 November 2004, IFZ2004/828M.

¹⁵⁷ Oosterhoff & Tiele, *ITPJ* (17) 2010/6. P. 430-433.

¹⁵⁸ Van Raad 2014, p. 219.

¹⁵⁹ Decree of 16 November 2004, IFZ2004/828M.

¹⁶⁰ Boers, Vermeulen & Wisman 2015, p. 17.

3.6.4 The activities performed by the representative are in line with the activities of the foreign enterprise

The importance of substance over form is also relevant for this criteria, they could even lead to the interpretation that the activities of the agent are of such a significant importance to the business, that the principle place of management is deemed to be in the Netherlands. This would make the company a resident taxpayer.¹⁶¹ However, it should be noted that this does not mean that the force of attraction applies, which allocates the taxation rights on all profits derived in the country of a PE to the state where the PE is present, regardless of the nature of this profit and regardless whether the PE was involved in the related transaction.¹⁶²

Furthermore, the occupations of the agent should not be restricted to the buying of goods for the enterprise.¹⁶³ This exemption could be seen as an extension of the exemptions mentioned in paragraph 3.4.

3.7 Deviations between the OECD model and Dutch tax treaties

Though jurisdictions have the right and freedom to add extra comments to (articles of) the OECD model, the Netherlands attempts to make use of this possibility as little as possible, because it is of the opinion that the power of a model treaty is harmed by making additional redundant comments.¹⁶⁴

However, in practice certain differences can be found between the PE concept in bilateral tax treaties and the OECD model. On several topics the policy of the Netherlands deviates from the OECD model, and on several topic the outcomes differ due to results of the negotiation process.

In the negotiation process with developing countries, the Netherlands is willing to come towards these countries and adopt provisions based on the UN-model in case this leads to an acceptable end result of the treaty negotiation. An accommodation position towards profit allocation could also be part of these negotiations.¹⁶⁵ This would e.g., lead to a reduced period for project PE's, or the inclusion of a services PE.

¹⁶¹ Hof Amsterdam, 12-07-1994, nr. 93/0826.

¹⁶² Fiscale Encyclopedie De Vakstudie Nederlands Internationaal Belastingrecht, Aantekening 1.7.1, *Force of attraction bij: OESO-Modelverdrag 1992, article 7 Business profits.*

¹⁶³ Van Raad 2014, p. 217.

¹⁶⁴ Notitie fiscaal verdragsbeleid 2011, Kamerstukken II, 2010-2011, 25 087, nr 7. P. 40.

¹⁶⁵ Notitie fiscaal verdragsbeleid 2011, Kamerstukken II, 2010-2011, 25 087, nr 7. P. 40.

A non-exhaustive list of significant deviations between the OECD model and Dutch tax treaties will be given, in the order of the articles of the OECD model.¹⁶⁶

3.7.1 Examples of permanent establishments

The Netherlands has conducted bilateral treaties in which other examples have been listed than the ones mentioned in art. 5 (2) OECD Model. These extra provisions include sales outlets,¹⁶⁷ farms or other agricultural or forestry activities,¹⁶⁸ and installations used for the exploration of natural resources.¹⁶⁹

3.7.1 Project PE

The Netherlands prefers the minimum length of construction activities of the OECD model (twelve months) above the UN model (six months).¹⁷⁰ The minimum period for a project PE, which is twelve months according to the OECD model and Dutch policy, is sometimes reduced in treaties with developing countries. The period could be brought back to three,¹⁷¹ six or nine months, but also be extended to eighteen months.¹⁷² In the recent treaty with Ethiopia for example the agreed period is six months.¹⁷³

3.7.2 Specific activity exemptions

Though most treaties concluded by the Netherlands contain a provision on specific activity exemptions similar to article 5(4) of the OECD Model Convention, this is not the case for every particular bilateral treaty. Many older treaties explicitly refer to “advertising, supply of information and scientific research” as activities of a preparatory or auxiliary character.¹⁷⁴ Furthermore, in some treaties the wording ‘delivery’ is excluded from (the corresponding provision of) article 5 (4) (a/b) OECD model. The last variety in Dutch treaties is the absence of a provision excluding specific activity exemptions.¹⁷⁵

¹⁶⁶ These dissimilarities have been derived from: NDFR Internationaal en EU-Belastingrecht, art.5 OECD Model, paragraph 10.

¹⁶⁷ See e.g. the treaties with India, Ukraine and Qatar.

¹⁶⁸ See e.g. the treaties with Australia, Ethiopia, Israel and Suriname.

¹⁶⁹ See e.g. the treaties with Armenia, Portugal and Malaysia.

¹⁷⁰ Notitie fiscaal verdragsbeleid 2011, Kamerstukken II, 2010-2011, 25 087, nr 7. P. 40.

¹⁷¹ See e.g. the treaty with Indonesia and Thailand.

¹⁷² See e.g. treaties with Macedonia, Poland and Slovenia.

¹⁷³ This treaty has been signed on the 10th of august 2012.

¹⁷⁴ Burgers 2015, p. 12.

3.7.3 *Continental Shelf*

The Netherlands favors the inclusion of offshore activities on the territory of the state, within the permanent establishment definition in bilateral tax treaties. When these activities are performed for more than thirty days, a permanent establishment will be deemed to exist.¹⁷⁶ However, not all countries seem to support such a clause, and therefore the Netherlands does not always insist on the adoption of this item to the permanent establishment definition, because other countries might want to broaden the scope of the concept even more, which is against the Dutch principles to facilitate international business and reduce administrative burdens.¹⁷⁷

3.7.4 *Services PE*

Another difference, though currently exceptional in Dutch bilateral tax treaties, is the adoption of a services PE.¹⁷⁸ This provision might however become more important after the update of the commentary on the OECD model¹⁷⁹, referring to the service PE incorporated in the UN-model article 5 (3) (b). However, the Netherlands is currently willing to adopt a service PE paragraph in their bilateral treaties with developing countries, if the request for the inclusion of such a provision is made for budgetary purposes and the services PE belongs to the standard treaty of that country.¹⁸⁰ In practice the minimum length of the services in order to establish a permanent establishment differ upon the treaty partner, deviating from ninety days to twelve months.¹⁸¹

3.7.5 *Other incidental dissimilarities:*

In some cases the Netherlands includes special provisions on technical services to ensure that these are not perceived as royalties by other countries.¹⁸² Furthermore, some treaties contain special provisions for insurance companies. E.g., if an insurance company collects premiums in another contracting state, or if the company insures risks situated therein.¹⁸³

¹⁷⁶ Notitie fiscaal verdragsbeleid 2011, Kamerstukken II, 2010-2011, 25 087, nr 7.

¹⁷⁷ Notitie fiscaal verdragsbeleid 2011, Kamerstukken II, 2010-2011, 25 087, nr 7.

¹⁷⁸ Such a specific exception has been included in the treaty with and on the initiative of Portugal.

¹⁷⁹ Paragraph 42.23 OECD Commentary on article 5.

¹⁸⁰ Notitie fiscaal verdragsbeleid 2011, Kamerstukken II, 2010-2011, 25 087, nr 7.

¹⁸¹ The minimum length is e.g. 90 days (panama), 6 months (China) or 12 months (Azerbaijan).

¹⁸² Burgers 2015, p. 10.

¹⁸³ Treaties with a paragraph on insurance companies are concluded with i.e. Brazil, France, etc.

3.8 The Permanent Establishment and Risk Management

In the past, the Dutch Tax Authorities have built a strong reputation on the provision of rulings to provide businesses certainty in advance about future taxation of business activities.¹⁸⁴ The Dutch ruling program is regulated by decrees that have been released in June 2014.¹⁸⁵

In such a ruling tax payers can reach an agreement with the tax authorities on the fiscal treatment on several issues, including, the application of the participation exemption to holding companies in international structures, the use of hybrid financing instruments and hybrid entities, the classification of activities, i.e. group services or shareholder activities but also on the existence of a permanent establishment.

These agreements are made to provide the taxpayer certainty in advance on the application of tax laws in specific circumstances. The Dutch Tax Authorities only sign the ruling on the application of tax laws if they are in good faith in respect of the Dutch tax law and the information provided by the taxpayer is presented completely and correctly.

The Netherlands does not only provide clarity upon the existence of a PE on Dutch territory, but is also willing to give their opinion on the presence of a PE abroad.¹⁸⁶ For businesses it is crucial to know in advance whether a Permanent Establishment exists, as it is subject to the administration obligations of article 52 GTA. Furthermore, if a permanent establishment is constituted a tax return should be filed.

The Advanced Pricing Agreement (APA)/Advanced Tax Ruling (ATR) team of the Dutch Tax Authorities (DTA) in Rotterdam provides foreign business within a limited timeframe outcome on the question whether a permanent establishment will exist in an ATR, if all required information is provided the ruling can be provided within eight weeks.¹⁸⁷

Considering the developments that will be described in the next chapter, the uncertainty on the existence of a permanent establishment is considered to rise. Therefore, it might be expected that companies will make use of the opportunity more regularly.

¹⁸⁴ It should however be noted that the future is still unsure after Starbucks case, in which the European Commission has stated that the ruling the Netherlands has concluded in this case was considered as state aid. Furthermore the automatic exchange on rulings, on which both the OECD and the EC have agreed, will have impact on the ruling practice of the Netherlands.

¹⁸⁵ Decree 14 June 2014, DGB 2014/3098 and Decree 14 June 2014, DGB 2014/3099.

¹⁸⁶ Boers, Vermeulen & Wisman 2015, p. 17.

¹⁸⁷ Kamerstukken 2, 2014-2015, 34002, K.

3.9 Summary

The sub question that has been addressed in this chapter is:

What is the current definition of the permanent establishment in domestic and international tax law?

Regarding the allocation to tax jurisdiction from income derived from business activities performed in another country than the country of residence, the Netherlands makes use of the permanent establishment concept. In general, the Netherlands adheres to the OECD model in its treaties. In its national practice, the PE concept has been formed by case law. A clear distinction seems to be made between outbound and inbound cases.

For inbound cases the law states that income from permanent establishments is part of the taxable object for foreign entities liable to Dutch corporate income tax, however no explanation of the definition of the permanent establishment is given. For outbound cases the Netherlands has included the permanent establishment concept in national law, which is almost similar to the definition in the OECD model.

Apart from the model, case law is the primary source describing the definition of the permanent establishment. Three types of permanent establishments can be distinguished: the fixed place permanent establishment, the project permanent establishment and the agency permanent establishment. The main criteria set in case law are similar to the OECD criteria that have to be met in order to recognize a permanent establishment, though for some specific requirements a somewhat different interpretation is given.

A dissimilarity with more significant consequences is the project PE and the specific activity exemptions in inbound cases. In literature no coherent view exists on whether these parts are included or excluded for inbound situations, leading commentary of Van Raad on case law states that these provisions do not apply on non-treaty inbound situations.

In treaty negotiations the Netherlands uses the OECD Model as a starting point, however in some treaties deviating paragraphs can be found, including different examples of permanent establishments or specific activity exemptions. Furthermore, the Netherlands sometimes includes additional paragraphs to the permanent establishment concept, like provisions on offshore activities or the performance of 'services'.

In general it can be concluded that the Dutch PE concept is in line with the international PE concept and that there are significant qualitative criteria that prevent the source country to tax.

4 The BEPS project

4.1 Introduction

In June 2012 the first notion was made about a study on the Base Erosion and Profit Shifting (BEPS). The G20 gave a mandate to the OECD to do research on BEPS, as it forms a significant risk for not only the tax revenues of states, but also the trust of society in the integrity and functioning of tax systems. As a reduced trust in the tax administrations could have a spillover effect to the legitimacy of the whole government,¹⁸⁸ the relevance of this study is undisputable. Furthermore, the BEPS is ought to have a negative impact on worldwide investment, competition, allocation of production factors and therefore could limit economic growth on a worldwide level.¹⁸⁹

The OECD started working on identifying the components of BEPS, its position and impact in taxation systems and started considering possible ways to encounter BEPS. After a first report in February 2013,¹⁹⁰ the well-known action plan consisting of fifteen different topics was published.¹⁹¹

The final report of the BEPS project has been released on October 5, 2015. In the meantime, public discussion drafts have been released on which public stakeholders have delivered input that was taken into consideration by the OECD when compiling the definitive report.

The final BEPS report consists of the following:

- New minimum standards, intended to tackle issues in situations where deviating policy from some countries would have led to negative spill-overs on other countries
- Common approaches and best practices for national legislation
- A report on the measurement of Base Erosion and Profit Shifting

The specific actions of the BEPS action plan have been structured around three pillars: coherence, substance and transparency. Two specific actions do not fall within the scope of these pillars since they are analytical reports with recommendations on broader issues like multilateral instruments and the digital economy.

¹⁸⁸ Gribnau 2009, p. 153-164.

¹⁸⁹ OECD, *Declaration on Base Erosion and Profit Shifting*, adopted on 29 May 2013.

