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CURRENT FISCAL CHALLENGES OF MODERN DIGITALIZED ECONOMY: THE ANSWERS FROM THE EU LEGAL ORDER

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Abstract (English)

Taxation has always been of great importance for every state. Since it is the major source of public income, it is crucial that the regulations properly address all types of taxable goods, entities and operations. Nevertheless, during the past century, the nature of economic transactions has been changing drastically due to globalization and digitalization, and tax regulations can barely keep up. In fact, current international fiscal regulations prove to be inadequate in addressing certain operations in such a rapidly changing economic scenario. Even though there is global understanding regarding the fact that a single, universal tax-system is needed to tackle the challenges, such an agreement is difficult to reach. Some of the major challenges being faced are determining which jurisdiction shall collect taxes on enterprises' digitally created profit, which operations are taxable, and the amount of the tax to be imposed. International organizations such as the OECD, the UN, and the EU have been putting great amounts of efforts in attempting to find solutions – so far, with relative success.

Key words: digital economy, international fiscality, taxation, permanent establishment

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Riassunto (Italiano)

La tassazione è sempre stata di grande importanza per ogni Stato. Essendo la principale fonte di reddito pubblico, è fondamentale che i regolamenti coprano tutti i tipi di beni, entità e operazioni tassabili. Tuttavia, nell'ultimo secolo la natura delle transazioni economiche è cambiata drasticamente a causa della globalizzazione e della digitalizzazione, e le normative fiscali riescono a malapena a tenere il passo. Infatti, le attuali normative fiscali internazionali si rivelano inadeguate ad affrontare determinate operazioni economiche in un panorama economico di rapida evoluzione. Anche se esiste una comprensione globale sulla necessità di creare un sistema fiscale unico e universale per affrontare tali sfide, l'accordo è difficile da raggiungere. Alcune delle principali difficoltà riguardano la determinazione della giurisdizione che deve riscuotere le imposte sui profitti creati digitalmente dalle imprese, quali operazioni sono imponibili e l’importo della tassa da applicare. Organizzazioni internazionali come l'OCSE, le Nazioni Unite e l’UE si impegnano per trovare soluzioni – fino ad oggi, con relativo successo.

Parole chiavi: economia digitale, fiscalità internazionale, tassazione, stabilimento permanente

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Abstracto (español)

La fiscalidad siempre ha sido de gran importancia para todos los Estados. Al ser la principal fuente de ingresos públicos, crucial es que las regulaciones abarquen todo tipo de bienes, entidades y operaciones imponibles. Sin embargo, durante el último siglo el carácter de las transacciones económicas ha ido cambiando rápida y drásticamente debido en gran parte a la globalización y la digitalización, y la normativa fiscal apenas puede seguir el ritmo. De hecho, las actuales normativas fiscales internacionales resultan inadecuadas para abordar determinadas operaciones en el escenario económico tan rápidamente cambiante. A pesar de que existe un consenso mundial sobre la necesidad de un sistema fiscal único y universal para hacer frente a estos retos, es difícil llegar a un acuerdo. Algunos de los principales retos consisten en determinar qué jurisdicción recaudará los impuestos sobre los beneficios creados digitalmente por las empresas, qué operaciones son imponibles y la cuantía del impuesto que debe aplicarse. Organizaciones internacionales como la OCDE, la ONU y la Unión Europea están dedicando grandes esfuerzos a intentar encontrar soluciones – con relativo éxito.

Palabras claves: economía digital, fiscalidad internacional, imposición, establecimiento permanente

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Disclaimer: All the information provided throughout the present investigation is valid until October 2023.

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Introduction

With the appearance of commerce and trade in human history, the concept of taxation has been present in one form or another.

The Egyptians, the Chinese as well as South American natives such as the Incas all lived in theocratic regimes, where their leader was considered god.[1] As such, paying tribute to the governor was a very common practice, both from a religious perspective as well as governmentally.[2]

As a matter of fact, it was from as early as around 3200 B.C. that historians found documentations of taxation in the Ancient Egypt, imposed by their emperor, King Scorpion I.[3] Taxation, then, also existed in Babylonia, of which documentation is available from as early as the 25th century B.C.[4] Thus, it may be in these civilizations – which, nevertheless, have evolved independently of each other – that the roots of taxation can be found.

