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MASTERTHESIS TAX LAW

INTERNATIONAL PROFIT ALLOCATION IN THE DIGITAL ECONOMY AND CASH FLOW TAXATION AS ALTERNATIVE

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Abstract: Digital technology has created new business models with specific characteristics differing from the characteristics of traditional business models. Therefore mismatches in current international tax legislation may occur. For instance, the combined use of the residence- and source based principles may contain deficiencies in order to tax multinational enterprises in the digital economy. These multinational enterprises may be able to influence their effective tax rate using these deficiencies. The residence of an entity for example is not necessarily the state where income is created but international tax legislation sees it as a reference point for taxation. Also the source state where the income is created is a reference point for taxation. However, specific characteristics like the mobility of intangibles in the digital economy makes it difficult to allocate the place of source or define the arm's length prices of assets. The choice of business is then influenced by the height of tax rates, because the deficiencies allow multinational enterprises to choose where they are taxed. Subsequently, the debate on taxing multinational enterprises has grown in recent years. Two deficiencies when taxing multinationals in the digital economy seem to arise. First, when states are not able to detect a permanent establishment in their jurisdiction. Second, in the area of intangibles with respect to transfer pricing. If the taxation of multinational enterprises in the digital economy contain deficiencies, new ways to tax multinationals in the digital economy need to be examined. One taxation opportunity is a cash flow taxation that is based on the destination of consumption. This thesis researches whether cash flow taxation is an alternative to the deficiencies of the permanent establishment and transfer pricing concepts in order to tax multinational enterprises in the digital economy.

"Se vogliamo che tutto rimanga come è, bisogna che tutto cambi"[1]

- Giuseppe Tomasi di Lampedusa

[1] Translation: "If we want things to stay as they are, things will have to change". This is what the young fictional character Tancredi Falconeri said to his tutor and uncle, the prince of Sicily don Guilio Fabrizio Tomasi, as an explanation of Tancredi's revolutionary behaving, just before the Italian unification (Il Risorgimento). Di Lampedusa wrote this in his magnus opus *Il Gattopardo* (The Leopard) in 1954.

Preface

This master thesis is written as the final project, a Swan song, for the master's program of the study Tax Law at Tilburg University. In order to graduate for and receive the title Master of Laws (LL.M.), the completion of a thesis is required. In 2008 I enrolled in this study program and took a one year break in 2010 because of a full-time board year within a student (non-study related) association. I started my master in September 2014 and finished my bachelor in the summer of 2014.

In February 2014 I have been a participant in the Moot Court Competition in Leuven, thanks to the Fiscal Institute of Tilburg University. This is the only international Tax Law Moot Court competition in the world. During the competition students from more than 15 universities from around the world are pleading against each other and judged by professional (amongst others ECJ) judges. On Friday, at the end of the Moot Court week, there was a BEPS conference as part of the "F. Vanistendael Lectures in International & European Tax Law". This conference contained speakers from the OECD, the EC and professors from universities. It triggered my interest for the subject of BEPS. However, my thoughts conflicted with the words and attitude of the speakers. It felt like they approached the subject too much from their "ivory tower", thereby neglecting the political challenges from real life. Therefore the BEPS project and a more philosophical side of thinking about tax could not leave my mind. Hence, the BEPS project is the instigator for my subject choice.

Also, academic thinking is the ability to think about how things should be. It is for that reason as well that I chose this abstract subject. In ancient times Plato already said that both (extreme) wealth and poverty are harmful to society.[2] It was Hobbes who stated from a natural law perspective that every individual in society is equal and therefore taxation should be evenly.[3] Later, in the 19th century, Mill and Marx opened the path for the (political) discussion about respectively liberal[4] versus social taxation[5]. Notwithstanding the political debate on taxation, it is clear that in some ways taxation should contain aspects of fairness in order to maintain a solid society. Therefore the chosen subject of this thesis is relevant. Critical questions should be asked and alternatives or solutions should be propounded. For that reason I sincerely hope this thesis is an actual addition to the BEPS discussion and international taxation as a whole.

[2] Russel 2008, p.132
[3] Ydema 1997, p. 240
[4] Backhaus 2012, p. 231
[5] Aaron & Boskin 1980, p. 361

Furthermore, I cannot resist to name a few of my humble and unspoken thoughts on academia. The academic environment has been changed the last decades. Positively, the universities have become more equal and the interaction between professor and student has become more informal. However, the universities have also become larger and more eager for competition. Therefore the intellectual shaping of students have become secondary. Students are motived top-down to study highly specialized, quickly and almost without incentives for further intellectual development. In my view universities should also provide students with intellectual and ethical baggage in order to make the right choices and decisions in the future. As a highly educated person, *noblesse oblige* should be a habit, inherited from the university. Plato, Machiavelli, Spinoza, Locke and Mill are as unknown in the lecture halls as they have been important for the thinking about taxation worldwide: very. I am sure that if (law) students would only be encouraged to read for example Dostoyevsky or Kafka, they would be more shaped as an academic person. I am not pleading for educating students as a *homo universalis* or adding fiction writers to the curriculum. However, it is in my opinion for the greater good that the university keeps in mind that education as a whole is more than only learning things the curriculum and professors prescribe. In the end, Tilburg University stands for *understanding society*. I suppose it can be agreed that understanding something complex as society, more knowledge is needed than solely the, how interesting it is, wisdom from compulsory prescribed lectures and books.

This thesis could not have been written without the help of some persons. First I would like to thank my supervisor, Dr. Daniel Smit, for helping me with the subject, for his knowledge and his critical view. Also the conversations about other worldwide tax issues and –something completely different-living in Amsterdam kept me excited. Subsequently, I would like to thank the second reader of my thesis, who is at the moment of writing still unknown, for his/her undoubtedly critical eye. Thereafter I would like to thank my friends that have helped me a lot with clearing my mind. My girlfriend, although far away, gave me her support and was on the same level because she also had to write her thesis. Last but definitely not least I would like to thank my parents for keeping their trust, helping me financial and above all motivational. Also my sister and my brother had their share.

Content

Preface 4

I. Abbreviations 8

II. Thesis 9

1. Introduction 9

1.1 Introduction 9

1.2 Relevance of the subject 9

1.3 Research question 11

1.4 Motivation of the subject 11

1.5 Structure of the thesis 12

1.6 Research method 13

2. The digital economy 14

2.1 Introduction 14

2.2 The definition of the digital economy 14

2.3 The different business models of the digital economy 14

2.3.1 Introduction 14

2.3.2 E-commerce 15

2.3.3 Prominent digital economy business models 16

2.3.4 Characterization of the digital economy business models 17

2.3.5 Tax aspects of the business models 18

2.4 The OECD BEPS report on the digital economy 18

2.5 An example of a tax planning structure of an MNE in the digital economy 19

2.6 The Ottawa principles 20

2.7 Conclusion of the digital economy 21

3. International profit allocation in the digital economy 23

3.1 Introduction 23

3.2 The basis of the permanent establishment concept 23

3.3 The substance qualification of the PE concept in the digital economy 24

3.3.1 The physical presence 24

3.3.2 Preparatory or auxiliary activities and the agent clause 24

3.3.3 The permanent establishment and digital selling points 25

3.4 The basis of the TP concept 26

3.5 TP problems with intangible assets 27

3.6 Commissionaire arrangements and similar strategies 29

3.7 Conclusion 29

4. The basic principles of international taxation ... 31
4.1 Introduction ... 31
4.2 The legal and economic principles of international taxation and the Ottawa principles ... 31
4.3 The legal and economic principles of international taxation ... 31
4.3.1 International double taxation ... 31
4.3.2 International double non-taxation ... 32
4.3.3 Legal principles ... 33
4.3.4 Conclusion of the legal principles of international taxation ... 36
4.4 Conclusion of the basic principles of international taxation ... 36
5. Cash-flow taxation as a possible solution ... 37
5.1 Introduction ... 37
5.2 The basis of cash-flow taxation ... 37
5.3 The tax base of the corporate cash-flow tax ... 37
5.3.1 Introduction ... 37
5.3.2 Destination-based (cash-flow) tax ... 38
5.3.3 The R-base CFT ... 39
5.3.4 The R+F base CFT ... 39
5.4 Comparison of the CFT with the principles ... 40
5.4.1 Comparison with the legal principles ... 40
5.4.2 Comparison with the Ottawa principles ... 41
5.5 CFT as alternative for the deficiencies of the current international profit allocation rules ... 42
5.6 Conclusion ... 43
6. Thesis conclusion ... 44
III. Resources ... 48
i. Literature ... 48
ii. Reports & Legislation ... 50
IV. Appendix ... 51

I. Abbreviations

APA	-	Advance Pricing Agreement
B2B	-	Business-to-business
B2C	-	Business-to-consumer
C2C	-	Consumer-to-consumer
BEPS	-	Base Erosion and Profit Shifting
CEN	-	Capital Export Neutrality
CFT	-	Cash-flow Tax
CFC	-	Controlled Foreign Company
CIN	-	Capital Import Neutrality
CIT	-	Corporate Income Tax
DCITA	-	Dutch Corporate Income Tax Act 1969
ETR	-	Effective Tax Rate
ICT	-	Information and Communication Technology
MNE	-	Multinational Enterprise
OECD	-	Organization for Economic Co-operation and Development
OECD MC	-	OECD Model Convention
PE	-	Permanent Establishment
TP	-	Transfer Pricing
UCC	-	User Created Content
VAT	-	Value Added Tax

II. Thesis

1. Introduction

1.1 Introduction

"We are not accusing you of being illegal, we are accusing you of being immoral," said the British Member of Parliament Margaret Hodge in 2012 to managers of Amazon, Google and Starbucks, during an interrogation about 'aggressive tax planning structures' that these multinational enterprises (MNEs) might be using.[6] It seems like international tax evasion has become a sensitive political issue. In heated debates, the nuance often disappears and consequently structure is needed to investigate the subject of international taxation. Therefore, this first chapter introduces the relevance of the subject of this thesis. Secondly the research question is formulated. Thirdly the subject choice is motivated. Fourthly the structure of the thesis is outlined. In the end of this chapter the research method is set put.

1.2 Relevance of the subject

Since 2012, the debate on taxable base erosion and fiscal profit shifting (BEPS) by MNEs has become an important issue on the agenda of the Organization for Economic Co-operation and Development (OECD).[7] The subject has also been endorsed by the G20[8].[9] By investigating the flaws in the current tax climate and formulating solutions to address these issues, the OECD tries to provide a worldwide barrier against BEPS.[10] Also the recent public and political debate derives from dissatisfaction of the current international taxation of MNEs.[11] The recent "LuxLeaks" for example has intensified the public debate about taxation of MNEs because it revealed the usually confidential agreements

[6] Helia Ebrahimi, *Starbucks, Amazon and Google accused of being '*immoral', The Telegraph November 12, 2012. It is possible to watch a clip of this event on Youtube.com with the title 'Amazon, Starbucks and Google grilled by MP's over tax'.
[7] The OECD is a co-operation of 34 (predominantly Western) countries that discusses, studies and coordinates the social and economic policy of these countries.
[8] The G20 is a group of 19 countries and the European Union (EU) that includes more than 80% of the world trade.
[9] Ault, Schön & Shay 2014, p. 275
[10] OECD BEPS 2013, p. 51
[11] See for example in the Netherlands: Letters to the Dutch State Secretary for Finance of November 24, 2014, *nr. IZV 2014-622 U* about tax evasion of multinationals or of December 1, 2014, *nr. DB/2014/492 U* with questions whether the Dutch government is resisting the OECD approach with respect to tax evasion.

between MNEs and the Luxembourg tax authorities.[12] Not only thanks to these agreements may the effective tax rates (ETRs) of MNEs be reduced, but also because of the characteristics of the digital economy in combination with the concept of international profit allocation like the permanent establishment (PE) and transfer pricing (TP). Social and political indignation is the result of news items that report tax planning of MNEs. Questions arise such as why the local bookshop, just as an MNE subjected to CIT and effected by the crisis, pays relatively more taxes than an MNE. Or the question why governments are cutting back their expenses because of budgetary problems, influencing the purchasing power of citizens, while MNEs are able to evade taxes on a global scale. Question marks can be placed with respect to the double standard of politicians and an oversimplified political discussion can bring harm to the business climate of European countries in particular.[13] Therefore this thesis attempts to form an accurate picture of the supposed problems and tries to contribute to a solution. The digital economy has resulted in new business models with specific characteristics that differ from the traditional business models on which international tax legislation is based. The thesis consists primary of a disquisition of two concepts that are part of international taxation: the permanent establishment (PE) and transfer pricing (TP) concepts and their relation to the digital economy. If a PE can be considered, the profit of a PE is determined by the international used OECD TP Guidelines.[14] It is the result of art. 7 of the OECD MC that lets the OECD TP Guidelines apply for the valuation of the transactions between associated enterprises. Therefore the PE and TP concepts become related to each other. What are these concepts and do they cause problems? If so, why are the PE and the TP concepts causing extra issues in the taxation of the digital economy? What are the underlying principles of these concepts?