¹⁹⁰ OECD, *Addressing Base Erosion and Profit Shifting*, OECD Publishing 2013.

¹⁹¹ OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing 2013.

Within this chapter action 1 and action 7 will be discussed. Action 1 covers the impact of the digital economy on taxation and Action 7 includes the artificial avoidance of the Permanent Establishment status, which is part of the ‘substance’ pillar.

4.2 BEPS Action 1

The BEPS report on Action 1 defined several key features that have special relevance for business models within the digital economy. In the first subparagraph of each feature relevant for the delineation of the digital economy referred to by the OECD BEPS report 1 will be described. Thereafter examples of business models within the digital economy will be given. The consequence of the features within these business models provoke certain challenges regarding the treatment of these business models under the current taxation system.

4.2.1 Features

4.2.1.1 Mobility

The increased mobility within the digital economy is relevant for (intangible) assets, consumers and business processes. Regarding intangible assets, it must be noted that specific software is often the most important aspect to generate value as a digital business. The rights on this software, however, can easily be separated from (the geographical location of) the business activities.¹⁹²

Improved IT systems allow businesses to be managed from any geographical location, which enables businesses to do business in remote markets, while no significant people functions are present in that country. However, it must be noted that due to the differences in local markets there is still need for local managers and software adapted to the local market conditions.¹⁹³

4.2.1.2 Reliance on Data

Another aspect of the digital economy is the importance of data for the business, according to the OECD. Data on users, suppliers and operations is used to optimize products and services and address new markets. The analysis of big data can thus add significant value to businesses.¹⁹⁴

4.2.1.3 Network effects

The network effect is based on the fact that decisions and increase of use by other users might directly benefit the user experience of other users. These externalities can both have positive effects, e.g., being

¹⁹² OECD 2014, *Public discussion draft BEPS Action 1: address the tax challenges of the digital economy*, p. 65-68.

¹⁹³ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 65-68.

¹⁹⁴ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 68-70.

the only user of a social medium would not lead to the optimum user experience, while an increased use amongst your network is likely to increase your perceived value, but also has negative effects: the use of the same communication network at the same time will often lead to distortions of the network.¹⁹⁵

4.2.1.4 Multisided business models

The multisided business model is another typical feature of the digital economy. Action 1 of the final BEPS report describes the concept as follows:¹⁹⁶

“A multi-sided business model is one that is based on a market in which multiple distinct groups of persons interact through an intermediary or platform, and the decisions of each group of persons affects the outcome for the other groups of persons through a positive or negative externality”

Though this concept is also applied in offline business models, e.g., in newspapers, the use of this concept in digital economy is much broader, e.g., search engines, video streaming services and game applications make use of the concept, where customers can make use of the services of a company for free or under cost price, while the company providing these services derives its income from advertisements that are shown to the user of the platform. By making use of big data these customized advertisements are more profitable than in offline situations. Furthermore, the flexibility and the reach of the business models lead to an increased use of this business model in the digital economy.¹⁹⁷

4.2.1.5 Tendency towards monopoly or oligopoly

A typical aspect of the digital economy is the advantage of the first mover due to network effects and low incremental costs. Users often prefer to make use of one single provider for services on ‘the same side of the market’, resulting in situations where only a few providers dominate the market.¹⁹⁸

4.2.1.6 Volatility

A somewhat contrary aspect to the one mentioned before is the fact that within the digital economy, low market entry barriers exist. This results in volatility on the markets, when another business invents a better technology, companies can lose their market share rapidly.¹⁹⁹

¹⁹⁵ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 70-71.

¹⁹⁶ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 71-72.

¹⁹⁷ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 71-72.

¹⁹⁸ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 73.

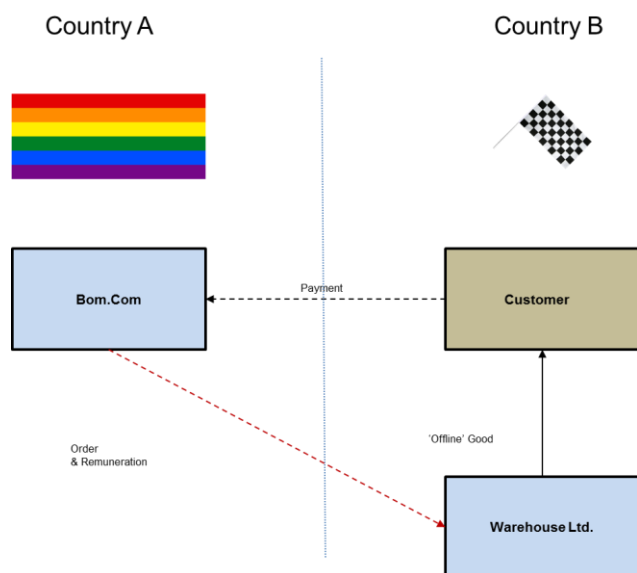
¹⁹⁹ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 73.

4.2.2 Examples of business models in the digital economy

This paragraph describes various business models in the digital economy, in which certain features mentioned in the last paragraph can be recognized.

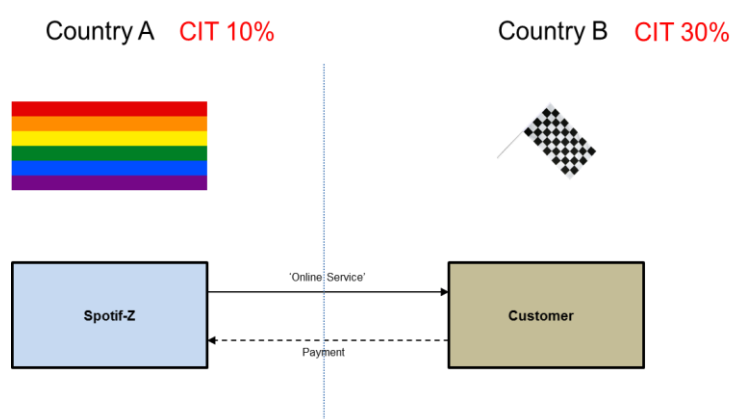
4.2.2.1 Offline E-commerce

One of the examples of a business model in the digital economy is the online sale of goods or services, conducted via computer networks by methods that are specifically designed for the purpose of receiving or placing the orders. These goods or services are then delivered through conventional channels. According to the OECD, the name of this type of transaction is indirect or offline e-commerce.²⁰⁰ The country where the product is fabricated and the country of destination do not have to be the same, see the example in figure 4.2.2.1, where a customer places an order at Bom.Com, resident in Country A. The good however, is delivered via the warehouse situated in Country B.



4.2.2.2 Online E-commerce

Another example of a business model within the digital economy is the sale of online products, in which both the order and the delivery of the goods or services takes place completely electronically. The OECD refers to this concept as online e-commerce.²⁰¹ An example of this is shown in figure 4.3.2, where an online streaming service is sold to a consumer that resides in another state than the producer of the online service.

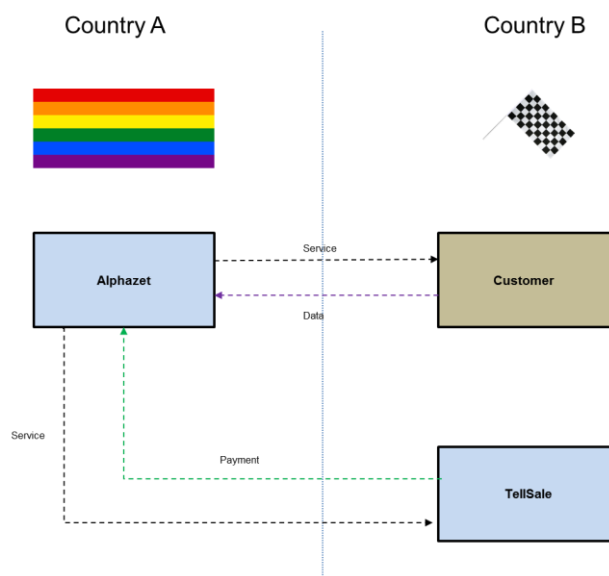


²⁰⁰ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 55.

²⁰¹ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, P. 55.

4.2.2.3 Multisided Business models

Another example is the existence of multisided business models, which has already been mentioned in paragraph [4.2.4]. Figure 4.3.3 shows an example of such a business model where company TellSale advertises to a customer via a third company Alphazet. The consumer enjoys a free streaming service from Alphazet, for which Alphazet asks data in return. Via cookies the company will be able to determine characteristics of the consumer behavior of the customer, which it can use to display a tailored advertisement of company Tellsale, for which Alphazet is compensated with a payment. Though both the customer and the advertising company reside in the same country, the country of destination, only Alphazet, which resides in Country A, is collecting taxable income.



The figure clarifies the explanation given above, the data provided by the customer is essential for the business of Alphazet, as TellSale is only willing to pay the price to Alphazet, as they are able to provide certain characteristics on the consumer behavior of the customer.

4.2.3 Challenges Perceived

The key features of the digital economy and the business models described above, have shown that traditional bricks and mortar business differ in a certain extend to businesses in the digital economy. Since the principles underlying the concept of corporate income taxation, and the attribution of profits to the source state as a consequence of the recognition of a permanent establishment have not changed significantly since its introduction in the 1930's, some characteristics of current businesses infringe with the current legislation. Within this thesis I will describe the 3 main challenges that could be determined by combining the knowledge of the requirements to establish a permanent establishment and the characteristics of the new business models.

4.2.3.1 Reduced need of physical presence

The most distortive feature of the digital economy is that physical presence is no longer needed to address customers in another country. Via web shops on the internet, customers have easy access to products from companies residing in other states. In the past when business models were based on sale via traditional bricks and mortar establishments, this was not the case. Products were bought from local shops, which were liable to tax in the same country. Via the internet the burden to conduct business abroad has decreased enormously. Often no permanent establishment is needed to set up sustainable business activities and generate profit in the other country. This is based on the fact that to meet the threshold of the current permanent establishment concept, a vital criterion is physical presence.

The physical presence criterion has already been mentioned as a problem before the rise of the internet. Companies could already address foreign markets via catalogues in the pre-internet era. Though the proportion of these companies was relatively small compared to the companies that conduct business in foreign countries without creating taxable presence in that state, this problem has already led to problems by then.²⁰² However, the increase in offline e-commerce is mainly due to the specific features of the digital economy mentioned in paragraph 4.2, furthermore the rise of online e-commerce has only increased the relevance of this challenge.

4.2.3.2 Increased customer interactions

Within the digital economy the importance of the customers to the business has increased compared to the traditional business. Especially regarding the multi-sided business models, where the value of advertisements sold to third parties depends on the customer base of the platform. However, also in other business models the value that the customer adds to a business cannot be denied. An example is the analysis of customer decision making in a business model with distance sales. Though the company is not present in this country, there is value derived from the territory of the customers by making use of the consumer behavior, which proceeds optimized marketing offers leading to an increase of sales.

Another example is the value that businesses create by outsourcing their customer service to an online platform where customers can give each other advice on the use, installation and trouble shoot of products sold by that company. It is obvious that such a platform leads to a decrease in support needed from that company, the customers adding content and advice to such fora contribute thus to the value creation of that company.

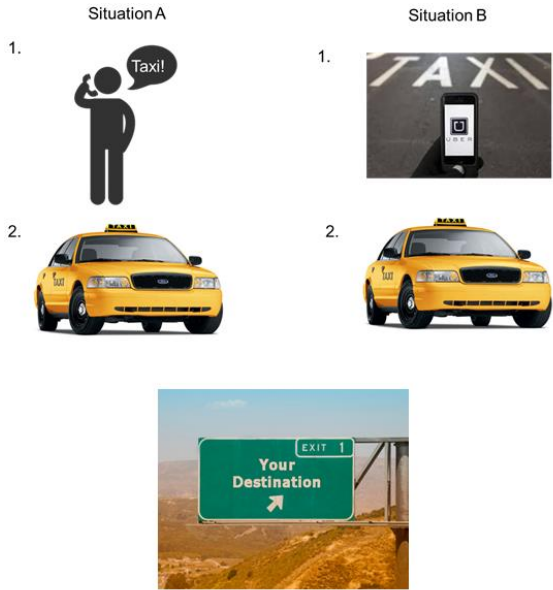
²⁰² De Wilde, *NTFR Beschouwingen* 2015/10, paragraph 2.1.

Another example is the sharing marketing content of companies in exchange for a chance on a free product or service from that company. The customers provide free advertisement to that company, though this does not create taxable presence for the company.²⁰³

Furthermore, increased automation and digitalization of business factors will lead to a combination of reduced need for physical presence and an increased reliance on customer input. The market share of self-learning robotics and 3D printers for example, business models that are currently being developed and are already implemented on a small scale, will rise significantly in the future. Taxation systems should also be able to address these models.