Taxes existed in Ancient Roman and Greek civilizations as well, mainly in form of import duties, that were collected on goods coming into the territory of the empires.[5] Taxes were imposed on such products, since these were easier to control (when passing through borders) than goods in domestic production.[6]

Later, yet still more than 2000 years ago, in the regime of Augustus Caesar, substantial economic reforms were made in his Empire.[7] Among other novelties, he introduced three types of taxes: 1% of sales tax was collected on good across

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[1] W. D. SAMSON, *History of taxation*, in *The international taxation system*, 2002, pp. 21-41.

[2] *Ibidem*, pg. 21

[3] *Ibidem*, pg. 22

[4] *Ibidem*, pg. 23

[5] CH. E. MCLURE, M. S. COX, & F. NEUMARK, *Taxation*, in the *Encyclopedia Britannica*, 2023, https://www.britannica.com/money/topic/taxation, (hereinafter: MCLURE et al., *Taxation*, 2023).

[6] *Ibidem*

[7] G. DAVIES, *A History of Money: From Ancient Times To Present Day*, University of Wales Press, (edn. 3), 2002.

the entire Empire, the *tributum soli*, ("soli" meaning ground or soil in Latin indicates one percent of imposition on estimated value of land properties), and the *tributum capitis* (a fixed rate of tax per person that each adult citizen was subject to pay).[8]

In the upcoming centuries, even though import duties kept being one of the most important form of taxes across many states, new forms of levies have also been introduced, such as taxes on properties, on net-worth and different types of direct taxes.[9]

Over centuries, taxation systems have become more and more sophisticated and often politically controversial in the economies around the world.[10] Since the different types of taxes altogether are the major sources of public income of every state, clearly, they play a fundamental role not only globally, but also for the economy of each single country; and just like each state has their own political system, they also have complete sovereignty over establishing their own regulations regarding taxation.

Considering national tax regimes in the international scenario, the different tax policies are translated into a global system of very divergent fiscal rules, also given the fact that states do not take into consideration other countries' regulations when they create their own. As such, the many non-alike systems leave areas unaddressed or uncovered, introducing gaps and fiscal inconsistencies from an international perspective.

However, such loopholes in singe states' tax policies are relevant to differing extents, depending on the type of taxes considered. For example, considering taxes on private property, differences in tax regimes do not really meet. But what happens when commercial activities are considered?

Since international as well as inter-regional commerce have developed over the past centuries into a system that now dominates today's global economy,

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[8] *Ibidem*

[9] McLure et al., Taxation, 2023.

[10] *Ibidem*

diverging tax regulations started to become an issue of ever-growing importance. Thus, the present investigation is elaborated in light of corporate taxation only.

Even more specifically, the different tax regimes regarding corporate income taxes started to give rise to two concepts that are at the two extremes of the same spectrum: double taxation and tax evasion.[11]

In order for jurisdictions to make up for the inconsistencies and gaps between their tax laws, first bilateral treaty agreements were established, which, started to be supported or, in some cases, taken completely over by multilateral agreements during the 20th century through extensive works done by competent international organizations.

However, in today's global scenario even these agreements, whose establishments typically date back generically to the mid 1900's, became outdated, given the fact that they cannot deal with newly introduced practices in the international economic panorama. As computerization and digitalization appeared, it gradually expanded itself into the economy as well, eventually taking over almost completely traditional economy itself.

As a consequence, digitalization in commerce introduced never-seen-before possibilities of cross-border trade, leading up to scenarios, which, existing regulations, designed for the traditional economy, ceased to cover. Since the physical presence of online conducted businesses operations is not a requirement, services provided by digital commercial practices travel easily across borders.

Furthermore, and more specifically to taxation matter, digitalization contributed significantly to the possibility for internationally operating firms to transfer (or shift) their profits and register the earnings of those same profits in their offices that are located purposefully in jurisdictions where taxes are low or none. Such and similar scenarios have clear implications, raising fundamental questions:

[11] The issue of double taxation as well as tax evasion are elaborated in Chapter 1, under Paragraphs 1.1.1. and 1.1.2.