Cash-flow taxation (CFT) has recently been proposed as a research worthy solution to taxation issues regarding the digital economy and the associated e-commerce.[15] It has also been postponed in the seventies as an alternative for taxation in the US.[16] Notwithstanding the centuries that has passed since the seventies, CFT is relatively unknown in worldwide tax science. This thesis therefore consists of the research on a cash-flow based taxation. CFT varies with the current worldwide accepted corporate income tax (CIT) as basis for company taxation. CFT may be an alternative for profit allocation issues because it contains whole other taxation properties.

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[12] “LuxLeaks” is the name of the leaking of tax rulings concluded by the help of the accountant firm PWC with the Luxembourg tax authority. See for example in the Netherlands the Letter to the Dutch State Secretary for Finance of December 19, 2014, *nr. IVZ/2014-728 U*.
[13] Engelen 2013, p.2
[14] Günther & Schoueri 2011, p. 73
[15] European Commission, *Commission Expert Group On Taxation Of The Digital Economy*, Brussels 2014, p. 8
[16] Meade Report 1978

1.3 Research question

The research question of this thesis is formulated as following:

"To what extend are the permanent establishment and transfer pricing concepts appropriate for taxing MNE's in the digital economy and can cash flow taxation be an alternative solution to deficiencies of these concepts?"

1.4 Motivation of the subject

The digital economy is relatively new and contains specific business models that differ from the traditional business models. Tax legislation on the other hand is in principle based on traditional business models. Politicians may lack to supply sufficient tax legislation.[17] While the digital economy stimulates globalization, tax legislation consists of national rules of sovereign countries. Mismatches in tax legislation for cross border operating companies may occur. As a result, issues arise for states to properly tax MNE's that use tax planning structures that can be optimized with help of the specific properties of the digital economy. The taxation of the digital economy is thus an emerging issue to pioneer.

Furthermore, the international taxation system seems to experience several issues that also effect the taxability of MNEs in the digital economy. For example, over the past decades the CIT rates in the European Union (EU) and the OECD countries have been decreased.[18] These decreasing rates in combination with difficulties in defining the presence of an enterprise (the PE concept for the subject) and the complex "at arm's length" calculation with respect to intangibles (the TP concept for the object) within a multinational company structure, may cause issues for states to tax MNEs sufficiently. Therefore international profit allocation is important to examine.

CFT has been discussed in (Anglo-Saxon) fiscal and economic literature over the past decades as an alternative manner of taxation and is based on completely different principles. Researching CFT as a solution to international profit allocation deficiencies is relevant because it has been proposed as a serious option by the EC. CFT may result in an alternative for taxing parts of profit of MNEs in the digital economy. Inserting a CFT in the EU, may be unallowed state aid or equality principle issues, for example when CFT is only applicable for MNEs or when CFT is in the EU only implemented in big countries (e.g. France, Italy, Germany and Spain). Therefore the implementation of a CFT must be

[17] Kavelaars 2014, p.1

[18] See appendix 1 and 2 for charts with CIT-rates of OECD countries in 1981-2013 and the Netherlands on its own.

considered as an implementation union wide (i.e. the whole EU) or worldwide for the purpose of this thesis.

1.5 Structure of the thesis

In order to address the research question the following structure is used for this thesis. For the purpose of understanding the digital economy, the main business models of the digital economy are examined. Subsequently, the taxation issues of these business models are addressed. Because the digital economy consist of many different and constantly evolving business models, solely the most common business models are described. This part of the thesis ends with an answer to the question how the digital economy differs from the traditional economy. In order to obtain an image with respect to possible deficiencies in taxing the digital economy with respect to international profit allocation, an example is made. The example is the situation where a digital economy company reduces its ETR. International profit allocation is part of the structure in the example. The principles of the taxation of the digital economy formulated by the OECD (the Ottawa principles) are outlined as well. The choice for the Ottawa principles has been made because the OECD uses academic sources for their research, is representative and has political influence in the international taxation discussion. In the end of this thesis part the question will be answered what the tax challenges are in the digital economy and what the Ottowa principles consist of.

Thereafter, the current international profit allocation rules on PE and TP are researched by describing their basic aspects. With respect to the PE concept, the qualification of substance in a state is addressed. Emphasis lays on digital selling points that may not result in a PE. The OECD PE standard is used as reference point. With respect to the TP concept, emphasis lays on companies which are associated with a huge amount of intangibles. Then the possible deficiencies of the taxation of MNEs and the relation with the digital economy are outlined. In the end of this part of the thesis the question whether the PE and TP concepts contain deficiencies for taxing MNEs in the digital economy will be answered.

Furthermore, the principles of international taxation are addressed. In order to compare the PE and TP properties with CFT, the principles of international taxation can be used as an explanation of whether current international profit allocation rules contain deficiencies for taxing MNEs.

A CFT is not based on the source and residence principle and therefore may give an alternative opportunity for the current rules of international profit allocation. In principle, a CFT does not affect investment decisions regarding the location of a jurisdiction nor needs physical substance but is rather based on the destination of consumption. If the current international profit allocation rules

give such deficiencies that MNEs cannot be taxed in a sufficient way, a CFT on profits that is destination and consumer based, may give a solution. Therefore, this thesis focusses on a CFT that can be seen as most realistic, that is the R+F base CFT. Then a comparison of the R+F base with the PE and TP concepts in the digital economy can be made with guidance of the international and Ottawa taxation principles. It is important to notice that the CFT theories are explained generally in this thesis. That is because this thesis is primarily fiscal-juridical. The mathematical/economic analyses of the CFT that have been done by academic researchers are not challenged or recalculated in this thesis. Other platforms or study disciplines are more suitable for such analyses. In the end of this part of the thesis the question will be answered what CFT contains, which CFT system is the most appropriate and if it can be an alternative solution current international profit allocation deficiencies in the digital economy. This will be done by putting the CFT concept next to the PE and TP concepts with the help of the international and Ottawa taxation principles.

Note that this thesis is focused on international direct taxation of company profits. It is not in the scope and the purpose of this thesis to examine the indirect taxation (for example: VAT) aspects of international taxation.

1.6 Research method

As research method with respect to the digital economy, the Ottawa principles and international taxation principles, conventional academic literature is used in combination with government and OECD reports (BEPS action plans). For the PE and TP concepts more specific academic literature and reports are used. The tax planning example that is used in this thesis is abstract. The example is based on a combination of examples used in literature and based on structures that are used in practice. This thesis analyses the theory of CFT by examination of especially Anglo-Saxon scientific studies of which the outcome is described in papers and other scientific publications. The conclusions of all the subparts are combined in order to formulate a final conclusion.

2. The digital economy

2.1 Introduction

This chapter first describes the definition of the digital economy. Then the commonly used business models in the digital economy are investigated and issues regarding taxation thereof. Subsequently, an abstract example is given of a company structure where deficiencies regarding international profit allocation are outlined.

2.2 The definition of the digital economy

There is not yet a universal definition of the digital economy but the OECD and the EC are in the process of formulating a definition.[19] The OECD sees the digital economy as a result of a transformative process brought by information and communication technology (ICT).[20]

For the purpose of this thesis the digital economy is characterized as:

'The section of the economy where ICT and all its additional digital aspects are used, applied and of influence.'

This characterization has been made as broad as possible, because companies that operate or are part of the digital economy are changing all sectors of the economy, come in all sizes and serve hundreds of millions of users.[21] A too narrow definition may let relevant subjects be left unnoticed.

2.3 The different business models of the digital economy

2.3.1 Introduction

Every sector in the economy makes use of ICT for several business reasons because the traditional business models of MNEs have been transformed into models that make use and are dependent of interconnection through the internet.[22] Cost reductions (e.g. transport and administrative) thanks to digitalization let MNEs take advantage of the global environment. It is possible for MNEs to manage the development, research, design and production in a central place and use suitable countries for

[19] In literature Hellerstein even makes the equation with pornography: "we know it when we see it" to define the digital economy. See Hellerstein 2014 p. 346
[20] Action Plan 1 Digital Economy September 2014, p. 11
[21] Collin & Colin 2013, p. 2
[22] OECD BEPS Action Plan 1 of September 2014, p. 71

specialized parts in the business model. These so called 'highly integrated global enterprises' have specific characteristics. For example the use of new financial products that put pressure on many traditional tax concepts and have increasingly mobile tax bases.[23] Another huge advantage of the digital economy is that profit can be earned on a place where there is no physical presence required. As the digital economy business models result in tax challenges it is important to describe the business models that are used in the digital economy. For the purpose of this thesis certain business models will be described: firstly the concept of e-commerce secondly other business models that (partly) is depending on ICT.

2.3.2 E-commerce

In order to define e-commerce, the recent OECD BEPS report definition is used:

"The sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing orders. The goods and services are ordered by those methods, but the payment and the ultimate delivery of the goods or service do not have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organizations".[24]

For e-commerce a difference is made between (i) (completely digital) goods and services that are fully ordered, paid and delivered online, (ii) goods and services that are ordered, paid and delivered and where somewhere in that process still physical (not digital) events occur and iii) e-advertising, the selling of online behavior of users and (potential) customers. Continuing, three prominent types of e-commerce can be distinguished: *business-to-business* (B2B), *business-to-consumer* (B2C) and *consumer-to-consumer* (C2C) models. B2B consists of a business that sells products or services to another business. It is the most used part of e-commerce and it includes online versions of traditional transactions where a wholesaler purchases a good online and sells it to consumers from retail stores or outlets.[25] B2C is selling goods or services to individuals that are acting out of their profession. The goods or services can be tangible or intangible and if the goods or services have the right properties, they can be delivered digitally to customers from the location of the seller.[26] C2C business models contain only consumers selling to consumers and the profits are made by intermediaries that help individual consumers to sell or rent their assets and charge the consumer or the seller that gain profit from the consumer for their services. All types of e-commerce can vary in

[23] Burgers & de Haan 2011, 7.1.1
[24] OECD BEPS Action Plan 1 of September 2014, p. 74
[25] OECD BEPS Action Plan 1 of September 2014, p. 74
[26] OECD BEPS Action Plan 1 of September 2014, p. 75

the degree of using computer networks for ordering, paying and delivering. The bandwidth varies from only ordering online to fully order, pay and deliver online. This is important because the more computer networks are used in a production to delivery process, the more difficult it is to find reference points for taxing profits.[27]

2.3.3 Prominent digital economy business models

Other typical and prominent digital economy business models according to the OECD are: payment services, app stores, online advertising, cloud computing, high frequency trading and participated networked platforms.[28] These business models are summarized below including their revenue models. It should be noticed that these business models may overlap or partially contain the same properties.