4.2.3.3 Inevitable erosion of national tax base through monopolistic online e-commerce

The erosion of national tax base through monopolistic online e-commerce is considered to be the most concrete and urgent challenge that is perceived by tax jurisdictions. To discuss this challenge, a real life business case will be described, on the taxi service UBER. UBER is a company intermediating in worldwide taxi services by making use of efficient information technologies. Via mobile applications, a customer of Uber can efficiently reach out to a taxi service, and conclude a deal online. Uber is a typical example of a company within the digital economy, as most relevant features are applicable on the service and also part of its success. As it is more efficient to use one service on any location, people will make less use of direct contact to local taxi-services, or local intermediaries, leading to a monopolistic situation.



As UBER is an online e-commerce service provider, it does not need to be physical present in a country to conduct business. Due to the advantages of network effects, both taxi service providers and customers will make use of UBER. This results in erosion of a tax base locally as local taxi services will inevitably lose income, while the customer uses the exact same service as is graphically illustrated in figure 4.2.3.3. Uber in this case, or any similar service provider will locate in the country with the most beneficial tax climate and erode tax bases from its sales markets.

²⁰³ Pelleffigue, *ITPJ march/april 2015*, p 95-100.

4.2.4 Concluding remarks on Action 1

As stated in the introduction, new ways of doing business have evolved in the last years. However, not only new internet-based business should be seen as the digital economy, as information technology is used by firms in all industries. This has led to changes on both the demand side in terms of consumption modalities and on the supply side regarding organization and market structure.²⁰⁴ More detailed, it could be noted that in comparison with the traditional businesses, geographical entry barriers have been taken away resulting in an increased addressable market for suppliers.²⁰⁵ Consumers have the opportunity to select their preferences from a broader range of products, therefore there is an increased competition amongst suppliers. The suppliers however have the opportunity to address customers more easily and to generate significant profits due to scale effects. Furthermore, the productivity and efficiency of firms increases through process optimization, increased innovation and a reduction in sourcing, marketing and transaction costs.²⁰⁶

Despite the development of the economy, resulting in fundamentally different business models, an challenges on the reduced need for physical presence, increased customer interactions and base erosion resulting from tax competition and the possibility to conduct distance sales, the final report on BEPS Action 1 does not provide any recommendations on itself. The report states that due to the rise and interlocking of the digital aspects within the economy itself, the digital economy cannot be ring-fenced from the economy for tax purposes.

The tax challenges and risks relating to the digital economy have solely been identified by BEPS Action 1, but have been addressed by other actions of the BEPS plan. The challenges include avoidance of the permanent establishment status, transfer pricing regulations and CFC rules. The reframing of the permanent establishment to prevent artificial avoidance of taxable presence is the topic that is relevant for this thesis and is elaborated on in BEPS Action 7. The considered alternatives offered by BEPS Action 1 seem to be mentioned as food for thought. The withholding tax, significant economic presence and equalization levy, which are mentioned in the report will further be discussed in chapter 6.

²⁰⁴ Pelleffigue, *ITPJ march/april 2015*, p 95-100.

²⁰⁵ OECD, *The Impact of Internet in OECD Countries*, OECD Digital Economy Papers, Nr. 200 (OECD Publishing 2012).

²⁰⁶ McKinsey Global Institute 2011, paragraph. 4 And Bertschek, Cerquera & Klein 2013, paragraph. 3-4 , And Muet, 57 *Revue Economique 3 (2006)*, p. 347.

4.3 BEPS Action 7

4.3.1 General outline of Action 7

Action 7 addresses the artificial avoidance of the PE status to prevent shift profits out of the countries where the sales took place and to prevent the exploitation of the specific exceptions to the PE definition provided for by article 5 (4) OECD model.²⁰⁷ In coherence with Action 6, which addresses the inappropriate granting of treaty benefits, the measures proposed should result in a re-establish taxation in cross-border situations, where income has been untaxed or taxed at very low rates due to the unintentional treaty benefits they made use of.²⁰⁸ In the report three different categories of measures can be distinguished. The first one addressing the commissionaire structures, the second addressing the avoidance through the specific exemptions and the third addressing the artificial fragmentation of business activities.

The proposed treaty changes could be implemented in bilateral treaties already, depending on when the treaty negotiations between countries take place. Furthermore, the OECD will focus on Action 15 in 2016, and hopes to finish the multilateral instrument at the end of the year. Ninety countries participate in this project²⁰⁹ and for these countries the proposed changes could get implemented into multiple treaties at the 1st of January 2017, provided that the preparations for the multilateral instrument will be finished by the end of this year.²¹⁰

4.3.2 Commissionaire structures

Both paragraph 5 and 6 of the OECD model will be modified as a consequence of BEPS Action 7. The former wordings did not reflect the policy well and left room for the artificial construction of commissionaire arrangements and similar strategies, which have led to the erosion of the taxable base of the state where sales took place. Within the old wordings, a condition to meet the threshold requirements was the habitual conclusion of contracts in name of the foreign principle. The new concept is extended with the following wordings:

“habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise and these contracts are

a) in the name of the enterprise, or

²⁰⁷ OECD 2015, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, p. 9.

²⁰⁸ OECD 2015, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, p. 9.

²⁰⁹ Including countries like The Netherlands, the USA, the UK, France, Germany, China, Brazil, etc..

²¹⁰ OECD 2015, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, p. 11.

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise,”

This leads to a significant change of the commissionaire concept. After the change of the treaty, companies whose activities consist merely of convincing buyers to accept standard terms of a contract without any material modifications of the contract terms, could be considered as a PE in the future. Thus, the contract does not need to be concluded in the name of the agent to form a PE. The promotion of drugs via active calls by a representative of a pharmaceutical enterprise would not directly lead to a PE.²¹¹ However, the sales of products mainly via online unmodified contracts would lead to a PE.²¹²

Paragraph 6 has been modified even more rigorously. The exemption of paragraph 5 for independent agents keeps existing, but the specific examples of possible independent agents: the broker and general commission agent have been removed. Furthermore, persons who act exclusively or almost exclusively (90% or more)²¹³ on behalf of an enterprise that is closely related (an interest of 50% or more) should not be considered to be an independent agent. The effects for low-risk distributors have also to do with Action 9, which addresses the relation between risk and capital but might form a ‘solution’ for companies who want to avoid the PE status. However, this demands significant changes in the business depending on the facts and circumstances.

4.3.3 Specific exemptions

The specific exemptions under article 5 (4) OECD Model, have been limited to preparatory or auxiliary situations only. This new addition is relevant for all subparagraphs a-d,²¹⁴ however not all states have agreed with these modifications. Some states are of the opinion that the anti-fragmentation measures which will be discussed in the next paragraph, are sufficient to address BEPS concerns.²¹⁵ The final report does not give a clear view on which countries do, and which countries do not agree with the proposed changes to the specific activity exemptions.

For the purpose of this article it is important to know the definitions of preparatory and auxiliary. The exact applications of these concepts depend on the activity of the enterprise as a whole. However, as a

²¹¹ Proposed Paragraph 32.5 OECD Commentary on article 5.

²¹² Proposed Paragraph 32.6 OECD Commentary on article 5.

²¹³ Proposed Paragraph 38.8 OECD Commentary on article 5, however all facts and circumstances should be taken into account to make a well-founded judgement on the independent-agent status.

²¹⁴ Subparagraph e and f are included as well, but these have been limited to situations where the business unit is of a preparatory or auxiliary character already in an earlier adaptation of article 5.

²¹⁵ OECD 2015, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, p. 28.

general rule preparatory can be described as: *carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole*. Auxiliary activities are described as: *carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole*.²¹⁶

The concept remains rather unspecific, the OECD leaves enough room for interpretation. There seems to be a more functional or economical approach, instead of the literal approach of the specific activity attribution. Though the commentary on this paragraph offers some examples of possible cases under each subparagraph, a case by case analysis is needed to be able to clarify whether there is a PE or not.

4.3.4 Fragmentation

A new anti-fragmentation paragraph will be added to article 5, in paragraph 4.1. This extra paragraph will have the following wordings:

“Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and

a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.”

This extra paragraph aims at excluding activities performed by a place of business to a related activity, which already forms a PE or would form a PE if it would be seen in combination with that place of business from the specific activity exemptions.

Example:

This rule might have consequences for e.g., a warehouse with solely the purpose to supply goods to a closely related store in the same country, which would fall under the scope of the former article 5 (4b)

²¹⁶ OECD 2015, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, p. 30.

OECD Model but would be considered to form a PE under the new paragraph 4.1 due to the fact that the activities should be seen as a cohesive business operation.

Furthermore, the artificial splitting up of contracts to avoid a PE has been addressed. This is however not constituted in Action 7 but in the light of Action 6 of the BEPS project, which aims at the preventing the granting of treaty benefits in inappropriate circumstances. If the activities would have solely been set up with the main purpose of claiming an exemption under article 5 (3) OECD Model, the Generally Anti Abuse Rule (GAAR) discussed in Action 6 would apply, in this case a principle purpose test (PPT).

An alternative solution proposed is to include an additional provision, which would add the period closely related enterprises would perform connected activities at the same project if such activities would last for more than thirty days.

A definition of connected activities however is not given, therefore it should be interpreted that the nature of the specific activities, depending on the facts and circumstances is leading.

A contract of twenty-two months that has been split up in two periods of eleven months granted to two closely related enterprises will be deemed to form a PE after the implementation of the new commentary on the PPT Rule.²¹⁷

4.3.5 Concluding remarks on BEPS action 7

Action 7 of the BEPS project consists of amendments of Art 5 (4-6) OECD Model. Before the changes, only the activities subject to subparagraph e) and f) had to be of a preparatory and auxiliary character in order not to result in a PE. The newly proposed paragraph 4 adds the requirement for any activity. In order to determine whether a certain activity is of a preparatory or auxiliary character, the proposed new version of the OECD MCC elaborates more on what can be understood by these thresholds especially regarding the character of a warehouse. Furthermore, the OECD introduced an anti-fragmentation rule to prevent a group of closely related enterprises from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

Moreover, since the amendments of paragraphs 5 and 6 are covering agency PEs and commissionaire arrangements, the OECD Model no longer provides a strict legal approach but adopts an economic approach: the substance over form principle. Especially for the latter amendments, a case-by-case analysis is necessary to be able to decide whether a PE is recognized or not. According to De Wilde, the most important aspect of the BEPS Action 7 is the provision on the artificial avoidance of the agency

²¹⁷ OECD 2015, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, p. 42.

PE.²¹⁸ However, he states as well that the impact might be neutralized because MNEs might change their structures by making more use of Limited Risk Distributors (LRDs).²¹⁹ The use of an LRD will not lead to the recognition of a permanent establishment because in contrary to other commissionaire structures, the LRD will be the owner of the goods before the sales take place.

In practice the results of broadening the PE-concept are expected to lead to a rise in the amount of permanent establishments recognized.²²⁰ For companies this might lead to an increase in administrative burdens and more uncertainty about future tax positions, as economic reality is harder to control than contracts. As there might be room for interpretation on the exact level of involvement of the agent in the conclusion of contracts with customers, no guarantee exists that tax authorities of two states will come to the same result. Governments might therefore re-assess the business activities performed in a country and will recognize a PE more easily than before.

When the profits derived from the activities in the source country already have been taxed by the country of residence, there will be a risk of double taxation. A Mutual Agreement Procedure (MAP) might bring outcome, but this would not be an ideal situation since the MAP procedure does not force both states to find a solution.²²¹ Over the last years the number of pending MAPs have increased significantly²²² and it is unsure whether the situation will improve in the next years since BEPS Action 14 has not resulted in a minimum standard on a mandatory binding arbitrary commission.²²³

Though the number of permanent establishments is expected to rise, the significance of the modifications regarding the profit allocation to these permanent establishments remains to be seen.

4.4 The Dutch reaction to BEPS actions 1 and 7

The view of the Dutch government regarding special tax law for businesses involved in e-commerce is awaiting. In the reaction of the final BEPS reports, the secretary of State maintained that currently no specific measures are needed to address the tax challenges of the digital economy regarding direct taxes. The proposed actions in the other Actions of the BEPS project should be sufficient to address abuse effectively according to State Secretary Wiebes. The government, however supports the monitoring of

²¹⁸ De Wilde, *NtFR* 2015/2730, Paragraph 9.2.

²¹⁹ A Limited Risk Distributor is a buy-sell distributor, which distributes products in its own name and for its own account for a principal company under an arrangement in which most risks are borne by the principal and only limited risks are borne by the LRD.

²²⁰ De Wilde, *NtFR* 2015/2730, Paragraph 9.4.

²²¹ Article 25 of the OECD model only requires states to endeavor to find a solution.

²²² See e.g., <http://www.oecd.org/ctp/dispute/map-statistics-2013.htm>.