Where does an enterprise have to pay taxes on digitally conducted operations? Or, formulating the same question from the point of view of public sphere: on the basis of which principle is it determined, which jurisdiction has the right tax firms' digital commercial practices? Part of the challenge is also to determine which are those operations that taxes should be imposed upon (taxable operations); this may lead to the next question: what is the minimum amount of revenue obtained from such taxable activities that should be subject to taxes? Finally, what percentage of tax shall be imposed on them?

Such questions have arisen at national as well as at international levels and are now being addressed with more and more enthusiasm by competent international authorities, raising hopes of comprehensive solutions to develop.

On the basis of such considerations, the main objective of the present work is to shed light on and explore in detail the problematic nature of the current international scenario regarding taxation matter. Furthermore, with particular attention to digitalization, this investigation also tries to give a detailed insight on the current standpoint regarding initiatives in fiscality that would better target the challenges of the 21st century's economy.

The present investigation is desk research, where previous studies, official journals as well as court cases have been analyzed, and is divided into the following 5 chapters.

The first chapter describes the concept of Permanent Establishment, as the major taxable nexus for parent companies' foreign taxation. It addresses the concept from a critical point of view, given the fact that the term has first been formulated before the turn of the 20th century, yet is still in use today. Although its definition went through changes and updates over time, none of them were sufficient for adapting the term to adequately address the challenges of modern global economic scenario.

Next, the second chapter addresses the modern economic scenario with particular attention to the digitalization. First, it tries to give a detailed insight on the meaning of digital economy and how it became the dominating the form of the economy as a whole. Later, the chapter will explore the ways in which the digital economy poses challenges and complex issues to be tackled in fiscal matters.

Next, the third chapter reports recent international initiatives on fiscal regulation addressing the digital economy, with particular attention to international organizations' work such as the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU). Although some of the works reported have not been implemented, these contain, nevertheless, important considerations for current and future initiatives.

The fourth chapter reports a real-life example of corporation that had applied malicious tax planning strategy for decades, by evading its due taxes in all the jurisdictions where it should have had the obligation to pay them. This chapter sheds light, first, on the bigger issue of how tax regulations do not cover adequately all areas of modern economy, and consequently, on the urgent need to develop international tools that can cope with such issues.

Last, the fifth chapter makes considerations based on the previous chapters and briefly introduces the future outlook of tax regulations at a European level. It explores some of the ongoing works that may eventually become a definite solution for EU level taxation that is apt for the digital economy as well.

Chapter 1

The concept of Permanent Establishment – evolution, definitions, and its relation to international fiscality

This chapter will be focusing on describing the concept of Permanent Establishment; first its evolution will be briefly introduced, while the next paragraphs will explore the concept itself in greater detail. Finally, the chapter will look at the main challenges it brings to authorities in terms of its taxation.

1.1. Main factors leading to the conception of the notion: Permanent Establishment

Over centuries every country has established their own tax regimes, given that it falls in the center of their own sovereign rights. Clearly, single states' tax policies differ from one-another in the way they approach specific issues and thus, there are inconsistencies between them.

Such a segmented tax regulation on a global level, however, is more or less relevant, depending on the type of taxes that are considered. For example, considering taxes on personal property such as real estate, differences in tax regimes do not really matter since in no moment these have a legal encounter internationally. However, the case is different for taxes on trade and commercial activities that cross borders every day.

Since international as well as inter-regional commerce have developed over the past centuries into a system that now dominates today's global economy, diverging tax regulations started to become an issue of ever-growing importance. Thus, the present investigation is elaborated in light of corporate taxation only.

Even more specifically, the different tax regimes regarding corporate income taxes started to give rise to two concepts that are at the two extremes of the same spectrum: double taxation and tax evasion.[12]

With commercial activities becoming more and more complex over the course of the past centuries, especially in parallel and due to the opening of markets that guaranteed promising economic benefits for enterprises, governments were continuously facing novel challenges in maintaining the adequacy of regulations.