Payment services

Because the payments for online transactions contain sensitive and confidential financial information, the payments need to be secure. Therefore payment service providers act as intermediaries between online purchasers and sellers, in order to structure a secure way of payment. The revenue model of payment service providers is the fee charge for each completed transaction.

App stores

App stores charge fees for providing the platform to sell apps. The apps themselves are digital products that can be downloaded, installed and used on hardware. The revenue from an app is diverse, some apps require fees for downloading and others are free but generate revenue by earning from membership costs, costs for additional futures or advertising through the app. Also for other software (e.g. games) these revenue models are used.

Online advertising

Regarding online advertising, the revenue models are diverse. Online advertising differs from its traditional equivalent because it is able to interact with customers and consequently gain data. For example, a popular online platform gains data from its customers, users and visitors. This data can be used targeted in order to reach the right potential customer. Payments are subject to new

[27] Lambooij 2001, 6.3.4
[28] OECD BEPS Action Plan 1 of September 2014, p. 74 and further contains a summary of the different and prominent business models that are used in the digital economy.

calculation methods where per click, per action or per thousand message displays, the used platform receives revenue.

Cloud computing

Cloud computing is the use of shared physical and virtual resources for provision of standardized, configurable, on-demand online computer services (e.g. computing, storage, software and data management). Revenue is mostly generated through advertising, data sale on user behavior or the payment for expanded services on at first instance free basic services. Revenue can also be acquired by monthly subscription for the usage of storage or starting fees. The cloud computing services are provided online and the location of the storage devices does not matter in principle.

High frequency trading

The location of the servers for high frequency trading is extremely important. The trades are completely electronic and do not require personnel in the state where the infrastructure that makes the trades is located. But because of the aspect of the business that requires extremely fast trades, an advantage is a server that is located close to the relevant exchange. The trades are made by complex lagorithms and therefore successful trading depends on several factors. The revenue is received by a fee per trade (fixed or a percentage of the realized profit).

Participative networked platforms

The concept of participative networked platforms is the collaboration and contribution for user-created content (UCC) for a certain platform. An intermediary receives revenue in various ways. Examples are per-item charges (i.e. every article that can be read needs to be paid for), advertising-based (also data supply) and 'voluntary' contributions with the possibility of sharing in the profit for the contributor (a form of crowdfunding).

The revenue models of the described business models are, just like the business models itself, ranging and overlapping. Because the possibilities of the internet are extremely diverse, a large range of revenue models are possible.

2.3.4 Characterization of the digital economy business models

The digital economy business models contain characteristics differ from the traditional business models. Firstly, the increased mobility of consumers and sellers thanks to ICT, results in difficulties with respect to location identification. In the section of e-commerce, sales can be made through a web page located on a server in state A, the payment through a server that only works as an

intermediary in state B and the delivery can be managed in State C, while the customer is in state D and the seller in state E. On top of this, the website could be managed in state F and the payments could be managed in state G. Secondly, the mobility of intangibles, users and business functions are relevant from a tax perspective and characterize the digital economy.[29] The development and exploitation of intangibles are key features of the digital economy: it creates value and economic growth for MNEs.[30] The rights to those intangibles can be assigned and transferred to associated enterprises in other states. The legal ownership of the assets then may be separated from the activities that resulted in the development of those assets. Thirdly, business functions can be managed from one place thanks to ICT. Therefore MNEs can separate the locations where the operations are carried out from the locations where the suppliers and customers are located.[31] A combination of these aspects results in an arguably different situation in comparison with the pre-Internet period. The source and territory allocation of the place where the value is added and the income is created, is more difficult to effectuate. Also the calculation of the value adding factor of highly complex digital technology (i.e. logarithms) and intangibles is complex and (overhead) costly.

2.3.5 Tax aspects of the business models

The above mentioned business models have specific characteristics which differ from the traditional economy. Subsequently, from a tax angle differences arise. As we have seen, a company is able to sell a product in a state, without the need of physical presence in that state. Because international taxation is partly based on the residence principle, a physical presence may be needed to create taxability. Thereby, the used business models are susceptible to allocation issues. Because functions and risks can be allocated to entities in low-taxed states or intangibles (that are highly prominent in the digital economy) and the management of the intangibles can be allocated to a state by choice.[32] Consequently MNEs are able to assign taxable risks and functions because of their value creating properties, to a subsidiary that is situated in a low-taxed jurisdiction according to the residence principle. These issues are related to international profit allocation. The PE and TP concepts and their relation to the digital economy will be outlined further on.

2.4 The OECD BEPS report on the digital economy

[29] OECD BEPS Action Plan 1 September 2014, p. 84
[30] OECD BEPS Action Plan 1 September 2014, p. 85
[31] OECD BEPS Action Plan 1 September 2014, p. 85
[32] OECD BEPS Action Plan 1 September 2014, p. 84

The BEPS Action Plan contains 15 actions with the main goal to counter BEPS.[33] In Action Plan 1 the OECD describes the BEPS report and the work that has to be undertaken to address the tax challenges of the digital economy. The OECD has stated in the last publication of Action Plan 1 that the digital economy does not form a separate part of our economy. According to the OECD a stand-alone solution is not needed because "the other actions will be appropriate in order to challenge the issues of the digital economy".[34] Amongst others these "other actions" consist of examinations on the PE and TP concepts. However, the OECD concludes that the taxation in the digital economy contains several points of attention. The report mentions that the digital presence (mostly a server) does not provide sufficient substance for taxation. If there is substance, issues arise in other states to find a starting point to realize taxation. It is admitted in the report that it is difficult (even when sufficient presence for realizing taxation can be recognized) to calculate and allocate the profit and the value of the digital services that are attributable to the digital instrument. Even by determining a subject and an object it can be hard to factually realize taxation.[35] These points of attention can be linked to the PE and TP concepts of international taxation. However, it can be argued whether the OECD adopts the right view by solely treating these concepts separately and not by treating the digital economy as a challenge on its own. If the digital economy contains many opportunities for MNEs to reduce their ETR, it can be argued whether the digital economy not indeed forms a separate part of the economy. Digitalized products that are sold in a digitalized way (i.e. app stores, big data, cloud computing) may not be in line with the current taxation concepts at all. If these concepts are not sufficient, alternatives has to be thought off. The OECD may pass this issue too easily, by in fact admitting the challenges of the digital economy but with the lack of addressing them as a stand-alone issue.

2.5 An example of a tax planning structure of an MNE in the digital economy

MNEs may be able to use tax planning structures that allow them to decrease their ETR. International tax planning may be done by the use of tax treaties, fiscal concepts of profit attribution (e.g. PE and TP concepts), mismatches because of domestic tax rules and differences in tax rates between states. The following example is an abstract image of a company structure in the digital economy where international profit allocation is part of the taxation.

[33] OECD (2013), *Action Plan on Base Erosion and Profit Shifting,* OECD Publishing.
[34] BEPS Action Plan 1 2014 September
[35] Kavelaars 2014, p. 1

Company X sells software products online, namely applications for tablets and computers in state A and B. Company X wants to structure its company tax efficiently (with the lowest ETR possible) in order to reduce costs and maximize profits for its shareholders. X is established with entity X in state A, a state with a medium-low CIT rate (i.e. 10%) and the possibility to conclude an Advance Pricing Agreement (APA) with the tax authorities of state A. Company X has an enterprise in state B and state C. State B has a CIT of 40% and state C has a CIT of almost nihil.

Because of the relatively high CIT rate in state B, company X does not want to constitute a PE in state B because that would mean the profits made through the enterprise in state B are taxable in state B according to art. 7 OECD MC. The sale of the products in B only go via a web store. Because of PE rules (art. 5 OECD MC) it is possible to not let a PE be present in state B. The profits that arise from the sales in state B are only taxed in state A against a relatively low CIT rate of 10%.

Furthermore company X transfers intangibles and other mobile assets to its enterprise in state C. These intangibles as trademarks, patents, trade names, designs and models, literary and artistic property rights, know-how and trade secrets are highly available in company X, because they add value to the applications. Tt allocates almost all the risks and functions of their product development to state C. Company X wants to constitute a PE in state C in order to tax the profits that arise there be taxed against the nihil CIT rate. A significant part of the value creation of the products is allocated with the help of the arm's length principle (art. 9 OECD MC) to state C with a CIT rate that is practically nihil. Because company X makes use of the intangibles that are located in state C, the profit in state C arises because of the remunerations that are made to state C in order to use the intangibles and to pay for the risks and management of the intangibles in state C.

In conclusion, the ETR of this company can be reduced. Besides VAT that is paid by the product consumers in state B where the products are sold, nothing is taxed in state B. Consider this example when state B represents an amount of states where enterprises of a State A entity X are present. Products can be sold online but the profit gained in the states where the selling has been taken place cannot be taxed by these states. In addition a huge amount of profit is shifted to 'tax havens' (i.e. jurisdictions with nihil or almost nihil tax rates). A company then can significantly reduce its ETR.

2.6 The Ottawa principles

On March 24 2014 the OECD has published a public discussion draft as a result of research done by the Task Force on the Digital Economy, a subsidiary body of the Committee on Fiscal Affairs (CFA).[36]

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[36] OECD, *Public Discussion Draft, BEPS Action 1: Address The Tax Challenges Of The Digital Economy,* OECD Publishing 2014

The Task Force emphasizes that they still support the principles of the "Ottawa Ministerial Conference on Electronic Commerce". These principles contains five criteria that apply to taxation of e-commerce:[37]

Neutrality
Taxation between different forms of electronic commerce and between 'conventional and electronic commerce' should be neutral and equitable.

Efficiency
The minimization of the administrative burdens for taxpayers and tax authorities.

Certainty and Simplicity
Tax rules should be clear and simple, so taxpayers can anticipate on the tax consequences in advance of a transaction.

Effectiveness and Fairness
Taxation should be take place at the right time and produce the right amount of tax. Minimization of the possibilities for tax evasion and avoidance with the remark that anti-abuse measures should proportional to the involved risks.

Flexibility
The taxation systems should contain flexibility and dynamics to ensure that they keep pace with technological and commercial developments.

Nonetheless the main problems of the digital economy are outlined in broad categories by the OECD. These so-called 'policy challenges' are summarized as follows.[38] Firstly a nexus problem: the reduced need for businesses for extensive physical challenges. Secondly the difficulties in attributing value created by data and totally digital products. Thirdly uncertainty in the characterization of payments made in the context of new business models because new digital products and delivering services create these uncertainties. The first problem can be linked to the PE issues and the second and third problem can be linked to the TP problem, both discussed in further chapters.

2.7 Conclusion of the digital economy

For the purpose of this thesis the digital economy is characterized as the section of the economy where Information and Communication Technology (ICT) and all its additional digital aspects are

[37] Hinnekens 1999, p. 440
[38] OECD, *Public Discussion Draft, BEPS Action 1: Address The Tax Challenges Of The Digital Economy,* OECD Publishing 2014, p. 56

used, applied and of influence. The OECD BEPS report on the digital economy states that the digital economy does not need a stand-alone approach. This statement may be incorrect because the digital economy contains many opportunities for MNEs to reduce ETRs. Because current rules do not seem to be sufficient, alternatives may be needed for aspects of the digital economy. The digital economy then needs to be addresses on a stand-alone basis. Furthermore, thanks to ICT opportunities the business models of MNEs have been changed and consist of characteristics that are inherent to the digital economy. The mobility of users, intangibles and business functions have been changed and therefore MNEs are able to choose the location of profit. Therefore structures of tax planning can be created by MNEs that result in tax evasion and low ETR's. Such structures have been explained with the help of an example in where ETRs can be reduced by a company with many intangibles with the use of international profit allocation. The Ottawa principles are formulated by the OECD and contain of the principles neutrality, efficiency, certainty and simplicity, effectiveness and fairness and flexibility.