²²³ OECD 2015, *Making Dispute Resolution Mechanisms More Effective, Action 14 - 2015 Final Report*, P.15.

the developments until 2020 and also agrees that with regards to the indirect taxes, VAT should be paid in the legal domicile of the consumer.²²⁴

The Secretary of State has reacted supportively to outcome of the final report on BEPS Action 7.²²⁵ The proposed new paragraph 5 will be incorporated in the starting point of the Netherlands in treaty negotiations on new treaties or revisions of existing treaties. However, the Secretary of State has refrained to give a more detailed analysis on the policy regarding the future of the permanent establishment. It could therefore be interpreted that all the proposed provisions are part of the Dutch treaty policy,²²⁶ despite prior words of the Dutch Secretary of State stating that he does not favor a wider permanent establishment concept.²²⁷ The Dutch government supports expanding the permanent establishment concept in a multilateral approach to combat the artificial avoidance of tax, leading to an international coherent tax system. The process of developing a multilateral instrument that is initiated by BEPS Action 15 is welcomed by the Netherlands.²²⁸

4.5 Conclusion

The sub question that has been addressed in this chapter is:

What are the relevant recommendations and considerations of BEPS Action 1 and 7 and what where the incentives leading to these proposed amendments?

In this chapter the context of reference point of this thesis, the developments on OECD level regarding the permanent establishment concept, is described. The position of the two relevant actions within the whole BEPS project is outlined. Thereafter, a more in depth analysis of the relevant BEPS actions is given.

BEPS Action 1 describes the developments in the economy as a whole and the business characteristics of companies involved in the digital economy that deviate from traditional business models is discussed. The mobility of the business and the growing importance of the consumer in the value creation are considered to be the most important changes. Though questions are posed regarding the position of the

²²⁴ Kamerbrief appreciatie uitkomst BEPS-project en vooruitblik Nederlands fiscaal vestigingsklimaat. Ministerie van Financiën. 5 oktober 2015, ZV/2015/657.

²²⁵ Kamerbrief appreciatie uitkomst BEPS-project en vooruitblik Nederlands fiscaal vestigingsklimaat. Ministerie van Financiën. 5 oktober 201, ZV/2015/657.

²²⁶ De Wilde, *NFR* 2015/2730, Paragraph 9.1.

²²⁷ Notitie fiscaal verdragsbeleid 2011, Kamerstukken II, 2010-2011, 25 087, nr. 7. P. 68.

²²⁸ Kamerbrief appreciatie uitkomst BEPS-project en vooruitblik Nederlands fiscaal vestigingsklimaat. Ministerie van Financiën. 5 oktober 2015. ZV/2015/657.

current permanent establishment as a nexus threshold, no specific suggestions regarding the digital economy were made, apart from the proposed amendments resulting from BEPS Action 7.

Action 7 consists of three main changes to the current permanent establishment concept in the OECD Model. In the future all specific activity exemptions are only applicable in case they regard preparatory or auxiliary activities. Furthermore, the splitting up of contracts and the separation of business activities is addressed by the anti-fragmentation rule. Moreover, commissionaire activities will constitute a permanent establishment more easily in the future as the threshold moves from the legal perspective to the more economic perspective.

Physical presence remains a necessary criterion to establish a PE. Currently this results in challenges for digital business models like on- and offline e-commerce with special attention for multisided business models. Within BEPS Action 1 several alternatives to taxation of multisided business models, off- and online distance sales have been made. These and other alternative nexus approaches, which are suggested in literature or implemented in other countries, will be discussed in the next two chapters. In general it can be concluded that the business models in the digital economy put more pressure on the further existing of the current permanent establishment concept, as firstly value creation seems to shift more towards the demand side in the market and secondly it becomes easier to conduct business in countries without the necessity to create a taxable present business in that country.

Furthermore, due to the mobility of the market and the possibility to address customers more easily than before, significant profits could be derived within a short period of time. The changes to proposed in Action 7 do not address the perceived infringements as the 20th century bricks and mortar PE concept is still taken as a starting point and no notion is made to the increased involvement of customers in business models.

5 Comparison of PE/Digital Economy taxation initiatives of EUCOTAX countries

5.1 Introduction

In the current chapter the initiatives of countries in which universities participating in the EUCOTAX Wintercourse reside are discussed. As a preparation for the Wintercourse, students of all countries prepared a questionnaire on specific issues relating to BEPS 1 and BEPS 7 in their countries. A selection is made on the most relevant actions taken by EUCOTAX countries in the field of implementation of legislation related to BEPS Action 1. Paragraph 5.2 offers a list with examples, this list is non-exhaustive, but includes the most relevant proposals. Paragraph 5.3 consists of a list with recent legislation and proposals relating to BEPS action 7.

This chapter only provides an overview of proposals of EUCOTAX countries related to BEPS Action 1 and 7. The specific initiatives will be evaluated in chapter 7.

5.2 Actions taken to encounter PE problems related to the digital economy

This paragraph includes recent proposals of 4 countries regarding legislation on direct taxation in the digital economy, as a consequence of the BEPS project.

5.2.1 Italy

For the Budget Plan of 2014, Italy introduced two new proposals on ‘web-tax’. One proposal was on income taxation, the other on transfer pricing.

The VAT legislation required that web advertisements viewable on Italian territory could only be bought by entities with an Italian VAT number.²²⁹ However, the legislation did not comply with the European freedom of goods and services and was therefore repealed by the Italian government in March 2014.

The regulations on transfer pricing required another profit allocation method than the cost-plus for services related to web advertisements.²³⁰

Italy planned to introduce a new set of regulations on the prevention of online tax avoidance. These regulations would extend the PE concept with the following wordings:

²²⁹ Gallo, *IBFD News* 7 January 2014, p. 1-3.

²³⁰ Quarantino, *European Taxation (54) 2014/5*, p. 214.

“if a non-resident company has a continuous presence of online activities, for a period not shorter than six months, so as to generate in the same period payment flows directed to it [...] for an amount not lower than five million Euro”

Furthermore, inducing non-resident companies to spontaneously declare the existence of an Italian permanent establishment, the bill provides for a 25% withholding tax on payments directed to non-resident companies for goods and services purchased online, requesting Italian financial intermediaries to act as withholding agents.²³¹

However, these measures mentioned above have not been included in the Budget Law for 2016, as the measures above have not been included.

A proposal that in the end did make it, is article 1, paragraph 927 of Law 208, adopted on 28 December 2015. This article in a specific measure on the constitution of a PE in case of involvement of Italian workforce on online gambling from a non-resident company. As this is a specific measure on the gambling industry this provision will not further be discussed.

5.2.2 Spain

In Spain there is jurisprudence that broadens the scope of a fixed place of business from a Dutch point of view. In the Dell Case it was argued that the existence of physical presence through a server was not a necessary factor to meet this criteria. The significance of the activities performed (i.e., the work on a website, not hosted through a server within Spain) through a subsidiary, was considered as an argument. ‘Virtual presence’ was ought to be sufficient to constitute a permanent establishment, as the ‘final objective of art. 5 (1) OECD Model should always be taken into account’.²³² In the particular case, employees from a Spanish company, Dell Espana SA (DESA), performed activities for the Spanish website, which had a local domain name, hosted through a server located abroad. These services were performed for an affiliated Irish based company, Dell Products Limited (DPL). Although DPL had no physical presence, the presence through the website in combination with the activities of employees from DESA performing significant functions related to the website performed through a stable and permanent framework, a virtual PE was deemed to exist according to the Court.²³³

²³¹ A. Persiani, *Diritto Mercato Tecnologia 2015*, paragraph. 1-4

²³² TEAC 15 March 2012, R.G. 2107-07.

²³³ Sprague, *Management International Journal* 2013/48, paragraph 2-3, and T. Rosembuj 2015, P.85.

5.2.3 France

The French permanent establishment concept has been based on case law and refers to the habitual exercise of commercial activities as a main criteria.²³⁴ Regarding the digital economy, special notion should be made to the possibility to tax if a complete business cycle of commercial transactions takes place. In this case, no physical presence is required if all the business activities take place in France.²³⁵ However, if they are decided upon, managed and controlled directly by a non-resident this provision will not apply.²³⁶ It is therefore not considered to be able to efficiently address the digital economy.

The French government has drawn its attention to new possibilities to tax the digital economy.

Already in 2011 there existed plans to adopt an online advertising tax, taxing 1% of the total expenditures on B2B advertisements. Though the senate has adapted this law, it was later withdrawn.²³⁷

Furthermore, a tax on online distance sales was proposed, the so-called Tascoé tax. Company selling goods or services via the internet would be subject to tax of 0,5% over the amount of costs for the supply of services or goods via the internet, exceeding the threshold of 460.000 euro.²³⁸ This proposal was withdrawn as well.

A report of Colin and Colin published in 2013, proposes to introduce a virtual PE, meaning that a permanent establishment is deemed to exist when a service is provided in that country by making use of data collected through regular and systematic monitoring of users in that country.²³⁹ The data collection of online activities of French consumers in particular would also be taxable on itself.²⁴⁰ The tax would be levied as a unite charge per monitored user, taking into account a certain threshold.

5.2.4 Hungary

In Hungary there is an advertisement tax active as of July 2014. The tax base is the net sales income from selling media time or space displaying advertisements. Additional rules apply in case the taxpayer advertises his own products or services. The tax is levied at progressive rates ranging from 0% (up to

²³⁴ Deltour, *France - Permanent Establishments*, Topical Analyses IBFD, paragraph 2.1.1.1.

²³⁵ Schmitt & Silberstein, *International Transfer Pricing Journal* (7) 2000/6, p. 234.

²³⁶ Cordier Deltour, *France - Permanent Establishments*, Topical Analyses IBFD, paragraph 2.1.1.1.

²³⁷ Marini 2012, p. 14-16.

²³⁸ Marini 2012, p. 44.

²³⁹ Collin and Colin 2013, paragraph 5.1.1.

²⁴⁰ Collin and Colin 2013, paragraph 5.1.1.

HUF 100 million) to 5.3% (for revenues in excess of HUF 100 million). If the taxpayer is a person ordering publication applicable tax rate is 5%.²⁴¹

Furthermore the Hungarian government proposed to introduce a tax on transfers of internet data. All data consumption above a certain threshold would be taxable at a rate of HUF 150 (ca EUR 0,50) per gigabyte. However this proposal was withdrawn due to protests.²⁴²

5.3 Unilateral actions taken related to BEPS Action 7

This paragraph consists of three subparagraphs describing unilateral initiatives and summarizing relevant existing legislation of the EUCOTAX countries on the measures initiated by BEPS Action 7.

5.3.1 Specific Activity Exemptions

No specific measures were taken or statements were made by EUCOTAX countries on the proposed regulations regarding the limitation of specific activity exemptions. Therefore a short notice on the current legislation is given below.

5.3.1.1 Existing legislation and jurisprudence

Article 5(4) OECD Model contains a list of activities that, when carried on through a fixed place of business, are not sufficient for these places to constitute a PE. The exceptions mainly cover activities traditionally viewed as preparatory or auxiliary such as the use of facilities for the purpose of storage, display or delivery of goods.

Some participants such as Austria, France, Germany, Poland, Spain and Sweden do not have in their domestic law any specific exemptions for preparatory and auxiliary activities carried out on their territory. Nevertheless, in these countries, auxiliary and preparatory activities just do not enter into the definition of a FPB and could not constitute a PE because of their lack of permanence and independent business activity, and independently generated income. Nevertheless, these countries integrate the wording of Art. 5(4) of the OECD Model in their double tax treaties so that in practice there is an automatic exemption for every preparatory and auxiliary activity.

Some participants have important case law concerning the interpretation of what constitutes an “auxiliary and preparatory activity”. In France for instance, the Supreme administrative court decided in a case where a Swiss resident company was providing air-transport services in international traffic and the same company was also providing maintenance of aircraft equipment and training courses for

²⁴¹ Torma, *Hungary - Corporate Taxation*, Country Surveys IBFD.

²⁴² <http://www.ft.com/intl/cms/s/0/e847f75e-60e2-11e4-894b-00144feabdc0.html#axzz3ZQyig4w7> .

pilots, activities which were carried out on French territory, that the supplementary activities of maintenance of aircraft equipment carried out by the Swiss company constituted a separate business conducted in France since the company was employing staff specifically for carrying out such activities. The Supreme Court did not find that the company's activities on French territory fell under the auxiliary activities exemption.

According to Belgium's domestic law a stock of goods will constitute PE. Nevertheless, since domestic tax law is only applicable in the absence of a tax treaty, a stock of goods and a mere warehouse will usually not constitute a PE if there is a tax treaty containing the exemptions of Article 5(4) of the OECD Model. In Belgium, much case law exists on the nature of preparatory and auxiliary activities in Belgium. The Belgian domestic law regarding what can constitute a PE seems to be somewhat broader than the OECD Model.