As a consequence, the need for the transparency of commercial activities meant necessary adaptations of policies so as to keep up with changing economic scenarios. As for what concerns specifically taxation matter, the gradual sophistication of business models and before-not-seen cross-border commercial practices introduced tax-ambivalent scenarios that needed specific arrangements and regulations.

For instance, companies instead of exporting and selling home-produced goods abroad, gradually started displacing of their manufacturing activities in jurisdictions different from their "homeland". They began doing so, for example, so as to reduce transportation costs, to search for less costly labor force, or to reducing tax obligations in territories with more loose regulations; such phenomena often led to scenarios where taxes were imposed either doubly or not at all, due to unclear or non-established regulations.

1.1.1. <u>The issue of double taxation</u>

From one side, double taxation is a phenomenon of crucial importance when considering international tax regulations. The term refers to the fact that tax-liable entities (whether legal persons or companies) are taxed by two different states due to lack of harmonization of tax rules and, therefore, theoretically both legally

[12] P. MERKS, *Tax evasion, tax avoidance and tax planning*, *Intertax 34*, 2006, pg. 272.

apply.[13] In other words, it often occurs as an unintentional result of insufficient or non-consistent tax regulations among states, whether bi- or multilaterally.[14]

Particularly common became the prevalence of double taxation of international and multinational corporations, whose commercial activities cross borders every day: in these cases, profit was taxed both in the state where the enterprise was resident, as well as in the jurisdiction where the profit was created, such as through selling their products.[15] Such cases began to raise concerns among contracting governments, so as to eliminate irregularities and inconsistencies and harmonize policies in order to incentivize cross-border commerce.[16] The elimination of double taxation constituted a strong motive that led governments and international organizations to the development of international agreements.

1.1.2. Delocalization of businesses

Another phenomenon that must be considered crucial when talking about the development of international fiscal regulations: delocalization of certain corporate activities. This concept has to do with enterprises that actively search for the obtention of competitive advantages.

Corporations from the beginning of the past century started to displace their activities to foreign jurisdictions – a phenomenon that is also frequently referred to as "offshoring" of activities.[17] Since then, corporations gradually started to become aware of the potential advantages they could obtain if their production, or most often, only part of their production, was "transferred" to certain foreign territories, regions and even continents (leading to a strong fragmentation of

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[13] S. A. Bank, *The origins of double taxation*, in *From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present,* New York, 2010 (online edn, Oxford Academic, 1 May 2010), https://doi.org/10.1093/acprof:oso/9780195326192.003.006.

[14] *Ibidem*

[15] *Ibidem*

[16] *Ibidem*

[17] A. Prencipe & F. Fontana, *Framing Offshoring: Antecedents, Processes, and Outcomes,* in *International Journal of Innovation and Technology Management*, 2012.

activities in production related activities) where circumstances were more advantageous for the entity.[18]

Either simply as an attempt to reach new markets or in order to obtain potential benefits – originating from states' divergent economic policies, regulations, the availability of natural resources, more efficient labor markets, and so on – companies were provoked to delocalize activities. As a result, offshoring became a common form of corporate strategy.[19]

In addition to the potential advantages such as those mentioned above, most relevant to the current investigation are the unfair fiscal benefits that enterprises under certain jurisdictions' regulations could and still can obtain.

There are certain states where tax conditions are disproportionately more favorable than in other states.[20] These "tax havens" have fiscal policies that are designed to offer null-tax or minimum-tax conditions for MNEs, primarily with the intention of encouraging foreign investment.[21] Similarly, some legislations, so called safe harbors, grant protection under certain conditions against otherwise "hostile" regulations for enterprises.[22]

Companies, by establishing manufacturing activities in those locations, could and can still easily reduce or even annul their fair share of taxes. Since firms continuously attempt to reduce taxes as much as possible, intentionally taking advantage of such beneficial conditions, also became a strong motive for offshoring.[23] Thus, such jurisdictions progressively became common corporate destinations.

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[18] D. MORGANTI & P. DE GIOVANNI, *Offshoring motivations driven by sustainability factors* in *Research in Transportation Economics 95*: 101222, 2022.