3. International profit allocation in the digital economy

3.1 Introduction

International profit allocation in the digital economy is addressed in this chapter. Firstly the PE concept and possible deficiencies with respect to substance is described. This chapter first describes the main aspects of the PE concept. Secondly the substance qualification is outlined with emphasis on the physical presence of a PE and the exemptions for preparatory and auxiliary agent type activities of the PE. Thirdly, the PE concept in combination with digital selling points is set out. This chapter then outlines the basic TP concept. The commissionaire structure with use of the PE is outlined after the TP concept. In the conclusion an answer will be given on the question whether the PE concept and TP concepts contain deficiencies for taxation in the digital economy.

3.2 The basis of the permanent establishment concept

In principle, a tax treaty provides the possibility for a resident state to exclusively tax business profits derived by an enterprise. However, as stated in art. 7 OECD MC, if the enterprise carries on a business through a PE, the source state may only tax the profits that are attributable to that PE.[39] The requirement of a sufficient level of economic presence indicates that the PE concept is based on the source principle because this presence requirement ensures that a source country is able to impose tax and has enforcement jurisdiction.[40] The PE is defined in art. 5(1) of the OECD MC as 'a fixed place of business through which the business of an enterprise is wholly or partly carried on'. Three criteria are distinguished.[41] First there needs to be a *place of business* that is at the disposal of a parent (the "right-to-use test"). This place of business necessitates some physical presence, some premises or equipment, which are used in the business. Second the place of business must be *fixed (*the "location test").[42] Therefore, it needs a distinct place that contains some degree of permanence (the "duration test").[43] Third, in addition to the fixed place of business, it is necessary that the enterprise that owns it needs to wholly or partly carry on its *business through* that fixed place of business (the "business activity test").[44]

[39] OECD Digital Economy 2014, p. 39
[40] OECD Digital Economy 2014, p. 39
[41] Holmes 2007, p. 151
[42] Holmes 2007, p. 151
[43] Schoueri & Günther 2011, p.69
[44] Holmes 2007, p. 151

3.3 The substance qualification of the PE concept in the digital economy

3.3.1 The physical presence

The existence of a PE is the minimum connection that is required for the source-based taxation of active business profits.[45] This minimum connection is based on a physical presence. In traditional commerce a threshold can be applied with coherence and certainty in order to attribute business profits to the more substantial and long-term presences of a corporation in a jurisdiction.[46] But in the digital economy enterprises can be part of the economy of a country without maintaining a physical presence in that country. Profits that arise may not be taxed by source countries, unless perhaps a computer server through which core activities are conducted is maintained in the source country.[47] The OECD makes the distinction between a server on the one hand and only software and data on the other hand.[48] As is clear from the OECD Commentary and the changes on art. 5 of the OECD MC, the OECD rejected the view that when there is solely a website and the website has the server at its own disposal, the website could be regarded as PE.[49] The OECD only stipulates that a piece of computer equipment in a specific place cannot constitute a permanent establishment unless it is fixed. That means the OECD excludes for example any application operated from a cloud computing platform from the PE definition.[50] Also solely the existence of a website selling products can in that way be excluded from the PE definition.

3.3.2 Preparatory or auxiliary activities and the agent clause

Paragraph 4 of the PE definition in art. 5 OECD MC states that “notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:” and then lists events that do not constitute a PE. With the application of this paragraph PE issues can occur that relate to e-commerce operations carried on through computer equipment. If the overall activity of such an equipment is solely of a preparatory or auxiliary character, there may be no PE.[51] If an enterprise carries on business of selling products through the internet in a certain state, the enterprise is not in the business of operating servers. It is not enough to conclude that the activities performed are more than preparatory or auxiliary. If the activities on the internet is exclusively used for advertising, displaying a catalogue of products and providing information to potential customers,

[45] Pinto 2006, p. 273
[46] Pinto 2006, p. 273
[47] Pinto 2006, p. 273
[48] Collin & Colin 2013, p. 113 and see also art. 5 OECD MC Commentary 42.4
[49] OECD Digital Economy 2014, p. 168
[50] Collin & Colin 2013, p. 114
[51] Art. 5 OECD MC Commentary 42.7

there will be no constitution of a PE.[52] Furthermore, websites will not constitute an agent (and thus possibly a PE) of paragraph 5 of art. 5 OECD MC, because an Internet Service Provider (ISP) will not have the authority to conclude contracts in the name of the enterprise. Thereby an ISP will not regularly conclude contracts. This paragraph cannot apply for a PE to exist by virtue of the website being an agent of the enterprise.[53] As has been stated in the substance paragraph of this chapter, this means that solely the existence of a website selling products is not excluded in the PE definition.

3.3.3 The permanent establishment and digital selling points

The principle of the PE has source principle aspects because it taxes items of income that have a reasonable nexus with the territory of the source state. A physical connection is needed. Because the source principles is concerned as more legitimate than the residence principle, the PE has been added in the legislation in order to act as a counterweight against the normal business profit principle that is based on residency. However, taxation problems occur with the PE. Multinationals avoid a PE status in their tax planning in order to reduce their ETR, as has been outlined in the example of chapter 3. Furthermore, the OECD denies the PE definition to be expanded with a virtual permanent establishment in order to, for example, address cloud computing tax issues. The virtual permanent establishment has been introduced as a solution to several PE issues. The thought behind a virtual PE is theoretically that in order to include income associated with the digital presence of a company in a country, the PE concept should include digital presence.[54] A company providing services in a country that exists of collecting data through regular and systematic monitoring of users in that country (also referred to as 'big data') could be having a PE in that country, in case of a virtual PE concept.[55] Also the placement of cookies (technical tools used by businesses to collect user data, notably for commercial purposes such as behavioral advertising[56]) on the computer of a user can be a profit making activity. That is because the placement of a huge amount of cookies in a certain jurisdiction generates the above mentioned big data that can be sold to parties that use the information for consumer behavior. The problem that arises is that this profit generating activity is difficult to allocate to a jurisdiction for taxation purposes. For instance, if a company that is established in state A places cookies on the computers of a million users in state B via the website that is managed in state A, the question is where this big data generating activity will be taxed. It seems impossible to establish a PE in state B with the current PE rules and because the concept of a

[52] Art. 5 OECD MC Commentary 42.9
[53] Art. 5 OECD MC Commentary, 42.10
[54] Hellerstein 2014
[55] Collin & Colin 2013, p. 115
[56] OECD BEPS Action Plan 1 September 2014, p.56

virtual PE does not exist. For the future it is uncertain what technologies will add to the digital economy.[57] Though it is certain that technology is able to let MNEs artificially decide whether a PE exists at the place they choose. If the above mentioned physical presence is not met, the activity is solely preparatory and auxiliary and there is no agent, there will not be a PE. MNEs can on the other hand frustrate a PE if that is tax efficient, for example when in the state the CIT or withholding taxes are lower than the residence state. The PE concept is sensitive, as we have seen in the example of chapter 2, for abuse in new business models. Because of the characteristics of the digital economy it is possible for MNEs to choose the location where the profit is made according to the current international profit allocation rules.

Furthermore, the OECD should be aware that the source principle may become obsolete because not only (human) individuals create income but also highly complex machines may create income. The interaction between the residence and source principle creates nexus difficulties which seem to be mostly an opportunity for MNE's that are active in the digital economy. Therefore, it is not unlikely that more problems will occur regarding the permanent establishment in the future of the digital economy.

3.4 The basis of the TP concept

Tax authorities can adjust the transaction price of goods and services that have been sold between related parties, to the terms that would have been negotiated had the parties been unrelated to each other. In that way authorities should be able to determine the proper allocation of profits that may be generated between related entities.[58] This "arm's length principle" is the standard that is applied in tax treaties to the concept of TP. The arm's length principle is set out in art. 9 OECD MC and is mostly reflected in domestic law.[59] Art. 9 OECD MC, which is used in many bilateral treaties, can be seen as a supplement to art. 7 OECD MC and provides a quantification of the income between associated enterprises to which contracting states are ascribed under taxing rights of art. 7 (1) OECD MC.[60] The arm's length principle is the base of the rules that are set in the Transfer Pricing Guidelines of the OECD.[61] The basis of the arm's length principle is the 'separate entity approach':

[57] For example, drones will changes the supply chain of companies and may change the current worldwide structure of companies.

[58] Avi-Yonah 2007, p. 11

[59] Art. 9 OECD MC Commentary, par. 1. See for an example art. 8b of the Dutch Corporate Income Tax Law (in Dutch: "Wet op de Vennootschapsbelasting 1969" or the "Vpb 1969")

[60] Cottani 2014, p. 22

[61] Cottani 2014, p. 1

associated enterprises or PE's need to be treated as dealing with other related parties as if they are independent.[62]

In principle, business profits are taxed according to the residence principle. Subsequently, if there is a PE, the taxation occurs on the basis of the source principle. Then, if there are intra-group transactions, the 'arm's length' principle shows up. As mentioned above, these intra-group transactions must be undertaken under the conditions which would have been obtained between independent enterprises in comparable transactions and comparable circumstances.[63] Profit attribution on an arm's length basis would thus be in line with the source principle.

3.5 TP problems with intangible assets

A principle TP problem that effects the taxability of the digital economy is the area of intangibles. Intangibles are often referred to as the most complicated area of TP.[64] TP is not purely a digital economy issue, but MNE's that are active in the digital economy can use TP issues with respect to intangibles in order to lower their ETR.[65] In an international view, the changes of technology have affected the TP policies of MNEs and created possibilities for restructuring supply chain activities within groups in order to affect the taxable base.[66] Transferring the intangible assets takes place irrespective of its legal identification in cross-border restructuring.[67] The first problem of intangibles is that it is difficult to determine the important risks and functions of an intangible for the justification of an intangible related return.[68] For example, risks of intangibles are associated with future earnings and future earnings cannot be determined exactly.[69] The arm's length principle is difficult to apply to controlled transactions that involve the transfer and exploitation of intangibles for commercial purposes.[70] Intangibles have special characteristics and may be only applicable for a certain industry, so the determination of the value can be very suggestive. Thereby the intangible is at the time of transfer only partially developed.[71] There is also an information asymmetry between the tax administration and the taxpayer that may result in a too high or too low valuation of an intangible. If the risk and/or function of an intangible needs to be allocated to a PE in a low-taxed state, the valuation may be higher and so the remuneration on the intangible increases. The high-

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[62] Cottani 2014, p.19
[63] EC Report 2014, p. 45
[64] Cottani 2014, p.123
[65] EC Report 2014, p. 43
[66] Cottani 2014, p. 2
[67] Cottani 2014, p. 87
[68] Cottani 2014, p. 94
[69] Fuest e.o. 2013, p.311
[70] Cottani 2014, p. 95
[71] Fuest e.o. 2013, p. 311

taxed state entity that pays the remuneration on the intangible can lower their fiscal profit. Two 'wins' appear for the MNE: a lower profit because of the deductible costs in the high-taxed state and a higher profit in the low-taxed state. Note that in most structures the low-taxed PE may only "on paper" contain risks and functions but still the capital and labor is created in the high-taxed entity. We have seen this deficiency in the example of the digital economy chapter 2.