In the United States, there are PE exceptions on a limited basis for securities, commodities and investment activities, to an unlimited extent, if the trading of such instruments is affected by independent agents. Otherwise, there is no list of general exemption for activities of a preparatory and auxiliary nature. However, as in Austria, France, Germany, Poland, Spain and Sweden, sufficiently limited activity will not give rise to a U.S. trade or business, which in effect means that such activities are exempt from taxation under the United States' business profits tax regime.

Other member countries such as Hungary, Italy, and the U.K. have, in their domestic law, the same exemptions as the ones stipulated in the OECD Model. The U.K.'s domestic PE concept as enacted in Section 148 FA 2003 and Section 1143 CTA 2010 includes – just like Article 5(4) of the OECD Model – specific activity exemptions. In Italy for example, domestic legislation provides that a FPB through which an enterprise engages solely in an activity of a preparatory or auxiliary character is not a PE.

5.3.2 Commissionaire Arrangements

Apart from the United Kingdom, none of the other member countries has implemented any unilateral measures tackling Article 5(5) of the OECD Model. As for Spain, judicial and administrative practice already ensures that many commissionaire arrangements do establish PEs. Belgium has an administrative circular announced for autumn 2016 which will include a widened scope of Article 5(5) of the OECD Model.

5.3.2.1 United Kingdom – Diverted Profits Tax

As of April 2015, a special tax is implemented by the British government, which has been implemented to tackle aggressive tax planning. The Diverted Profits Tax (DPT), a new tax (neither a CIT or a regular income tax) has been implemented as a consequence of the fair share debate, when it turned out that

many tech-based MNEs were perceived not to pay their „fair share“ in taxes in the United Kingdom (UK) despite making substantial profits.²⁴³ The DPT is levied at a rate of 25% on diverted profits, profits that would have arisen if the non-resident would have had a PE in the UK.²⁴⁴

The DPT arises in two different situations, either:

- a) If a company uses structures that avoid the establishment of a PE in the UK, or
- b) If a company residing in the UK, being a subsidiary or permanent establishment owned by a foreign entity, which has insufficient economic substance and has the underlying aim of eroding the taxable base in the UK.²⁴⁵

Several cumulative conditions have to be met in order for the first situation to apply: a non-resident company makes substantial sales or goods or services in the UK through another person (avoided PE), furthermore it has to be reasonable to assume that the activity of that person is designed to ensure that a PE in the UK is avoided.²⁴⁶ Additionally, either the so-called mismatch condition or the tax avoidance condition must be met. Small and medium sized companies (SMEs) in terms of Section 172 TIOPA 2010 are excluded from this act.²⁴⁷

The second provision mainly tackles aggressive transfer pricing and will therefore not further be explored in this report.

The DPT cannot be considered to fully address problems that have arisen as a consequence of the developments of the digital economy, as it still requires a company to have physical presence in the United Kingdom.²⁴⁸ Offline e-commerce is tackled by the DPT, however, online e-commerce is not.

5.3.3 Anti-Fragmentation

No specific measures were taken or statements were made by EUCOTAX countries on the proposed regulations regarding the limitation of specific activity exemptions in BEPS Action 7. Therefore a short notice on the current legislation is given below.

5.3.3.1 Existing legislation and jurisprudence

Most of the participants do not have any specific anti-fragmentation rule, but apply their general anti-

²⁴³ Cerioni, *European Taxation* (55) 2015/5, p. 185-191.

²⁴⁴ HM Revenue & Customs UK, *Diverted Profits Tax: Guidance* (30 November 2015) DPT 1000 & 1030.

²⁴⁵ HM Revenue & Customs UK, (n 123) DPT 1110.

²⁴⁶ Finance Act UK 2015, s 86 (1) (f).

²⁴⁷ HM Revenue & Customs (n 123) DPT 1140.

²⁴⁸ Cerioni, *European Taxation* (55) 2015/5, p. 185-191.

abuse rules in the case of abusive splitting of contracts. In France, two general anti-avoidance measures may potentially apply: the first one is the theory of “abuse of law” and the second one is the power of the French tax administration to re-qualify contracts where they believe the different activities are in fact part of a whole and therefore the PE standard is met.

In Hungary, the most important legal basis is contained in the Act on the rules of administration, which has served as the basis of the tax administration’s past efforts to combat aggressive tax planning, including the fragmentation of activities and splitting up contracts.

“Contracts, transactions and other similar operations shall be judged in accordance with their true content. For the purposes of taxation, an invalid contract or any other transaction of the like shall be considered to have any bearing to the extent of the apparent economic results it carries.”

Finally, in the United States general anti-abuse measures may apply to a situation of an artificial fragmentation of different activities.

In Spain, there is no legal base for regulating the fragmentation of operations in order to avoid the establishing of a PE, but this does not mean that the topic has not been treated by the Spanish courts and administration. In one case in particular, the principal fragmented his business activities into two auxiliary activities, one designated to the storing of the business products and services, and another for the promotion and delivery of the products. Both activities can be found in the list of auxiliary activities of the Article 5(4) OECD Model, so that is why they did not constitute a PE. Through this fragmentation of activities, the Borax business achieved the goal of artificially avoiding the PE status and avoided the Spanish taxation. In its decision, the court determined that these two new contracts could not be considered different activities when as a result of the connection between them, a permanent and complex business structure was created, which summing up can be translated as an anti-abuse rule in order to avoid the activities fragmentation.²⁴⁹

5.4 Conclusion

The sub question that has been addressed in this chapter is:

What solutions have been implemented or proposed by EUCOTAX-Wintercourse participants?

The majority of the EUCOTAX countries have not implemented unilateral measures to tackle challenges relating to the creation of taxable presence in the digital economy. In several countries discussions have

²⁴⁹ Spain, Supreme Court, 18/06/2014, No 2680/2014.

taken place, and concrete proposals for new legislations have been made, however in most of these countries the initiatives have not been implemented in national legislation.

In Spain the court seemed to have broadened the PE definition with regards to the term fixed place. In countries like France, Hungary and Italy several proposals were made but they were canceled in early stages.

Regarding action 7 the UK is the only country that did undertake a specific action, the other countries rely so far on their current legislation. Most countries including the Netherlands have thus awaited the BEPS reports and have not responded, as is in line with the final BEPS reports. Nevertheless countries are aware that the current tax system seems to be incapable to address new forms of business.

The mentioned initiatives by EUCOTAX Countries will be evaluated in chapter 7.

6 Solutions proposed in literature

6.1 Introduction

In literature various alternatives to the current permanent establishment have been put forward. In this chapter several of these proposals will be discussed. Several of these proposals refer to a nexus approach in which significant economic presence is considered to be the decisive factor to establish taxable presence. Some argue that solely creating revenues in a country would be enough, others put ideas forward which broaden the current PE concept with specific provisions for digital activities, requiring a certain nexus via users or presence via digital platforms. The proposals relating to significant economic presence are discussed in paragraph 6.2. The next paragraph puts forward a proposal based on the inter-state tax allocation in the USA. Paragraph 4 evaluates the proposal put forward both in literature and in BEPS Action 1 to strengthen the use of withholding taxes. In paragraph 5 another proposal that is discussed in BEPS Action 1 is mentioned: the introduction of an equalization levy to enhance equal taxation for foreign and domestic based businesses.

This chapter only provides an overview of alternatives to the current permanent establishment concept mentioned in literature. The next chapter will evaluate the principles described in this chapter.

6.2 Significant Economic Presence

6.2.1 *Quantitative threshold*

Several authors have proposed alternatives for the current permanent establishment, which are not based on qualitative criteria like a fixed place through which business is carried on, but which solely relies on the level of income derived by a company in another state. When the threshold of this income would be met, the company would be liable to tax in that state independent from the nature or length of his activities in that state.²⁵⁰ Another option is to add the quantitative threshold to the existing set of qualitative criteria.

The exact differences and aspects of replacing the (current) qualitative criteria with a quantitative approach are described in paragraph 7.2.

If the quantitative threshold would be added to the current concept, as Avi-Yonah proposes,²⁵¹ the current PE system based on qualitative criteria would remain intact, as such the supply side would still

²⁵⁰ See e.g. Doernberg & Hinnekens 1999, p. 307-308, McLure 2000 p. 14-15, Cockfield, *Canadian Business Law Journal* (38) 2003/400-422, paragraph 3.

²⁵¹ Avi-Yonah 2014, p.15.

be taken into account. However, if the whole PE definition would be replaced by a revenue only threshold, this would incur a radical shift from the current system to a destination based nexus approach.

6.2.2 *TDFE*

The Task Force on Digital Economy (TDFE), a subcommittee of the CFA has evaluated other options to address the artificial avoidance of PE status, within the final report of BEPS Action 1. One of these options was a new nexus approach, based on the concept of significant economic presence. This approach focuses on non-residents conducting sustained interactions with the economy of that country via technology and automated tools.²⁵²

The nexus could consist of three factors, namely a revenue based factor, a digital factor and a user-based factor. The revenue factor should be set keeping in mind the administration requirements for both businesses and government. Regarding the mobility and flexibility of profits, the revenue should be tested on a consolidated group level rather than on a separate entity level. Digital presence could be tested by controlling whether there is a local domain name, whether there is a local platform for promotion purposes and by evaluating the availability of local payment options. Furthermore, a third criterion consisting of user-based factors should be taken into account. The amount of monthly active users, the possibility to conclude contracts online and the amount of data collected would be indications for sufficient presence in order to be taxed by the other state.²⁵³

6.2.3 *Hongler and Pistone – Significant digital presence*

Hongler and Pistone have made a proposal, in which they suggest to implement a new paragraph 8 to the existing article 5 in the OECD Model. This proposal would ensure that taxable presence exists in case a foreign company exploits the digital market of a country, sufficient nexus is ought to be perceived:

*“If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum.”*²⁵⁴

²⁵² OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, P. 107.

²⁵³ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, P. 108-111.

²⁵⁴ Hongler & Pistone 2015, p.3.

In this situation online e-commerce would lead to the constitution of a permanent establishment, if a company meets certain quantitative thresholds regarding the amount of users and the turnover. These aspects are considered to be necessary to create significant digital presence.

6.3 MTC Nexus approach in the United States of America

In the United States of America, states have a rather significant autonomy regarding their taxation rules. As a consequence, companies residing in one state face different taxation rules if they are involved in business in various states. In order to divide taxable income amongst states, taxable presence needs to be recognized in each separate state.

The Multistate Tax Commission (MTC) is an inter-state organization focusing on the protection of states' fiscal sovereignty and facilitating equitable apportionment amongst states. The MTC has initiated a Nexus program, which focuses on the presence of substantial nexus to determine whether a state should be entitled to tax a company in that state.²⁵⁵

The Factor Presence Nexus Standard describes this nexus concept as follows:²⁵⁶

“Substantial nexus is established if any of the following thresholds is exceeded during the tax period:

(a) a dollar amount of \$50,000 of property; or

(b) a dollar amount of \$50,000 of payroll; or

(c) a dollar amount of \$500,000 of sales; or

(d) twenty-five percent of total property, total payroll or total sales.”

The nexus test is based on assets, functions or sales within one state. Unlike the Permanent Establishment, these tests are quantitative instead of qualitative. Of course the delineation of property, payroll or sales is of qualitative nature but the wordings with which these concepts are described are basic compared to the qualitative nuances and requirements set by the OECD Model and commentary.²⁵⁷

²⁵⁵ <http://www.mtc.gov/The-Commission>, <http://www.mtc.gov/Nexus-Program>.

²⁵⁶ http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf.

²⁵⁷ Compare MTC Nexus Standard Paragraph C. and OECD Model art 5, and commentary thereon.

6.4 Withholding Tax

Another option that exists is the strengthened use of withholding taxes. Currently withholding taxes are only levied on passive income i.e., income from interest, royalties and dividends. However, it could also be an option to use withholding taxes on active income.

The tax base for withholding tax is often the gross remuneration, costs are often not deductible. A sales tax is levied on outbound payments for activities performed in the destination state. Pinto however, has proposed a withholding tax on e-commerce transactions on a net basis. This withholding tax would be refunded to the business, in case a minimum threshold is not met.²⁵⁸

When looking at the implementation of a withholding tax, special attention should be drawn to reimbursements for the use of software. Many countries seem not to qualify these payments as royalties but as service costs.²⁵⁹ However, other (developing or transitional) countries do qualify outbound payments for the use of software as royalties and therefore levy withholding tax on these payments.²⁶⁰ Therefore, it is crucial that a clear definition exists on the tax base on which the withholding tax should be applied. The TDFE suggests that this definition should be broad and general in order to prevent disputes on the definition and remain flexible with technological developments. Such definition could include a withholding tax on all sales operations concluded remotely with non-residents.²⁶¹

The collection of tax would require the use of intermediaries in order to make sure that the large amount of transactions B2C could be addressed efficiently. However, such an intermediary would need access to specific data, which might be complicated to deal with regarding verification and avoidance strategies.²⁶²

6.5 Equalization Levy

Another option proposed by the TDFE is the equalization levy.²⁶³ This approach is proposed to ensure an equal treatment of the domestic and foreign suppliers. An equalization levy can have different forms depending on its ultimate policy objective. In general, the equalization levy would be intended as a way to tax the non-resident enterprises having a significant economic presence in the territory of the state with reference, for instance, to the political scope to tax the remote sale transactions with costumers in

²⁵⁸ Pinto 2003, p. 209-210.