[19] *Ibidem*

[20] T. BRUNS, *Eliminate Tax Loopholes and Off-Shore Safe Havens*, in *European Citizens´ Initiative Forum,* 2021, https://europa.eu/citizens-initiative-forum/discuss/idea/eliminate-tax-loopholes-and-shore-safe-havens_es.

[21] *Ibidem*

[22] *Ibidem*

[23] *Ibidem*

Furthermore, the exploitation of inconsistencies as well as improperly covered areas of taxation among single states' unilateral tax regulations – also frequently labelled as fiscal gaps[24] – are also amongst the most common motives for malicious tax planning strategies of today's enterprises.

Therefore, the two main phenomena that led to the understanding that international fiscal regulations were needed, are, from one side, the issue of double taxation where entities may be imposed taxes on the same source twice from different states, and from the other, the issue of double non-taxation where companies find opportunities to escape or significantly reduce due taxes by delocalizing certain activities into low or no tax requiring jurisdictions.

Clearly, neither of the phenomena are favorable in global terms, what is more, may have detrimental impact: not only governments but other enterprises as well as any tax-paying citizen may suffer consequences.

Initially, the issue was addressed by single governments that started to establish bilateral agreements[25] addressing specifically the elimination of double taxation; later, through extensive works of international nongovernmental organizations, multilateral agreements began to address cross-border taxation[26] on a global scale as an attempt to clarify and regulate principles. Thus, bi- and multilateral fiscal agreements began to serve as useful practices whose policies help reduce and potentially eliminate scenarios of double taxation and double non-taxation.

[24] Fiscal gaps are also often called "lagoons" in fiscal legislation, which stands for uncovered areas of taxation present in certain jurisdictions, allowing for taxpayers to benefit from lower taxes – whether in an intended or in an unintended way.

[25] Bilateral agreements are contracts between two parties (whether these are states, persons, or other types of entities), where both comply with the obligations or restrictions that is pertinent to them. When signed between two states, it is also referred to as 'bilateral treaty' or 'bilateral treaty agreement'.

[26] The work of international organizations such as the United Nations and the Organisation of Economic Co-operation and Development on multilateral agreements regarding the multilateral regulation of taxation will be demonstrated in Paragraph 1.3.

1.2. <u>The evolution of the concept of Permanent Establishment</u>

As the first bilateral agreements were established for the regulation of double taxation, a concept of crucial importance was introduced that ever since have been playing a key role in linking tax obligations of an enterprise to a foreign state: Permanent Establishment.

The very first time, it was in 1899 in a bilateral tax treaty, established by Prussia with the Austro-Hungarian Empire for the purpose of regulating double taxation of commercial activities between the two governments, that referred to a "*business establishment [that] includes branch establishments, factories […] where purchases and sales are effected and other business facilities by which the owner, partner, manager or other permanent representative carries on his normal business activities*"[27].

Economic activities in that period and even during the first half of the 20th century consisted of physical goods only and, therefore, a stable physical settlement was also essential for carrying out any activity – whether they be sales, marketing, or manufacturing itself. It was, therefore, a perfectly reliable factor to consider for taxation.

Developments in international commerce in the early 20th century and the opening of markets led to an expansion of first multinational enterprises (MNEs) where international commercial activities started to involve more than just one or two countries; thus, bilateral tax treaty systems started to become insufficient. This led competent authorities, especially international organizations, to investigate the idea of putting in practice a multilateral tax treaty system.

It was, in fact, the League of Nations[28] that started addressing the question in 1921 and led to the realization of the first Model Convention in 1928 addressing

[27] J. HUSTON, & R. L. WILLIAMS, *Permanent establishments: A planning primer*, by *Kluwer Law and Taxation Publishers*, 1993.

[28] Section 1.2.1. is dedicated to the introduction of the core mission of The League of Nations as well as of other international organizations relevant to the present investigation.

double taxation.[29] The League of Nation's Model Convention used the same concept as the treaty between Prussia and the Austro-Hungarian Empire did and named the term "Permanent Establishment". A few years later, in 1943, at the Tax Conference in Mexico City and then in 1945 in London, the Model Convention went through reforms, which also included the readjustment of the concept of Permanent Establishment by being complemented with additional specifications (namely, "construction sites" was added to qualifying conditions).[30]

After all, Permanent Establishment's international recognition became more and more widespread. As a matter of fact, it shall be pointed out that the League of Nations certainly could not envisage the duration of the structure and principles of the Model Convention, and the relevance it would have in future tax-regulatory conventions[31]. In fact, it gave a strong basis to the future generations of models on double tax regulation.