As we have seen, it is difficult valuating the allocated profits on intangibles. This problem is inherent to the arm's length principle, which is in essence a source-principle. The arm's length principle may let tax authorities require MNEs to allocate their profits rightly. However, because of the information asymmetry and the difficulty of valuation, the TP rules may not be rightly applicable to MNEs with a lot of intangibles and mobile capital. If these intangibles are unique and only applicable on this specific MNE, it is almost impossible to calculate the correct remuneration that a third party would pay for this certain specialized intangible. For example, when an MNE has a monopoly as the supplier of a good, there are no other potential purchasers of the patents that the monopolist MNE owns. This means the value of the patent cannot be calculated completely correctly with the arm's length principle. The value of the patent will become different when the monopoly position is breached. Also when the patents are only useful if these patents are combined with each other, a separate patent can be seen as value = zero. In real the patent should be worth more when a third party would purchase both patents.[72] Furthermore, the APAs are amongst others a result of the complexity TP issues combined with the risk of TP audits.[73] Although the OECD has brought more guidance on TP aspects of intangibles in addition to the TP Guidelines, the fact that the OECD still needs 33 (!) examples is a prove that this is a too complex and uncertain part of international taxation.[74] These examples do not formulate a workable definition and they do not specify the essential characteristics of intangible property.[75] The fundamental problem of any source-based tax is that allocating profit among source states is complex and uncertain and sometimes conceptually meaningless.[76] The TP deficiencies are connected with the PE deficiencies. MNE's that are predominantly active in the digital economy use a combination of the TP and PE issues and can erode their tax base, shift profit and therefore lower their ETR. Because intangibles are highly present in MNEs that are active in the digital economy, this area is extra sensitive for tax planning.

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72 Auerbach, Devereux & Simpson 2008, p.33
73 Cottani 2014, p. 156
74 OECD TP & Intangibles 2014, p.6
75 Cottani 2014, p. 125
76 Auerbach, Devereux & Simpson 2008, p.34

3.6 Commissionaire arrangements and similar strategies

A commissionaire agreement consists of a structure where certain activities in the value chain are reclassified in order to avoid high taxation in a state. Amongst others the purpose is the assurance that there is no PE in such a (high-taxed) state. We have also seen this in the above mentioned example. Subsequently, a subsidiary acts as a distributor and becomes an agent that is linked to a group of entities by a commissionaire contract. The sales revenues are reduced to only the agent's commission and the entrepreneurial risks are only related to the activity of the agent. A commissionaire arrangement does not constitute a PE and the state is deprived of its power to tax the parent company.[77] These structures can be advantageous from a tax perspective.[78] Because the entities that can be seen as the source entities strip their original functions and risks and act as commissionaires for a low taxed entity that acts as a principal, the last company has the substantial low taxed income.[79] The last company is not the company where the labor and capital is situated. Because of the residence principle the low taxed entity is taxed in a tax haven. Because of the source principle states want to tax the PE's, but if a PE can be avoided by such a principal and commissionaire structure, the concept does not work out well. This problem is challenged by the OECD in their Action 7 of the BEPS Action Plan.[80] However, reducing ETR's of digital economy companies is still possible by using the PE and TP deficiencies. We have also seen this in the example of chapter 3. The digital economy makes it easier for MNEs to structure their companies with commissionaires. Technology removes communication and transport problems and makes the managing of commissionaire arrangement easier and more efficient. Intangibles are key aspects of software and highly present. Because intangibles are very mobile, they can be transferred more easily. These intangible aspects creates opportunities for MNEs to structure their company tax efficient.

3.7 Conclusion of international profit allocation in the digital economy

This thesis stipulates three main problems of the PE concept. First, there is the problem of the requirement of physic presence. In the current changing business environment it is possible that profit is earned in a state where there is no physical presence. Because international taxation rules do not constitute a PE, nothing is taxed in that state. The second problem is the impossibility of constituting a PE when there is solely a preparatory and auxiliary character. Third, a PE cannot be

[77] Collin & Colin 2013, p. 18
[78] Cottani 2014, p. 6
[79] Cottani 2014, p. 90
[80] OECD BEPS Action Plan 7 2014

constituted when a profit making object cannot conclude contracts as a person and therefore cannot be an agent. Concluding, the PE concept cannot let digital selling points be a PE. Furthermore, the use of a commissionaire structure in order to not let a state conclude that there is a PE, is easier because in the digital economy there are no transport or communications issues anymore. The virtual PE may be a solution but is not adopted by the OECD and future changes in the digital economy may cause new problems that result in continuous changes of the PE definition and opportunities for MNE's in order to misuse the definition. The PE concept is based on the source principle and is an adjustment of the residence based business profit taxation principle. Because the PE concept is a consequence of the source principle and with the residence principle laying in the basis of the taxation, the conclusion is that the idea of the PE creates problems with respect to current international taxation principles. The characteristics of the digital economy create possibilities for MNEs to choose the location where the profit is made, according to the current international profit allocation rules. Therefore an MNE can shift profit easily to states where it is taxed most efficiently.

The TP issues in combination with the use of intangibles have been discussed. The arm's length principle is the base of TP and can be seen as part of the source principle. With respect to intangibles, the valuation is difficult and can be arbitrary because of information asymmetry. The fundamental problem of any source-based tax is that allocating profit among source states is complex and uncertain and sometimes conceptually meaningless. The OECD guidelines do not supply sufficient information for determining the right prices. Because the MNEs that are active in the digital economy have a lot of intangibles on their balances and work as innovative companies, they are very susceptible for TP issues on intangibles. Intangibles are a key factor of the digital economy and because of their mobility, MNEs can move intangibles and so the remuneration on the intangibles to low-taxed states by establishing a PE. Therefore MNEs can use these TP issues in order to lower their ETR. Because both the PE and TP issues are source principle based it can be concluded that the source principle (also in combination with the residence principle) is not sufficient enough for taxing MNEs in the digital economy.

4. The basic principles of international taxation

4.1 Introduction

This chapter firstly outlines the legal and economic principles of international taxation. Secondly the Ottawa principles will be described. The chapter ends with a conclusion. The principles will be used in order to offset the properties of CFT with the PE and TP concepts.

4.2 The legal and economic principles of international taxation and the Ottawa principles

International tax law concerns situations where two or more states levy taxes, mostly resulting in double taxation. In general, double taxation consists of a taxable (legal) person that is *subjected* to one state but receives proceeds from an *object* of another state.[81] Both states have jurisdiction to levy taxes: the state where the person has its residence and the state where the person receives its proceeds (the source state).[82] This may result in double taxation or double-non taxation and therefore international tax law contains legal and economic principles of taxation in order to allocate tax jurisdiction. Non-taxation may occur when mismatches arise and MNEs may use it to reduce their ETRs. The international taxation principles are relevant because international profit allocation is based on principles of international taxation. The principles of international taxation can be used in this thesis to compare the PE and TP concepts with CFT in a legal way.

The Ottawa principles are more based on political and ethical principles of taxation. Not the legal and economic characteristics of taxation are outlined but these principles are more based on how in an ideal world the digital economy should be taxed. The Ottawa principles are relevant because they show the purpose of the OECD countries. These principles can thereby be used to compare the PE and TP concepts with CFT.

4.3 The legal and economic principles of international taxation

4.3.1 International double taxation

Literature speaks of two forms of international double taxation: international juridical double taxation and international economic double taxation. International juridical double taxation is generally defined as ‘the imposition of comparable taxes in two (or more) states on the same

[81] Van Raad 2012, IBR 0.1
[82] Van Raad 2012, IBR 0.1

taxpayer in respect of the same subject matter and for identical periods'.[83] International economic double taxation is defined as 'the imposition of taxes in two (or more) states on the same economic transaction, item of income or capital during the same period, but in the hands of different taxpayers'.[84]

Economic double taxation can for example occur if state A -as the source state- qualifies the proceeds of a right to profits as a dividend. Subsequently state A taxes the proceeds with withholding tax. But on the other hand state B -as the resident state- as the receiver of the proceeds, taxes the proceeds as normal profit of the company. Consequently if there exists no permanent establishment in the source state (State A), the right to levy will fully accrue to the resident state (State B) and the source state shall not be obliged to credit the withholding dividend tax, which is already levied by the source state.[85] This results in unintentional double taxation. The distinction of both definitions (economical or juridical double taxation) is of importance because in principle tax treaties contain rules to avoid international juridical double taxation.[86] Since tax treaties are mainly based on the OECD Model Convention (OECD MC) with the PE concept in art. 7 and the TP concept in art. 9, international juridical double taxation is addressed also by both PE and TP concepts.

In order to allocate taxation rights to a jurisdiction, economic principles should be a factor of influence in addition to the legal principles of international taxation. As discussed above and as commonly accepted, taxation should be neutral and minimize the effect on business and investment decisions, as business and investment decisions should be based on obtaining the best pre-tax rate of return.[87] In literature the distinction of capital export neutrality (CEN) and capital import neutrality (CIN) is used in order to study the tax effects on international factor allocation.[88] With the CEN and CIN definitions a qualitative research can be made on CFT in comparison with the PE and TP concepts and how they relate to each other and how they affect economically. The following paragraphs contain a brief overview of both definitions and their properties.

4.3.2 International double non-taxation

Initially intended as prevention of double taxation, non-taxation may be an outcome of the international tax (treaty) system. International non-taxation is unwanted because it creates inequality or tax gaps for governments. It gives a taxpayer a competitive advantage compared to

[83] Kemmeren 2001, p. 12
[84] Kemmeren 2001, p. 14
[85] Van Raad 2012, IBR 1.1.2
[86] Van Raad 2012, IBR 1.1.2
[87] Kobetsky 2011, p. 18
[88] Kemmeren 2001, p. 71

other taxpayers who are subject to ordinary taxation. Non-taxation can also create budget problems for states. It should be clear that the main purpose of treaties should be the prevention of double taxation and not the prevention of double non-taxation, although it seems that institutions like the OECD and the EU are currently switching from avoiding double taxation to addressing double non-taxation as starting point regarding tax treaties.[89] Also the idea of CFT, as we can see later in this thesis, can conceptually be seen as a possibility to avoid double-non taxation. CFT is in fact consumption and destination based and every time consumption takes place somewhere, a taxable moment occurs. In theory, double non-taxation could not occur because with a destination based taxation international profit allocation does not exist and so mismatches in allocating profits are not possible.

4.3.3 Legal principles

Legal principles shape the internal moral core of tax law, defend the legitimacy for a state and its authorities to levy taxes and protect persons that are subject of tax law.[90] Therefore international tax law should contain legal principles in order to be and be seen as legitimate. It is not in the scope of this thesis to provide an in-depth review of all the used principles. For this reason a brief overview of the most commonly used legal principles is given in this paragraph. These principles are useful for this thesis to qualify the PE and TP concepts because these concepts are based on these legal principles, and in order to make a comparison with CFT.