²⁵⁹ Lambooij 2009, p. 215.

²⁶⁰ Lambooij 2009, p. 215.

²⁶¹ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 113-114.

²⁶² OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 113-114.

²⁶³ OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, p. 115-117.

a market jurisdiction, to reduce the scope to transactions involving the contracts concluded for the sale of goods and services through a digital platform or to tax the value directly contributed by costumers and users.

A levy applied only to the non-resident enterprises could raise questions regarding the trade agreements and the EU law principles. A solution to answer the questions could be to impose the tax on both the domestic and foreign entities. In this case however, the risk could be that the same income is subject both to the levy equalization and to corporate income tax. To address these concerns, it would be necessary to structure the levy to apply only to the situations in which the income would be untaxed or subject to a very low tax rate.

6.6 Conclusion

The sub question that has been addressed in this chapter is:

What solutions have been put forward by legislators and literature to address the need for different threshold to create taxable presence?

In this chapter several solutions proposed in literature have been discussed. Some can be categorized in a shift towards a permanent establishment based on significant presence, hence broadening the nexus criteria. This can be done by either shifting towards a quantitative approach, either by adding additional qualitative criteria. Furthermore, the option to strengthen the use of withholding taxes is mentioned. Another proposal which came forward as an alternative in the BEPS Action 1 final report is discussed and lastly the possibility to allocate tax jurisdiction according to interstate practice within the USA. The mentioned options will be evaluated in the next chapter.

7 Evaluation of the proposed nexus approaches

7.1 Introduction

In this chapter the proposed modifications to the current permanent establishment concept will be reviewed based on the framework discussed in the second chapter.

Moreover, an additional element should be added to existing framework. As described in chapter 3, the current system generally allocates tax jurisdiction to the state of residence, except when the criteria of a permanent establishment are met. The nature and necessity of these thresholds requirements have so far not been part of the discussion, but I consider them to be of main importance in the analysis of a suitable alternative for the current PE concept. Therefore, the second paragraph of this chapter will comprise of an evaluation of the need for and desired elements of thresholds requirements that limit taxation at origin.

After these elements have been discussed, the definitive testing framework is described in the third paragraph. Paragraph 4 of this chapter contains an assessment of the proposed and withdrawn unilateral Actions in EUCOTAX Countries, in paragraph 5 the solutions mentioned in literature will be evaluated.

7.2 Threshold requirements

Current tax systems limit taxation at source with the use of various qualitative requirements, which are set for the creation of taxable presence for corporate income tax and the establishment of a permanent establishment. This paragraph evaluates whether a threshold on source taxation should be used, and if so, what it should look like. First the reasons for the existence of a threshold are discussed, thereafter the preferred nature of the threshold is considered.

7.2.1 Taxation at source: The need for a threshold

In literature, Arnold has researched the need and desirability for threshold requirements.²⁶⁴ The arguments he uses to defend the existence of threshold requirements are as follows:

Firstly, the threshold requirements are necessary to enforce taxation effectively. Identification of the non-residents and data collection, verification and tax collection would be too time consuming. Secondly, a threshold would provide certainty for the taxpayer, as the taxpayer would know that he would only be taxable in the country where he performs activities if he would meet the threshold criteria. Thirdly, the compliance costs of the business might exceed the tax due, as filing and administration requirements might lead to additional costs which are higher than the proceedings from the activities in

²⁶⁴ Arnold, *BIT* (57) 2003/10, p. 482.

the other country. Lastly non-residents might not comply, as they might not be aware of the regulations, or consider the third argument to be a reason not to pay, which would undermine the integrity of a tax system.²⁶⁵

Two contra arguments against thresholds are mentioned. One is the concern that tax revenues of source states might be lower than they should be, as the source country gives up the right to tax. The other concern put forward is the tax avoidance concern, if companies would avoid the threshold in a high tax jurisdiction, they would not be taxable there, but instead in a low tax jurisdiction where taxable presence is constituted.²⁶⁶ I would like to extend this list with an even more valuable argument: it would harm the goal of the OECD to tax profits at the place where value is created.

I consider the relevant argument in favor of the threshold that Arnold brings forward to be of the same nature. Effective taxation and compliance cost both relate to the same issue. The main goal of these arguments that the compliance costs for both the business and the tax administration should not be higher than the potential tax revenues for the government. Certainty is not considered to be the strongest argument, as there also exists certainty for a taxpayer if there would be no threshold. Unclear thresholds are considered to be the only factor reducing certainty. Non-compliance is not considered as a main argument either, as this argument does not take into account the possibilities which information technologies offer for both compliance and law-enforcement.

The contra arguments are relevant, but do not offset the arguments in favor, as businesses should not be discouraged to do business abroad, due to tax costs exceeding the additional benefits generated abroad. Instead the contra arguments plea rightfully for a threshold as low as possible and provide valuable input for the nature of such a threshold. In the end, if a company can make profit in a country, it will conduct business. As long as the profits are not double taxed, the argument that companies are discouraged to conduct business is not strong. The validity of this argument is also reduced by the fact that for the purposes of sportsmen and artist no similar threshold exists, similar to the absence of such a threshold for cross border personal income taxation.

The height compliance costs for both governments and companies depend both on legislation and management of information technologies. With regards to the first aspect, steps towards a simpler tax environment should be set. Regarding the latter, developments are in place already. New technologies provide ways to collect and process information in a more time and cost efficient manner. Moreover, large businesses already have to work on their internal data flows as a consequence of the Mini One

²⁶⁵ Arnold, *BIT* (57) 2003/10, p. 482.

²⁶⁶ Arnold, *BIT* (57) 2003/10, p. 483.

Stop Shop VAT regulations and Country by Country reporting as a consequence of BEPS Action 13. However, BEPS 13 regulations only require taxpayers with a worldwide turnover over 750 million to fulfill with the reporting requirements.²⁶⁷ For SME's the registration requirements should be minimized in order to limit the burden on involvement in international business. Therefore, it is important that tax authorities worldwide use the standardized reporting requirements, harmonized regulations on the creation of taxable presence and provide easy reporting facilities. The information systems necessary for VAT should with some additional modules also be suitable for CIT purposes. Therefore compliance costs should be reduced significantly. Furthermore harmonization of tax laws, as a consequence of OECD and EU projects will also contribute to reduced costs.

However, it cannot be denied that certain compliance costs need to be made when conducting cross-border business. Considering the fact that cross-border business should not be harmed or discouraged disproportionately, I consider a limited threshold to be justified. Such a threshold should not be set too high, nor too low in order to make sure that taxation takes place there where value is created. Determining the options for such a threshold two possible solutions can be distinguished; a threshold consisting of criteria of a qualitative nature, or a threshold based on a quantitative analysis.

7.2.2 Qualitative or quantitative threshold

In literature some stick to a qualitative test of the presence of the Permanent Establishment,²⁶⁸ others favor the inclusion of a quantitative sales threshold.²⁶⁹ In the next sections I will evaluate the most appropriate threshold requirement based on the arguments used for the justification of a threshold. An additional paragraphs on value creation and the prevention on artificial structures has been added, as these topics are central in this thesis.

7.2.2.1 Certainty

Both for taxpayers and tax administrations it is important that clarity exists on whether a foreign entity is subject to tax in that country or not. Comparing the certainty for taxpayers in a situation with qualitative criteria with a situation with quantitative criteria, not much elaboration is needed to conclude that quantitative criteria provide the taxpayer far more certainty than qualitative. Given the amount of case law mentioned in chapter 3 and the impact of BEPS Action 7 elaborated on in chapter 4, it is no surprise that a quantitative threshold would provide more certainty to stakeholders than a qualitative threshold.

²⁶⁷ OESO 2015, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report*, p. 3-5.

²⁶⁸ Hinnekens, *26-6 Intertax 192-200 1998*, p. 195-199.

²⁶⁹ Avi-Yonah 2014, p. 15.

7.2.2.2 Compliance Costs

As explained in the previous paragraph, the certainty for both taxpayers and tax administrations on the existence of taxable presence is not similar under a qualitative and a quantitative threshold. As a qualitative threshold leaves room for interpretation, both businesses and tax administrations will need to spend time and money on the argumentation on meeting the requirements of a permanent establishment.²⁷⁰ This won't be the case if there is only quantitative thresholds in place, given the fact that numbers are easier to measure than qualitative data.

Whether more PE's will be constituted or less, by using quantitative data instead of qualitative data, depends on the level of the threshold. This thus does not directly involve the compliance costs related to the nature of the threshold.

In general the compliance costs are expected to be lower with a quantitative threshold than with a qualitative threshold.

7.2.2.3 Transfer pricing - Profit Allocation

The current transfer pricing guidelines allocate profits based on functions, assets and risks, however as argued earlier sales should be added as a factor. If none of these factors would be present in a country, no taxable income would be attributed to that country. This means that if no value creation takes place in a country, there will be automatically no taxable presence in that country. However, it might be likely that at least some value creation is attributed to a certain jurisdiction. If this would be insignificant, it is argued above that a threshold requirement should prevent the source state to tax in this case.

In order to enhance the effectiveness of the implementation of a destination based PE concept, significant amendments to the current legislation would be required.

The alignment with the transfer pricing guidelines favors thus a quantitative threshold approach.

7.2.2.4 Preventing artificial structures

The existence of qualitative criteria without the inclusion of quantitative limits would leave room for taxpayers to artificially avoid fulfillment of these criteria. In that case, legal contracts will be the basis on which these activities take place. Though it might be argued that some of these situations might be tackled under the new substance over form approach initiated by the OECD, prevention of these situations through the inclusion of a quantitative threshold would be more effective.

²⁷⁰ The existence of a possibility to obtain an ATR on the existence of a PE is a good example of this.

7.2.3 Profits below the threshold

Now the question rises how profits attributed to a state in which no taxable presence exist, should be allocated. If the threshold requirements are not met, would this justify taxation in another state (e.g., the residence state), even though the value was created in another state? Or should this income remain untaxed? Both of these alternatives are not considered to be more desirable than granting taxation rights to a country on which territory the value is created. However, this would conflict with the arguments for a threshold.

Thus if the threshold is not met, no taxable presence should be constituted in that country, to ensure that compliance costs do not exceed the profits. Therefore it is considered to be the best option that the profits below the threshold should be divided amongst the sales states, on a one stop shop basis.

Certain solutions are mentioned in literature such as the unitary business approach, or the residual profit split. However, due to the scope of this thesis this aspect will be analyzed in depth.

7.2.4 Evaluation of preferred threshold approach

Taxable presence should be constituted regardless physical presence. This qualitative aspects can arbitrarily be avoided and should therefore not be included in the constitution of taxable presence. Hence, all qualitative thresholds that are not in line with the transfer pricing guidelines should be abolished. As the only argument not to consider someone taxable, despite the fact that he does create value, would be if the compliance costs would not be in line with the tax payable, only an additional quantitative threshold should be in place.

Aligning the qualifications for the constitution of taxable presence with the guidelines on profit allocation would enhance the efficiency, certainty and effectiveness of the system. This would prevent situations in which there is taxable presence but no profit allocated, or vice versa, which is currently the case. Furthermore, the system would be flexible and sustainable as the qualitative criteria that have been set in the early 20th century will not have to be adapted anymore.

7.3 Definitive testing framework

The definitive testing framework consists of 4 testing criteria. These criteria are based on the principles described in the second chapter, and the previous paragraph.

1) The alternative nexus test relies on quantitative criteria instead of qualitative criteria

As argued in paragraph 7.2, quantitative arguments are considered to be more effective criteria than qualitative criteria. They provide more certainty, require less compliance costs are better in line with the

transfer pricing principles and moreover, provide better protection against artificial avoidance of taxable presence.

2) *The alternative should take both the supply and demand side of the market should into account*

As stated in chapter 2, a preferred alternative for the current permanent establishment should meet the requirements set by the preferred economic and legal principles, enforced by the new nexus approach in paragraph 2.5. This means that the proposal should take an origin interpretation of the supply side into account, to ensure that a substance over form approach on the assessment of the supply side criteria takes place. Second, the demand-side should be included, as it is argued that the demand-side of the market also contributes to the profits that a company makes. In this way, the benefit principle, the neutrality principle and inter-nation equity principle are well-balanced taken into account.

3) *The alternative should have a 'holistic approach'*

The solution should be in line with the requirements set by the Ottawa Tax Framework. The tax measure should thus satisfy the following criteria: efficiency, certainty, simplicity, the effectiveness and fairness, flexibility and sustainability. As described in paragraph 2.3.1 I refer to these arguments as a holistic approach. To be more specific: under this framework a holistic approach prevails over a set of specific taxes covering only specific activities. In this way it is guaranteed that the tax system remains efficient, simple and effective. Off- and online e-commerce should thus preferably be addressed via the same measures.