4.3.3.1 The nationality principle

The nationality (or citizenship) principle advocates taxation that is based upon the nationality or citizenship of a person.[91] For instance, when a company is founded in the United States (and has the US nationality because it is founded by US rules), the only unlimited base for taxation is that nationality. An advantage is its relatively simple applicability.[92] In the US it is still used as a main principle for justification of a tax claim.[93] A disadvantage of the nationality principle is the fact that nationality is not an indication of the residence of the taxpayer and consequently monitoring the taxpayer causes issues. Moreover, with the use of this principle, a taxpayer who is citizen of a state but does not live and does not make use of the state's infrastructure and facilities, pays taxes for the people who actually do live in the state.[94] According to literature, taxation on the principle of

[89] De Broe 2008, p. 357
[90] Gribnau 2007, par. 3.8
[91] Kemmeren 2001, p. 27
[92] Van Raad 2012, IBR 1.2.1.B
[93] Kemmeren 2001, p. 27
[94] Van Raad 2012, IBR 1.2.1.B

nationality is not appropriate because being a citizen of a country does not produce any income or does not enable the possession of wealth.[95]

4.3.3.2 The residence principle

This principle allocates the right to tax to the place where a taxable object has its residence. Mostly, for legal bodies the place of residence is determined by the place where the effective management is situated.[96] The thought behind this principle is that the person who is seated in a state, makes use of and benefits from the infrastructure of that state and therefore needs to pay a remuneration. However, the determination of a residence can be problematic because a company when two states see a company as residence and tax on the base of the residence principle, double taxation can occur. On the other hand, when two states do not see a company as a residence (e.g. when a company is transparent for domestic tax purposes in a state), double non-taxation may occur. In the Netherlands for example, the primary base for taxation is the residence of a company. When a company is located in the Netherlands because it is administrated as a company in the Netherlands or, when this is not sufficient enough, based on factual circumstances, the Netherlands has taxation rights. In literature it is argued that the residence principle has stronger rights than the nationality principle but still is not actually a strong principle. That is because residency in itself does not create income or enables the possession of wealth.[97] CEN has been formulated by Musgrave[98] for the first time (as well as CIN).[99] The definition is explained as the idea that the investor should pay the same total (domestic plus foreign) tax, whether he receives a given investment income from foreign or domestic sources.[100] Domestic investors are equally treated, regardless of whether investment is made abroad or in their home state.[101] CEN results in a worldwide taxation system where a foreign tax credit is used in order to achieve neutrality.[102] Using a foreign tax credit and CEN as a basis, is generally viewed as applying the universality principle. This universality principle implies that all income and all capital of a person, irrespective of where it has arisen, been produced or located, may be taxed by the state concerned. The universality principle can be seen as connected to the

[95] Kemmeren 2001, p. 28
[96] See for example, amongst others, Van Raad 2012, IBR 1.2.1.C and Doernberg & Hinnekens 1999, p. 14
[97] Kemmeren 2001, p. 32
[98] Richard Musgrave was a German-American economist and professor that has been credited as being the first to distinguish between CEN and CIN.
[99] Pinto 2007, p. 280
[100] See amongst others Kemmeren 2001, p. 71 and Pinto 2007, p. 280
[101] Kemmeren 2001, p. 71
[102] Pinto 2007, p. 280

qualitative principles of nationality and residence, so for the ease and purpose of this thesis CEN and the foreign tax credit will be linked to the residence principle.[103]

4.3.3.3 The source principle

The formulation of the source principle is more complicated than the formulation of the above-mentioned principles. For the purpose of this thesis the definition of Doernberg and Hillekens is used: "Source jurisdiction in taxation is generally claimed with respect to items of income that have a reasonable nexus with the territory of the state concerned. These are economic activities and capital interest that are substantively connected with that state".[104] The withholding tax on royalty's, dividends and interest that come up in a certain state is an example of the source principle. This principle is more preferable than the nationality principle and the residence principle because, when used exclusively, it leads to a globally acceptable distribution of tax jurisdiction between the countries wherein the different economical proceeds are connected to.[105] Together with the residence principle, this principle is used most as a base for international taxation.[106]

However, the source principle may lead to tax planning by states and influences the location of production, which is economically not right.[107] Taxation should not influence business choices.[108] Literature criticizes the idea that the current source principle is the most appropriate principle because the possibility exists that the property is established and preserved or the income is produced in another state than where the person from which the property concerned and the income has been received is physically situated.[109] Therefore literature pleads for the source principle to be based on the concept of origin for income taxes and the economic location of capital for capital taxes.[110] However, for the purpose of this thesis the starting point is the source principle as it is used in current tax treaties. This source principle may cause taxation issues which will be set put in this thesis.

Capital import neutrality (CIN) is generally defined as the idea that capital funds originating in various states should compete on equal terms in the capital market of any state, irrespective of the

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[103] Kemmeren 2001, p. 50
[104] Doernberg & Hinnekens 1999, p. 14
[105] Van Raad 2012, IBR 1.2.1.D
[106] Kemmeren 2006, p. 430
[107] Bond & Devereux 2002, p. 3
[108] Pinto 2007, p. 280
[109] Kemmeren 2001, p. 34
[110] Kemmeren 2006, p. 433

investor's place of residence.[111] CIN implies a system of tax exemption that relates to a source-based taxation.[112]

4.3.4 Conclusion of the legal principles of international taxation

Because principles are the legal core of (international) taxation, it is of importance to formulate these principles. The legal principles are used for the allocation of taxation to states, in order to avoid double taxation or double non-taxation. In positive tax law three principles are mostly used in literature: the nationality principle, the residence principle and the source principle. The nationality principle and the residence principle both do not create income and are therefore not appropriate for international taxation. The source principle is most legitimate to allocate taxation to a jurisdiction, especially when it is origin-based. However, the source principle may lead to insufficient taxation and influences business choices which is economically undesirable. Generally two definitions are used in order to formulate the economic neutrality principle: capital export neutrality and capital import neutrality. CEN implies a foreign tax credit system that is based on the residence principle and CIN implies an exemption system that is based on the source principle.

4.4 Conclusion of the basic principles of international taxation

Taxation of a subject can result both in unintentional double taxation or double non-taxation. Therefore international tax laws should contain legal and economic principles in order to address these issues. The legal principles of international taxation can generally be summarized as the nationality principle, the residence principle and the source principle. The source principle can be seen as the most appropriate principle but can still lead to double non taxation. Together with the residence principle, the source principle is used most. The economic principles of international taxation speak of two definitions of necessary neutrality in order to ensure economic neutrality: capital export neutrality (CEN) and capital import neutrality (CIN). CEN uses a foreign tax credit that is based on the residence principle. CIN uses a tax exemption that is based on the source principle.

[111] See amongst others Kemmeren 2001, p. 72 and Pinto 2007, p. 280
[112] Pinto 2007, p. 280

5. Cash-flow taxation as a possible solution

5.1 Introduction

Cash flow taxation (CFT) is a taxation concept from another perspective than the current commonly used CIT perspective. Therefore this chapter firstly describes the main aspects of CFT. Secondly, two CFT concepts are researched: the R- and the R+F base. The CFT will be outlined further and will be assessed as an alternative for the PE and TP concepts. Subsequently, CFT will be tested on its consistency with the international and Ottawa taxation principles. In the end an answer will be given to the question whether CFT as an alternative can be a solution to deficiencies of the PE and TP concepts.

5.2 The basis of cash-flow taxation

Customary in the current system of international allocation of the right to levy corporation tax is the use of the residence-based principle as the primary principle.[113] Secondary the source principle can be seen as dominant.[114] In literature exists several other legal grounds for allocating taxation rights. Legal principles for international taxation and the allocation of the tax jurisdiction with respect to income and capital are the nationality principle, the incorporation principle, the principle of origin and the principle of functionality that can be considered as a part of the residence principle.[115] Less usual but also existing for direct taxes is the destination-based principle. This principle is usually related to indirect taxes like value-added tax VAT. The principle is based on the place (state) where the goods or services are consumed. CFT is based on the destination of consumption and has been proposed as a suitable alternative to taxing corporations in an international setting.[116]

5.3 The tax base of the corporate cash-flow tax

5.3.1 Introduction

In literature, since the Meade report, the three models that are customary mentioned are the R-base, R+F base and S-base system.[117] The Meade report is a result of the Meade Committee that

[113] Kemmeren 2001, p. 55
[114] Vogel 1988, p.216
[115] Kemmeren 2001, p. 27
[116] Devereux & de la Feria 2014, p. 1
[117] Meade Report 1978, p. 230

took a fundamental look at the UK tax structure in 1978.[118] In this thesis only two CFT models will be examined: the R-base and the R+F base. These CFT systems have the returns to marginal investment financed by debt and equity taxed at an effective rate of zero. This means that in principle the investment decision and the financial decision would not be distorted.[119] Because the size of the tax jurisdiction of a sovereign state is determined by economic political considerations, taxation should influence an efficient allocation of the production factors of labor and capital as little as possible or in the best outcome not even influence at all.[120] The so-called *tax neutrality* should prevail. If fiscal influence is missing when a choice is made how to operate as a company (for example the choice to use the type of financial instrument or the choice of the place where a business can be operated) worldwide prosperity will be enhanced, or in any case not be affected by the tax rules and differences of states.

5.3.2 Destination-based (cash-flow) tax

Suggestions were emerging in the early 2000s to think about an alternative allocation principle for taxing corporate entities, under which the proposal of a destination-based tax.[121] A destination-based tax is the taxation on the basis of where the final consumer lives and purchases a good or service, sometimes compared to an origin-based tax.[122] Normally economic theory on the international taxation of companies is based on the residence or source country model and is not based on the destination.[123] Therefore extensive analysis on the economic outcome is not highly available. Several recent research papers exists on the hypothetical economic outcome with respect to the implementation of a destination-based CFT in an open economy. According to these research papers a destination based CFT would tax corporate profits and works similarly to a VAT but the treatment of labor would then be regarded as a deductible business cost, which is not so under VAT.[124] In order to determine whether a destination-based corporate CFT is a real alternative to the current international tax rules, the criteria should not be linked to consumption, but rather to broad aims of an international system of taxing corporate profit.[125] Several countries already have destination-based taxation, mostly developing countries, namely for services.[126]

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[118] Meade Report 1978, p. xi
[119] Auerbach, Devereux & Simpson 2008, p.19
[120] Kemmeren 2006, p.438
[121] Avi-Yonah 2000, p.1671
[122] Auerbach, Devereux & Simpson 2008, p.47
[123] Bond & Devereux 2002, p.2
[124] Devereux & De La Feria 2014, p. 9
[125] Devereux & De La Feria 2014, p. 10
[126] Devereux % De La Feria 2014, p.13

5.3.3 The R-base CFT

In the R-base corporate CFT only real transactions are included in the tax base.[127] The flat tax base consists of the calculation of the *real* inflows minus the *real* outflows.[128] That is, the measurement of the difference between the sales (receipts) of products, services and fixed assets and the purchases (expenses) of materials, wages, fixed assets and other capital goods.[129] In a closed economy that has been taken as the example, an R-based CFT falls only on economic rent.[130] Simplified the R-base can be visually summarized as follows:

R-base = sales – purchases

Financial transactions are not included in the tax base. The R-base corporate CFT treats debt and equity in the same way because it disallows any deduction with respect to the financing of the investment.[131] For example interest payments are not deductible. More profound the R-base is visually abstracted as follows:

$$(R_1 + R_2 + R_3) - (P_1 + P_2 + P_3)$$

R_1 = Sale of produce

R_2 = Sale of services

R_3 = Sale of fixed assets

P_1 = Purchase of materials

P_2 = Wages, salaries and purchases of other services

P_3 = Purchase of fixed assets

This system results in the property that a corporation is not obliged to make a choice between different sources of financing because of fiscal reasons. For instance, a corporation is not under the influence anymore of the fiscal motive to prefer a loan more than capital because the interest is deductible.[132]

5.3.4 The R+F base CFT

With respect to the R-base model, a problem arises regarding financial instruments. The R-base is based on 'real' goods and services, while financial institutions also obtain profit and revenue through financial transactions.[133] Financial institutions would be exempt in the R-base system, because the

[127] OECD, Fundamental Reform Of Corporate Income Tax 2007, p. 94
[128] Merrill & Edwards 1996, p. 489
[129] Auerbach, Devereux & Simpson 2008, p. 3
[130] Bond & Devereux 2002, p.13
[131] OECD, Fundamental Reform Of Corporate Income Tax 2007, p. 94
[132] In this respect, the Netherlands knows deductibility of interest and therefore, amongst other reasons, the Netherlands is a favorite establishing country.
[133] Meade Report 1978, p. 233

excess of interest receipts over interest payments are not taxable. And because financial institutions like banks calculate and charge higher interest rates on their loans to their customers than the interest which they pay on sums deposited with them.[134] A solution to this is the insertion of the financial transactions into the tax base as well. This so-called R and F base can be visually summarized as follows:

R+F base = (Real sales + Financial sales) - (Real purchases + Financial purchases).

The following properties are specific to the R+F base: inclusion of net financial inflows in the tax base and immediate expensing of all investment expenditure. In theoretical setting and under certain conditions, an R+F base CFT would not distort the location, financial, pricing and investment decisions of an MNE.[135] However, some distortions can still occur with an R+F base CFT. When companies make location choices on the basis of a comparison of the post-tax net present value, a CFT would affect this choice. Furthermore, when a CFT require higher statutory rates in states, greater incentives for shifting profits between jurisdictions may be created.[136]

5.4 Comparison of the CFT with the principles

5.4.1 Comparison with the legal principles

We concluded that the origin principle as part of the source principle can be seen as the most favorable principle. In general, the source principle can be seen as based on the benefit principle: taxation should take place where the labor and capital is used. The same arguments can be used to destination-based CFT. Because the idea that the state where the income is generated should be compensated, a CFT can also apply to legitimatize destination-based taxation if one takes the origin of the income to be the place where profits are made because of consumption and not where the actors labor and capital are off influence.[137] A CFT can be seen as part from the source principle as a legal principle. It depends on the factor of importance that one gives to labor and capital as a profit generating factor in comparison with consumption. If a state creates circumstances thanks to public funding, where people can consume freely, safely and on a high scale, that state may create the source of profit. From that perspective a destination-based consumption taxation like the CFT is legitimate for international taxation principles.

[134] Meade Report 1978, p.233
[135] Devereux & De La Feria 2014, p. 3
[136] Auerbach, Devereux & Simpson 2008, p. 37
[137] Devereux & De La Feria 2014, p. 12

5.4.2 Comparison with the Ottawa principles

The Ottawa principle that has been the most important over the last decades is fairness.[138] The source principle is legitimized by the notion of entitlement. The tax jurisdiction should be the jurisdiction that is entitled to the income that is created within that jurisdiction. This argument can also be made to CFT, which is based on destination and the place of consumption. Because the possibility to consume originates within the borders of a state, the state provides services to let citizens have the possibility to consume and therefore in that state the income is originated.[139] The inter-nation equity, that is also a dimension of fairness, produces losers as well as gainers in terms of tax revenue. That is also applicable to a CFT. Inequality in tax proceeds is theoretically more present with a CFT. However, a CFT shall in any case provide more tax proceeds for countries in comparison with the current situation. As long as the source and residence principles will provide such enormous deficiencies in taxing MNEs, especially in the digital economy, a low amount of profit is taxed. A CFT will provide taxation possibilities. When the example of chapter 3 is taken and instead of a CIT-base tax, a CFT is used, the EU states can tax income, notwithstanding the lack of a PE. This means that in the end the worldwide tax proceeds will grow because of the higher ETRs. Also emerging economies can profit from a growing consumer class. The more consumers, the more tax proceeds for a state with a CFT.

With respect to the other Ottawa principles a comparison on the basis of the aspects of a CFT is made below. CFT is neutral because it can tax all the consumed objects at the same rate. CFT does not make a difference with respect to different forms of e-commerce. However, the tax rate of the CFT should be constant over time in order to create neutrality. Investors should believe that the tax rate will not change in the future.[140] When expecting future returns to be taxed at a different rate than the current investment is relieved, neutrality may not prevail. On the other hand is this a property of taxation in principle. No realistic tax can be neutral to the scale of investment when it is expected that the tax rate is fluctuating.[141] Furthermore, a CFT in the digital economy can be applicable to payments that are only made online. Because these payments result in automatic administration, the administrative burdens of taxpayers and tax authorities are low. In comparison with the PE and TP concept, the administrative costs are lower because a CFT is much less complex. Current administrative costs lies in expensive advisors and the need of experienced and specialized

[138] Devereux & De La Feria 2014, p. 12. The fairness principle may become more important in the future because the Picketty debate, where worldwide taxation forms a critical part, triggered the discussions on fairness.
[139] Devereux & De La Feria 2014, p. 13
[140] Auerbach, Devereux & Simpson 2008, p. 37
[141] Auerbach, Devereux & Simpson 2008, p. 38

tax authority employees. A CFT is furthermore certain and simple. Certain because when a product is consumed, it is taxed in the state where it is consumed. The effectiveness will be high, because a fixed rate on highly digitalized products that are sold through a web store can be taxed in a state where in the past has not been a tax effect, as we have seen in the example. A CFT can keep pace with technological and commercial developments because it does not need physical reference points or complex value calculations. CFT may not be completely fulfill the fairness requirement of the Ottawa principles because it contains flat tax properties. However, all taxation rates are subject to the problem of setting a right rate that is taxable effective and fair at the same time.

5.5 CFT as alternative for the deficiencies of the current international profit allocation rules

As we have seen in the second chapter, the source and residence principles are associated with respectively capital importing and capital exporting countries. We have also seen that the source principle is considered to be more legitimate in comparison to the resident principle. Still, differences in tax rates between countries distort the location of productive activity and is a problem that is inherent to the source principle. On the other hand does this problem also occurs with respect to neutrality within a CFT. However, because there is usually no single source of profit because profits arise from a whole range of locations (MNEs sell products all over the world), the traditional source principle is not appropriate anymore.[142] Because a CFT (especially R+F base) does not create distortions to any margins of business decisions, but still taxes corporate profits, it can be postponed as a suitable alternative. The CFT system does not affect decisions as to the scale of investment and a CFT does not discriminate between investments financed by different sources of finance. Consequently, these systems let the choice of a business location not be under the influence of taxation. The current international profit allocation rules are based on the source principle (as an adjustment of the residence principle) but because of the described problems that occur in the digital economy as we have seen in the previous chapters, the concepts are not appropriate in order to tax MNEs. A CFT may give a neutral taxation solution in the case that profits of products are sold through a website not constituting as a PE. Also the TP concept problem regarding intangibles, that results in extreme administration costs and difficulties for the value adding allocation (also because there is a location issue), may be overcome by simply taxing at the place where the products are sold. It is theoretically possible to use a destination based model for the allocation of corporate taxing rights.[143] Furthermore, the described TP deficiency contains the problem that in the digital

[142] Devereux & De La Feria 2014, p.8
[143] Devereux & De La Feria 2014, p.9

economy many intangibles exist. These intangibles are extremely mobile and the current TP rules may not be able to tax these intangibles because of their mobility. A CFT does not know such a problem because taxation is based on the place of the destination of consumption. The international profit allocation deficiencies described above are not an issue anymore with a CFT.

5.6 Conclusion

The R- and R+F base have firstly been described in this chapter. A CFT does not affect decisions as to the scale of investment. CFT also does not discriminate between investments financed by different sources of finance. Consequently, these systems let the choice of a business location not be under the influence of taxation. Because a CFT does not need substance, only consumption and a state that is the destination of consumption, no PE problem occurs. Because a CFT is easier to apply than the complex TP concept, it can also be used in order to tax sufficient. Also the problem of the mobility of intangibles in the digital economy that let MNEs use these mobile properties of intangibles in order to reduce their ETRs with the help of TP aspects, is not an issue anymore with a CFT. Furthermore, CFT is not based on the source and residence principle but on destination and consumption. The consumption principle can be seen as a legitimate legal principle to tax. Also the Ottawa principles seem to be covered by a CFT. Therefore it can be concluded that a CFT can be an alternative for the deficiencies of international profit allocation in the digital economy.

6. Thesis conclusion

The research question of this thesis is:

"To what extend are the permanent establishment and transfer pricing concepts appropriate for taxing MNE's in the digital economy and can cash flow taxation be an alternative solution to deficiencies of these concepts?"

In order to answer this question, the following subjects have been researched: the digital economy, the OECD Ottawa principles of taxing the digital economy, international profit allocation in the digital economy, the basic principles of international taxation and the CFT as a possible solution.

The digital economy is characterized as the section of the economy where Information and Communication Technology (ICT) and all its additional digital aspects are used, applied and of influence. The digital economy may contain opportunities for MNEs to reduce their ETR. Current international profit allocation rules may not be sufficient and alternatives may be needed in order to tax certain aspects of the digital economy. Because of new technologies, the business models of MNEs have been changed and contain characteristics that are inherent to the digital economy. For instance, the changed mobility of sellers and users, the major use of intangibles in the digital economy and the changed business functions that can be managed from one place, are properties of the digital economy that may not be taxed sufficiently with the current profit allocation rules. MNEs may be able to choose the location for profitable activities because of these deficiencies and may be able to assign taxable risks and functions because of their value creating properties, to an enterprise that is situated in a low-taxed jurisdiction according to the residence principle. Subsequently, tax planning structures are used by MNEs that result in tax avoidance and low ETR's. In chapter 2, a tax structure has been outlined by an example of the PE and TP concept. The example made clear that on an abstract basis a company can reduce its ETR with the current profit allocation rules. Furthermore, the OECD BEPS report on the digital economy states that the digital economy does not need a stand-alone approach. Question marks can be placed with respect to the rightness of this statement. The digital economy needs to be seen as a separate international taxation issue, if the purpose of the OECD is to address worldwide taxation issues, because the digital economy contains specific characteristics that need to be addressed as a single issue.

The OECD formulated the Ottawa principles with respect to the taxation of the digital economy: neutrality, efficiency, certainty and simplicity, effectiveness and fairness and flexibility. Except for

neutrality, a CFT seems to cover all the Ottawa principles, in contrast with the current profit allocation rules.

Subsequently the deficiencies of international profit allocation in the digital economy have been examined. The PE concept is based on the source principle and is an adjustment of the residence based taxation principle. Three main problems of the PE concept has been stipulated with respect to the digital economy. First, there is the problem of physical requirement. With the current changes in business models it is possible that profits are earned in jurisdictions with no physical presence. The second problem is the lack of the OECD MC article with constituting a PE if there is solely a preparatory and auxiliary character with respect to the business activity. Thirdly, the PE definition cannot let a web site be a PE if it does not conclude contracts and therefore is not an agent. The PE concept cannot let digital selling points (i.e. websites) constitute as a PE, although there is a profit making activity in the jurisdiction of the PE. On the other hand a PE can be constituted in a low-taxed jurisdiction in order to let the profits be taxed in that jurisdiction. Furthermore, the use of a commissionaire structure can be used to avoid PE status. This has become easier in the digital economy because there are no transport or communication issues anymore. The virtual PE has been stated as a solution but has not been adopted by the OECD. Future changes in the digital economy may cause new problems that result in continuous changes of the PE definition. Opportunities for MNE's arise again for abusing or make economic choices with respect to the PE concept. The PE concept is a consequence of the source principle. With the residence principle as the basis of the taxation and the conclusion that the concept of the PE creates problems with respect to current international taxation principles, the source and residence principles may not be sufficient enough for taxation in the digital economy. The digital economy characteristics may create opportunities for MNEs to choose the jurisdiction where the profit is made. An MNE can shift profit easily to states where it is taxed most efficiently by the use of the PE concept.