4) *The alternative should preferably have a tax base which does not exceed the operating profit minus businesslike interests*

Income taxes should ideally not be levied on sales, businesslike costs should be taken into account. The ability to pay principle would unnecessarily be harmed if taxes would be levied on sales. To prevent double taxation and guarantee neutrality, the full situation of a business should preferably be taken into account. Taxation on gross payments not taking into account business like costs should therefore be avoided.

Considering the argument mentioned above and the alternative solutions described in chapter 5 and 6, the definitive framework to which the proposed solutions will be tested is shown in the table below.

	Relies on qualitative criteria	Includes both the supply & demand side	Has a holistic approach	Taxes operating profit -/- businesslike interest
Current PE				
PE after BEPS 7				
DPT				
Dell				
Advertisement Tax				
Data collection				
Tascoé Tax				
Revenue Only				
Economic Presence - TDFE				
Digital Presence				
Withholding Tax				
Equalization Levy				
Origin based PE				
MTC Nexus Approach				

7.4 Evaluation of current PE definition and BEPS action 7

7.4.1 The current PE

The current rules about the permanent establishment has been described in chapter 3. As is clear from the current nexus approach under article 5 of the OECD model and the Dutch interpretation on this legislation, the threshold to create taxable presence exists currently of many different qualitative criteria. Furthermore, these criteria only reflect the input criteria on the market, the demand side of the market

is not taken into account, as no revenue threshold exists. Therefore the current permanent establishment does not treat value creating activities in the right way.

Furthermore the current concept seems to lack a coherent holistic approach. The qualitative criteria do not provide a simple and certain system for taxpayers and tax administrations. Furthermore, as the system relies on criteria which were invented in the times of bricks and mortar businesses, the system has proven not to be flexible and sustainable, as the aspects of new businesses models have been considered not to create taxable presence.

Therefore the current permanent establishment is not considered as a favored option.

7.4.2 BEPS Action 7

The changes proposed under BEPS Action 7 are based on the current PE concept, which has been described in paragraph 7.4.1. As this option includes the basic elements of the current PE, this option should preferably not be preferred.

BEPS action 7 mainly addresses abuse of the current qualitative criteria. Though one might consider that this solves some problems and situations which the current system failed to address and therefore might lead to a fairer tax system, the proposed changes to BEPS Action 7 increase uncertainty and make the system even more complicated.

Therefore the modifications as initiated in BEPS Action 7 are not considered to provide a suitable replacement for the current PE concept.

7.5 Evaluation of measures initiated by EUCOTAX countries

7.5.1 Unilateral actions in general

The characterization of a PE based on a domestic anti-abuse rules without implementation in bilateral tax treaties could result in double taxation, as the residence state only grants an exemption or a foreign tax credit in relation to the tax charged in accordance with the distributive rules of the tax treaty.²⁷¹ Furthermore, the increase in unilateral actions would lead to an uncoordinated tax environment in general, which would result in an opposite direction of more harmonized tax systems that are necessary for a fair tax system. Additionally businesses would be harmed by the additional compliance work involved, which is considered to be undesirable. Therefore, unilateral actions on itself should not be preferred.

²⁷¹ Bianco & Tomazela Santos, 70 *BIT*. 3 2016/3, paragraph 2-3.

7.5.2 Unilateral measures focused on advertisements

The proposals in Italy and France and the legislation in Hungary only address advertisements as a consequence of the digital economy. All proposals are based on the current PE concept, which has been described in paragraph 7.4.1. As these options refrain from solving the basic problems of the current PE, like the need for physical presence and the reluctance to take into account the demand-side for income generated from other activities than advertising, these options should preferably not be preferred. Including a special tax measure only on advertisements, would not contribute to a harmonized, simple and flexible tax system. A holistic measure including value creation in the country of destination is absent. Value generating activities like the analysis of data for off-line distance sales are not further taken into account, nor are other market conditions.

7.5.3 Specific unilateral measures

The DPT proposed by the UK is not addressing the digital economy efficiently either, as it relies on the old permanent establishment concept based on qualitative criteria and physical presence. This approach focuses on the avoidance of a permanent establishment according to the current criteria, and is therefore not considered to be a sustainable solution, it does not increase efficiency and simplicity of the tax system as a whole, this measure lacks a holistic approach. Furthermore, the inclusion of the demand side on the economy is selective and incomplete.

The decision by the Spanish Supreme Court in the *Dell Case* could not be seen as a requalification of all qualitative requirements for the permanent establishment, but is more a specific example of case law interpreted in relation to the digital economy. As the physical presence of employees of the affiliated group company was also decisive in this case, the Dell case could not be interpreted as a holistic solution addressing the broader questions regarding value creation and taxable presence mentioned.

The French proposal to tax data collection would be a step in the right direction, as it includes value creating activities in the destination country, which are currently disregarded. However, the tax is not taking into account the situation of the company, as a tax on the data collection of the company, regardless of the value of the data gathered by that company. Additionally, the current PE concept including its qualitative restrictions on the supply side remains intact, therefore this approach is not favored. This option is not considered to be the most efficient, however, the notion that consumer data collection is a value creating activity is accepted, and this factor is therefore considered to be relevant for the attribution of profits to the destination state.

The Tascoé tax is not considered to be a solution for the digital economy either, as it just addresses off-line e-commerce which is just one single aspect of the digital economy. Furthermore this tax does not alter the situation of the current PE, as discussed in paragraph 7.4.1.

7.6 Evaluation of methods proposed in literature

7.6.1 Significant Economic Presence

Three different approaches can be distinguished. The proposal to take only take the revenues accrued in a certain country into account, is based on a fully destination based tax. This would deny the fact that value is created on the supply side of the economy. As the view on value creation in this thesis also includes risks assumes, functions performed and assets used as value creating factor. The fact that this approach would lead to a simpler system, does not compensate disregarding value creation on the supply side, therefore this option is not considered to be favored.

The propositions of both the TDFE and Hongler and Pistone demand the fulfillment of specific qualitative criteria to create taxable presence. Though these criteria might represent several of the most important indicators for value creation on the demand side, these criteria do not guarantee that this list is exhausting. Furthermore the proposals do not include destination based taxation in all types of business models and furthermore the current PE concept relying on qualitative threshold criteria is still of major importance in this proposal. Therefore neither of these options is considered to be preferred as an optimal substitution for or addition to the current PE concept.

7.6.2 Withholding Tax

Introducing a withholding tax on international payments would include the destination state in various situations, however this approach would not correspond with a substance over form interpretation of the supply side of the economy. Furthermore this solution does not alter the current PE definition as described in paragraph 7.4.1., and the qualitative criteria remain thus intact. Moreover taxation on gross payments could result in an income tax in excess of the profit margin, which would result in a violation of the ability-to-pay principle. As different cost structures of taxpayers will not sufficiently be taking into account, the levying of withholding income tax on the gross amount could also effect in under-taxation of one part of the income and the over-taxation of other income.²⁷² Also, questions could be posed regarding the neutrality with non-residents and whether this would fit in a balanced tax system. Therefore this alternative is not preferred.

7.6.3 Equalization Levy

An equalization levy would not be a favored solution, as it would lead to an unequal treatment between resident and non-resident companies. This would infringe with EU law. Besides, an equalization levy would not address the fundamental issues of a permanent establishment as the qualitative requirements

²⁷² Bianco & Tomazela Santos, 70 *BIT*. 2016/3, paragraph 2-3, Referring to Palma, 38 *Intertax* 2010/12, p. 624-625.

differing from the profit allocation guidelines would infringe with the favored normative framework proposed.

7.6.4 Origin based interpretation of the PE definition

Additionally to the solutions described in the sixth chapter, the principle of origin also describes an alternative PE concept. The origin based interpretation of the PE would require ‘substantial income producing activities’ in a state.²⁷³ This would reflect a substance over form interpretation of the supply side, and is therefore considered to be a suitable alternative for the current qualitative criteria. However, by not quantifying a limit for the term ‘substantial’, and requiring a ‘case by case’ on the minimum length of the activities,²⁷⁴ this approach is considered to provide less legal to be inferior to a quantitative threshold. Furthermore, the destination market is not taken into account. The relevant value creating business characteristics are however taken into account and provide a more fine-tuned nexus approach than the current PE.

Considering the arguments mentioned above, the origin based interpretation is considered to put valuable input in the quest for a new nexus approach, but according to me it is not considered to be the best possible solution.

7.6.5 MTC Nexus Approach

The implementation of the nexus criteria of the MTC nexus approach would lead to taxable presence in case a company has over a certain amount of assets, employees or sales in a certain country. Hence, these criteria are not qualitative and do not add additional burdens in relation to the current transfer pricing guidelines, it even adds the destination country as a nexus factor, which has been advocated in the framework proposed. Furthermore replacing the current permanent establishment with a significant nexus test would lead to a simpler tax system, providing more certainty to taxpayers and tax administrations. With the aid of improved information technology, taxes could be levied efficiently and the full situation of the taxpayer could be taken into account.

7.7 Conclusion

Assessing the proposed options according to the criteria defined in paragraph 7.3, it is clear that many proposed solutions do not fulfill all these criteria. However, the set of solutions discussed was not exhaustive. Some other solutions such as the increased use of a service PE, have not been elaborated upon, due to the size of this thesis. The increased use of a service PE is not considered to be favored, as

²⁷³ Kemmeren 2001, p. 43.

²⁷⁴ Kemmeren 2001, p. 359.

this measure only applies to services and leaves the current qualitative criteria on the supply side intact. Similar contra-arguments could be made to other alternatives, therefore the set described above is considered to give a good overview of the possible alternative for the current permanent establishment.

To enhance the clarity off the evaluation of the solutions, a schematic overview of the discussed options is given in the table below. As can be concluded, the MTC nexus approach is considered to be the best nexus approach for the 21th century. It provides a holistic solution; does not make us of superfluous qualitative criteria, which enable tax payers to artificially avoid taxable presence; the approach takes into account the demand side of the market and does not conflict with value creation rules.

	Relies on qualitative criteria	Includes both the supply & demand side	Has a holistic approach	Taxes operating profit -/- businesslike interest
Current PE	Yes	No	No	Yes
PE after BEPS 7	Yes	No	No	Yes
DPT	Yes	No	No	Yes
Dell	Yes	No	No	Yes
Advertisement Tax	Yes	Partly	No	No
Data collection	Yes	Partly	No	No
Tascoé Tax	Yes	No	No	No
Revenue Only	No	No	Partly	Yes
Economic Presence - TDFE	Yes	Partly	Partly	Yes
Digital Presence	Yes	Partly	Partly	Yes
Withholding Tax	No	Partly	Partly	No
Equalization Levy	No	Partly	Partly	No
Origin based PE	Partly	No	Partly	Yes
MTC Nexus Approach	No	Yes	Yes	Yes

8 Recommendations

In the introduction it has been indicated that new businesses arise, digital resources are becoming more and more important to conduct business, resulting in a shift away from the significance of physical presence through bricks and mortar shops. Furthermore, it has been stated that regardless from new businesses, current taxation rules are being abused to avoid taxable presence.

When looking at the current practice regarding the allocation of tax jurisdiction, it is noted that the nationality and residence principle and the source principle, are the main principles on which allocation to tax jurisdiction takes place. In the first stages of the 20th century, a permanent establishment has been introduced in international context as a concept to limit and enable taxation at source. The qualitative thresholds on which the permanent establishment relies have not changed dramatically over time, even though times have changed and business models have changed accordingly.

Evaluating the nexus approaches that are currently used, some general accepted principles that justify taxation or set requirements for the taxing system were discussed. Also, the recent wishes of the OECD to allocate tax jurisdiction based on the location value creation were considered.

It turned out that the principles that are currently used either deny benefits and value created in other states than the state in which the enterprise is incorporated or has its *siège réel* (the nationality and residence principle), or either are based on a form over substance approach and require physical presence to create taxable presence (the source principle).

The two other nexus approaches discussed, the principle of origin and the destination based approach were considered to be more valuable alternatives. The first is considered to be a substance over form interpretation of the principle of source, which is thus entitling taxation rights to the country where the supply side of the market creates value in line with the current transfer pricing principles. The latter is a response to the existing nexus approaches, which somehow deny the fact that for the conclusion of contracts on a market two different parties are needed and therefore assume that income only depends on the 'input' factors on the market. However, the destination principle acknowledges that the prices of products, the amount of products sold and therefore the profits of a company also depend on the demand side of the market.