Furthermore, the TP issues on intangibles have been outlined. The arm's length principle is the basis of TP and TP can be seen as part of the source principle. MNEs may use these TP issues in order to lower their ETR. The fundamental problem of any source-based tax is that allocating profit among source states is complex, uncertain and sometimes conceptually meaningless. The OECD guidelines do not supply sufficient information for determining the right prices. The valuation of intangibles is difficult and may be arbitrary in cases when intangibles are unique. Because the MNEs that are active in the digital economy have a lot of intangibles on their balances and work as innovative companies, they are very susceptible for TP issues on intangibles. Intangibles are a key factor of the digital economy and because of their mobility, MNEs can move intangibles and the remuneration on this intangibles to low-taxed states by establishing a PE. Therefore MNEs can use these TP issues in

order to lower their ETR. Because both the PE and TP issues are source principle based it can be concluded that the source principle (also in combination with the residence principle) is not sufficient enough for taxing MNEs in the digital economy. The digital economy contains characteristics that let MNEs abuse the current international profit allocation rules in order to lower their ETR.

Furthermore, the basic legal and economic principles of worldwide taxation have been studied. International taxation may result in double taxation or double non-taxation. Therefore international tax laws contain legal and economic principles in order address double taxation. It seems that in the future more emphasis has been put on also the prevention of double non-taxation. The legal principles of international taxation have been summarized as the nationality principle, the residence principle and the source principle. The source principle is the most appropriate principle for international taxation, but can still lead to double non taxation. The source principle is together with the residence principle the most used principle in tax treaties. With respect to the economic principles of international taxation, two definitions of neutrality are formulated in order to ensure economic neutrality: capital export neutrality (CEN) and capital import neutrality (CIN). CEN uses a foreign tax credit that is based on the residence principle. For CIN a tax exemption is used that is based on the source principle. Because a CFT (especially R+F base) does not create distortions to any margins of business decisions, but still taxes corporate profits, it can be postponed as a suitable alternative. CFT is indeed not based on the source or residence principle. CFT system does not affect decisions as to the scale of investment and a CFT does not discriminate between investments financed by different sources of finance. Consequently, these systems let the choice of a business location not be under the influence of taxation. CFT also does not discriminate between investments that are financed by different finance sources. CFT lets the choice of a business location not be influenced by taxation. No opportunity to shift profits between countries exist anymore. A CFT does not need (physical) substance, it only needs consumption in a state that is the destination of consumption. Therefore no PE like problem occurs. Also because a CFT is easier to apply than the complex TP concept, it can be used in order to tax sufficient in the part where the TP concept is deficient. Furthermore, the described TP deficiency contains the problem that many intangibles are available in the digital economy. These intangibles are extremely mobile. MNEs can allocate these intangibles to the jurisdiction where they see the best tax opportunities. The TP concept deficiency regarding intangibles, that results in extreme administration costs and difficulties for the value adding allocation (also because there is a location issue), may be overcome by simply taxing at the place where the products are sold.

CFT is not based on the source and residence principle but on destination and consumption. The consumption principle can be seen as a legitimate legal principle to tax. Also the Ottawa principles seem to be covered by a CFT, except for neutrality. Therefore it can be concluded that a CFT can be an alternative for the deficiencies of the current international profit allocation rules. Because a CFT (especially R+F base) does not create distortions to any margins of business decisions, but still taxes corporate profits, it can be postponed as a suitable alternative. The current international profit allocation rules are based on the source principle (as adjustment of the residence principle) but because of the described problems that occur in the digital economy as we have seen in the previous chapters, the concepts are not appropriate in order to tax MNEs. CFT may give a neutral taxation solution in the case that profits of products are sold through a website not constituting as a PE or on the other hand if a PE is constituted in a low taxed jurisdiction in order to let the profits fall in that jurisdiction in combination with TP as we have seen in the example. It is theoretically possible to use a destination based model for the allocation of corporate taxing rights. The international profit allocation deficiencies described, are not an issue anymore with a CFT and therefore CFT is a possible alternative for the current international profit allocation rules.

III. Resources

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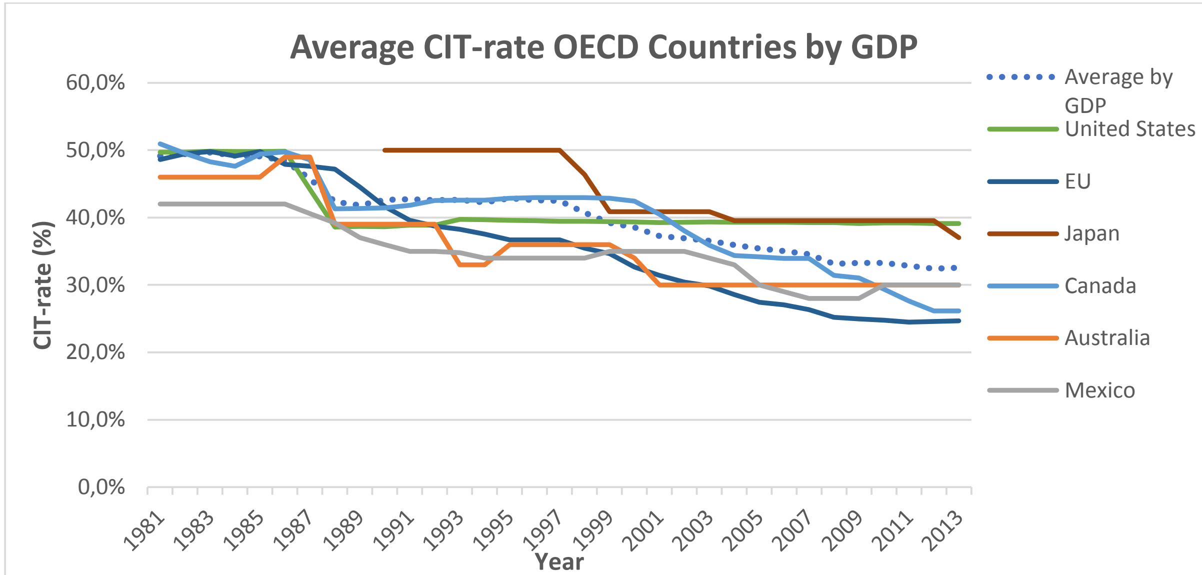
IV. Appendix

Appendix 1 CIT Rates specific OECD countries and EU 1981-2013

Chart 1:



Source: OECD Tax Database

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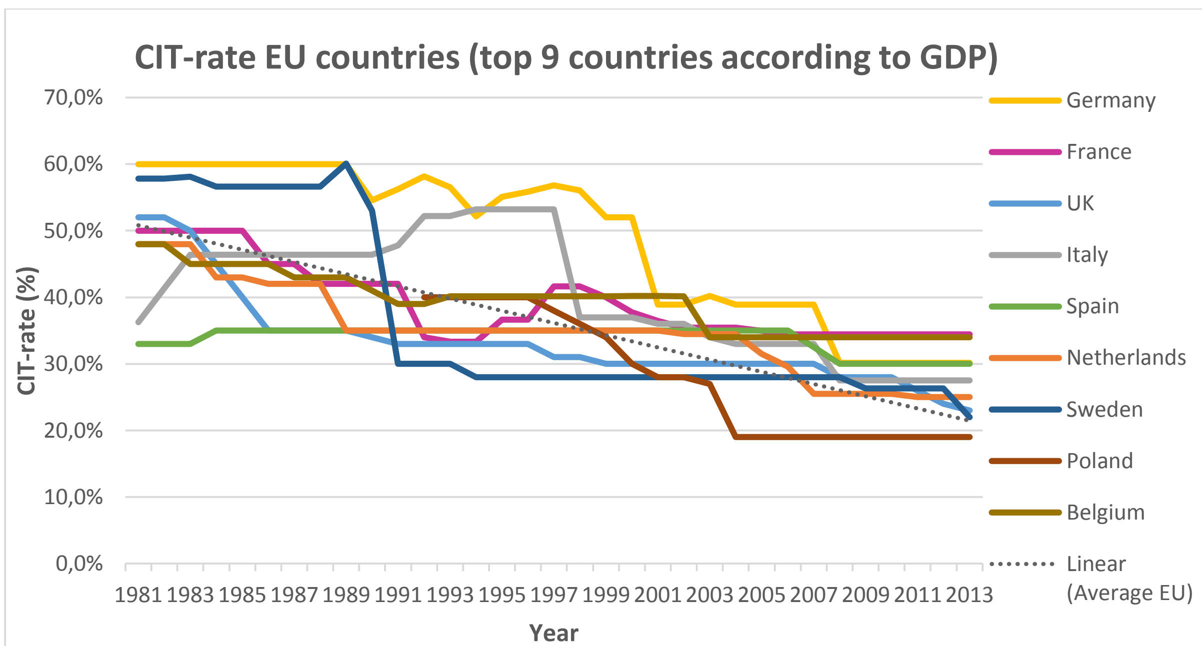
Chart 2:



Source: OECD Tax Database

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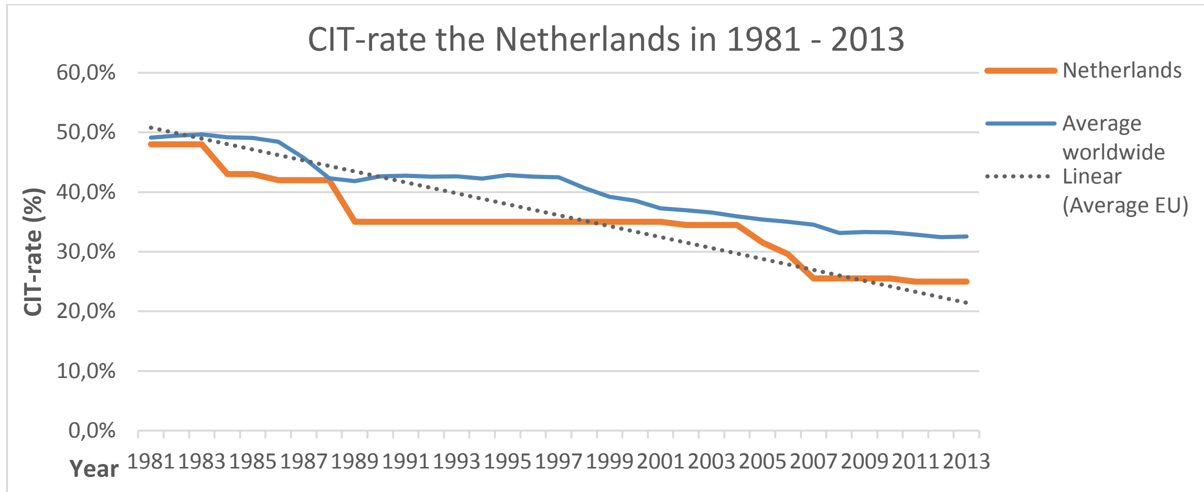
Appendix 2 CIT Rates of the Netherlands in 1981-2013

Chart 1:



Source: OECD Tax Database *© David Langerak*

Table 1: the Dutch CIT-rates in percentages 1981 - 2013

Netherlands	48,0%	48,0%	48,0%	43,0%	43,0%	42,0%	42,0%	42,0%	35,0%	35,0%	35,0%
Years '81-'91	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Netherlands	35,0%	35,0%	35,0%	35,0%	35,0%	35,0%	35,0%	35,0%	35,0%	35,0%	34,5%
Years '92-'02	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Netherlands	34,5%	34,5%	31,5%	29,6%	25,5%	25,5%	25,5%	25,5%	25,0%	25,0%	25,0%
Years '03-'13	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013

Source: OECD Tax Database *© David Langerak*