When the permanent establishment principle was developed, the interrelatedness between the supply and the demand side of the market was limited. However, globalization and digitalization have meaningfully changed market conditions, resulting in the opportunity to conduct business in any country while not constituting taxable presence in the market country, though still profiting from its public services and purchasing power. If income taxes would remain taxing solely the supply side of the

economy, it would stick to its arguable presumptions that the activities of a company are intended to be steps of a ‘recipe’ which would lead to profit, disregarding the question if a consumer wants to buy the product, against what price and in which location.

Therefore my first recommendation is to include the destination side of the market as a nexus factor.

My second recommendation is also inspired by an analysis of value creation. Though the OECD’s vision on transfer pricing does not include physical presence or corporate residency as value creating factors, it still considers them to be decisive to create taxable presence. This misalignment results in allocation of tax jurisdiction to a state not corresponding with the actual value creation. Therefore, the existence of qualitative threshold elements per se is questioned. Arguments supporting qualitative criteria are considered to be insignificant compared to quantitative criteria, as the latter provides more certainty, therefore less compliance costs and are better equipped to prevent artificial tax base shifting.

Therefore my second recommendation therefore is to step away from the current qualitative limitations to taxation at source, as the qualitative principles have proven to cause abuse of rules and avoidance of taxable presence. Instead, a quantitative threshold seems to be a better alternative.

Though I am in favor of following the transfer pricing principles in the determination of taxable presence, the destination country should be added as a value-creating factor next to a quantitative test on functions, assets and risks. Quantitative thresholds should thus exist both for the supply side and the level of sales in a country.

The new threshold approach proposed equals the MTC Nexus test:

Substantial nexus is established if any of the following thresholds is exceeded during the tax period:

(a) an amount of €50,000 of property; or

(b) an amount of €50,000 of payroll; or

(c) an amount of €500,000 of sales; or

(d) twenty-five percent of total property, total payroll or total sales.”

The proposed numbers have been inspired by the numbers of the MTC approach, however these numbers are open for discussion and should be adapted for developing countries.

This nexus approach would be based on property, payroll and sales. Corresponding to the transfer pricing inputs: assets, functions and risks, with additionally the supported sales factor. Assets are considered to equal property, payroll is considered to reflect functions and risks.²⁷⁵

Instead of entitling the residence state to tax profits that fall below the threshold, I consider it to be a better approach to divide these profits to market states. Whether a modified arm's length approach should be used resulting in a profit allocation based on residual profit split or whether a shift to formulary apportionment is preferred lies outside of the scope of this thesis.

Though practitioners and governments might initially oppose these ideas, as they are shifting away from the current situation, by bringing forward feasibility arguments, practice has proven itself that rigorous modifications to the current nexus approach are necessary. Furthermore, the goal of this thesis is to develop a decent tax system based on relevant principles from a scientific perspective and not to take hypothetical political implementation constraints into account, as these may oppose any shift away from the beloved but despised status quo.

The reaction of the OECD to address the abuse of the current rules and to ensure a balanced tax system for the digitalized future economy has been disappointing. Instead of taking one step back and considering the overall desirability and elements of the permanent establishment as a nexus approach, the OECD preferred to refine the current PE concept, creating more uncertainty and refraining from tackling the real problem. Therefore I make some recommendation special to the OECD

8.1 Desired response OECD

As most countries currently base their tax treaties on two principles, it will be an enormous effort to reach consensus to change the current system. Not only will a switch to a system fully based on the origin and destination principle cost a significant amount of time, it will also be costly for tax administrations to implement and also for taxpayers compliance costs are expected to rise as a consequence of a system change. However, these incremental costs are deemed only to apply on short-term basis. Technological developments and standardizations are expected to permit a significant decrease in compliance costs on long term.

As the OECD strongly favors a substance over form approach in its BEPS projects and argues that income should be taxed where the value creation takes place, it is undeniable that a rigorous change is necessary regarding the current thresholds to allocate tax jurisdiction to the source state.

²⁷⁵ According to BEPS action 8-10, the actual mitigation of risks is not considered to be executed by contracts, but by people. Therefore payroll reflects both functions and risks.

The outcome of the multilateral instrument, developed by the OECD countries as a response to BEPS Action 15, will be a step in the right direction and through this instrument the new proposed nexus approach should be introduced.

Even if not all countries would participate, a new system based on the MTC Nexus approach should be implemented, as the effects would of introducing destination based elements would not have negative impacts on foreign direct investment.²⁷⁶ The new article 5 of the OECD Model should however not be named ‘the permanent establishment’ anymore, as both the term ‘permanent’ and the term ‘establishment’ will not be elements of this new article. The new article 5 would be a substantial nexus test with the elements ‘payroll, property or sales’.

As mentioned earlier, how the profit should be attributed to destination states lies outside the scope of this thesis. Attributing a rate of the residual profits might work, but formulary apportionment is not excluded either. The amount of profit which should be attributed to the destination state should also reflect the position of the consumer in the value creation. Factors which should be taken into account are e.g., special consumer preferences,²⁷⁷ or the use of consumer data by companies.²⁷⁸ However, this list is not exclusive, further (sector specific) research is recommended. Furthermore the introducing a special uniform rate for corporate profits attributed to the destination state would be recommendable, in order to reach a coordinated and unified international tax system.

As a harmonized approach is desirable, it is recommended that a standardized and uniform approach, based on a strong IT system is used. Lessons should be learned from the recent introduction of the mini one stop shop for VAT purposes and the exchange of rulings and Country by Country reports, in order to prevent arbitration and misalignments of the system and keep compliance costs for all parties as low as possible. As the law will be leave less room for interpretation, it is even expected that compliance costs are expected to decrease, once the new substantial nexus test has been introduced.

8.2 Desired response Netherlands

The Netherlands should maintain its position as a small, open and export oriented economy with an attractive business climate. What the effects of the introduction of the new nexus approach would have budget wise is unclear. Extra revenue is expected to be generated by levying a destination based CIT, however this advantage might lead to a corresponding reduction in the supply CIT rate.

²⁷⁶ Beckery and Jungz, P.1

²⁷⁷ See the statement of Paul Oosterhuis in paragraph 2.5

²⁷⁸ As is explained in paragraph 4.2, new business models in the e-commerce world generate value thanks to the use of consumer data.

With regards to the position of the Netherlands regarding destination based income tax, it must be noted that such a system currently deviates significantly from such an approach. However, it does not seem that the Netherlands is totally against such a system, analyzing the comments of the Secretary of State to the recent BEPS projects. In the letter to the parliament he stated the position of the Government towards transfer pricing and also referred to the CCCTB project of the EU. He noted that profit was attributed based on three factors: functions, assets and sales. In this letter the only reason why the Netherlands would oppose to such an apportionment system, was the absence of inclusion of intangible assets in the formula. No reference was made to a negative position towards the inclusion of sales as a distribution factor.

A supportive role in a multilateral project, with no hasty decisions would ensure that both the tax authorities and taxpayers are not confronted with negative impact on FDI and enforcement problems. However, premature actions are not recommended, also regarding the current status of the IT of the Dutch Tax Authorities.²⁷⁹

²⁷⁹ <http://fd.nl/economie-politiek/1152113/belastingdienst-lost-ict-probleem-volgens-het-boekje-op>

9 Conclusion

Within the last chapter of this study, the research question as set in the first chapter will be answered.

To what extent should the permanent establishment concept be modified, regarding the international developments influencing nexus approaches, discussed in BEPS Action 1 and addressed by BEPS Action 7?

In order to answer this main research question, every chapter of this thesis has answered the sub questions described in the introduction of this thesis. The answers to the sub questions provide the ingredients to find an answer in the quest for a better nexus approach.

The introduction highlighted the recent developments in the economy and the field of taxation, including the BEPS project as a consequence of which this thesis was written as a part of the EUCOTAX Wintercourse Project. Several references were made to the change of businesses, which have appeared to demand for new forms of taxation.

In the second chapter the theoretical framework was set for this thesis. Existing principles underlying allocation to tax jurisdiction in an international context were discussed and also the underlying principles justifying taxation were reflected upon. By analyzing the existing nexus approaches in the light of these principles, taking into account not only justifying principles of taxation like the benefit principle, but also the ‘substance over form’ and the ‘taxing where value is created’ approach of the OECD, two different allocation methods were considered to be justified: the principle of origin, the substance over form interpretation of the source principle as a nexus approach for the supply side; and the destination principle taking into account the demand side of the market.

In the third chapter the current permanent establishment concept in the Netherlands in relation to the concept in international tax law was discussed. In general three types of permanent establishments can be distinguished: the fixed place permanent establishment, the project permanent establishment and the agency permanent establishment. The criteria for the PE in the Netherlands generally correspond with the OECD approach. A PE is constituted if there is a fixed place of business through which the business of an enterprise is wholly or partly carried on. The PE concept in the Netherlands has been developed in case law, resulting in a different treatment for outbound and inbound situations. For non-treaty inbound situations the specific activity exemptions, nor the project PE seem to be relevant for the constitution of a PE. In general it could be noticed that the PE concept exists of various complex qualitative criteria.

In the fourth chapter the results of the OECD’s BEPS Actions 1 and 7 were discussed. The relevant features of the digital economy were discussed, which are said to be addressed by the outcomes of Action

7. The broadening of the agent PE concept, the limitation of the specific activity exemptions and the anti-fragmentation rules proposed seem only to be anti-abuse measures, but do not answer challenges raised about the sustainability of the PE concept in general. Overall it can be concluded that the business models in the digital economy put more pressure on the further existing of the current permanent establishment concept, as both value creation seems to shift more towards the demand side in the market, and it becomes easier to conduct business in countries without the necessity to create a business liable to CIT in that country. The changes proposed in Action 7 do not address the perceived infringements, as the 20th century bricks and mortar PE concept is still taken as a starting point.

In chapter five and six proposals and new legislations with the aim to include business models of the digital economy were discussed. Chapter seven starts with a reconsideration of the threshold criteria used to limit taxation at source, to better understand the reason for a permanent establishment. Evaluating the arguments, the fact that compliance costs might exceed the profits gained abroad, is considered to be a valuable argument to limit taxation at source. When considering the just threshold, distinction was made between qualitative and quantitative criteria. Qualitative criteria were considered inappropriate, as these would lead to conflicts with the existing profit allocation regulations. If the qualitative threshold would be met, but these activities are not relevant from a transfer pricing perspective, being ‘taxable present’ for corporate income tax would not have any effect. However, in the other case, where a company is considered to perform value creating activities in a certain jurisdiction but no ‘taxable presence’ is perceived because some qualitative criteria are not met, the mismatch would lead to even more results. The only reason to limit taxation rights in the source country would be if businesses are discouraged disproportionately by compliance costs exceeding profits to be gained abroad. Qualitative criteria were considered to be inappropriate to attain this goal, quantitative criteria were considered to be more effective.

Apart from the nature of the threshold, solutions were also tested if they would include both the supply side and the destination side of the market, if they would meet the ‘holistic’ criteria set by the Ottawa Tax Framework and if they would not harm the ability to pay principle.

Evaluating the existing options, most of them were not considered to meet the requirements put forward by the normative framework set in the second chapter. The solution put forward by the MTC seems to offer all ingredients for a new nexus approach corresponding with the set framework.

A new nexus approach based on quantitative criteria on the presence of assets, labor or sales in a country would be a radical shift away from the current PE concept, but would at the same time be able to address several important disadvantages of the current system.

The old bricks and mortar concept has proven to be incompatible to address the new business models of the 21th century, as it still relies on the physical presence in a country, to entitle that state to levy corporate income taxes. Furthermore, the concept denies one of the most basic principles in the economy: the fact that the price in a market, and thus income, and thus profit, depends both on the supply and the demand side of the economy. When adhering to a system where income is taxed in the territory in which value is created, the demand side should therefore be taken into account.

The MTC Nexus approach would take away these disadvantages and would additionally take away loopholes in the current system and realize a more substance over form taxation. Situations in which taxable presence is constituted but no income is attributed will be taken away. Similarly, situations in which value is created, but no taxable presence in the source country is recognized due to the qualitative criteria will no longer exist.

The current allocation of tax jurisdiction is mainly based on the residence and source principle, from which the proposed solution deviates significantly. However, the globalized, mobile and fast changing world we live in at the moment requires also radical movements of concepts that have been invented to address business in a different era.

Whether it would be feasible to make such a radical shift remains questionable. Looking at the negotiations on the CCCTB,²⁸⁰ and the difficulties of the OECD to reach agreement on taxation regulations, the new system might be a step to far. However, as the developments in market are rigorous, the international tax system should adapt as well.

In the future tax system tax avoidance through refraining from creating taxable presence even though value is created in that state, should not be possible anymore. Corporate income tax should be levied in the state where the real activities of the supplier take place, but also in the state where that company sells its products. Compliance and enforcement costs of both taxpayers and tax administrations will be lower thanks to technological developments and the risks of harmful tax competition will be mitigated, as tax jurisdiction will also be allocated based on value creating factors which are less subject to abuse than the current ones.

²⁸⁰ Griffith, Hines, and Sorensen 2008, p. 6

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