As it is known, the League of Nations' work was taken over by the United Nations as well as by the Organisation for European Economic Co-operation after World War Two ended, and later in the 1960's by the Organisation for Economic Co-operation and Development.

1.2.1. <u>Introduction to the international organizations considered in the present study</u>

The League of Nations[32] was an international organization that was established by the Allies of World War One after the end of the war, specifically in the Treaty of Versailles and started to operate on the 10th of January in 1920. It was the first of its kind to address principally the importance of diplomacy and international

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[29] League of Nations: Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion (1928).

[30] Paragraph 2.3. will provide a detailed elaboration on this matter.

[31] M. KOBETSKY, *International taxation of permanent establishments: principles and policy*, *Cambridge University Press*, 2011, pg. 106.

[32] The United Nations (UN) Overview, *The League of Nations*, https://www.ungeneva.org/en/about/league-of-nations/overview.

dialogue in order to reach a higher level of collective peace and security, as well as global well-being.

The League of Nations was dismantled at the end of World War Two, and its work was taken over by the United Nations (UN)[33], created in 1945, which is chronologically speaking the second global reaching intergovernmental organization. The core purposes of the UN are multiple and similar to those of the League of Nations but address a much broader spectrum of key areas. These mainly consist of the following: advocacy for international cooperation for the protection of human rights, for the maintenance of collective peace and security and for promoting sustainable socioeconomic, cultural, and humanitarian development, while endorsing and preserving the precedence of the rule of law[34]. Falling into the area of the promotion of economic development, the UN also started to address the issue of interest of the present investigation, that is, international fiscal regulations, and more specifically, aiming at the elimination of double taxation.

Similarly, the Organisation for European Economic Co-operation (OEEC)[35] was set up after the end of WWII in 1948, principally for the sole purpose of easing the management and distribution of the financial aid for the restructuration of Europe that was provided by the Marshall Plan[36]. After more than a decade, when Canada and the United States as well the organization, it became a *de facto*[37]

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[33] The UN, *History of the United Nations*, https://www.un.org/en/about-us/history-of-the-un.

[34] The UN, *United Nations Charter, Chapter I: Purposes and Principles*, https://www.un.org/en/about-us/un-charter/chapter-1, Articles 1 and 2.

[35] É. Deschamps, *The Marshall Plan and the establishment of the OEEC*, in *Historical events in the European integration process (1945–2009),* 2021, https://www.cvce.eu/obj/the_marshall_plan_and_the_establishment_of_the_oeec-en-7cbc25dd-0c8d-49b1-924c-53edb2a59248.html; more information by The Organisation for Economic Co-operation and Development (OECD), *75th anniversary of the creation of the OEEC*, https://www.oecd.org/about/history/oeec/.

[36] M. Leimgruber, & M. Schmelzer, *From the Marshall Plan to global governance: Historical transformations of the OEEC/OECD, 1948 to present* in *The OECD and the international political economy since 1948*, 2017, pp. 23-61.

[37] The meaning of the term *de facto* is understood as being „in effect” in practice, but without written and formal recognition.

global organization and took up a new name and became the Organisation for Economic Co-operation and Development (OECD).[38] Today, the principal goal of the OECD is to achieve the highest possible economic progress, employment rate as well as the improvement of worldwide living standards[39]. Thus, the international regulation of fiscality, among many other areas regarding global economic development, is a central focus of attention of the OECD's everyday work.

It was in 1963 that the OECD began to draft its first double tax treaty Model[40], in which the OECD established a first definition of general character of the term Permanent Establishment. Its work was finalized in 1977[41], whose most recently updated version is in use today[42]. From now on, we will refer to the Model as OECD Model Convention (OECD-MC). In 1980 the United Nations as well launched its Model aimed at extinguishing double taxation[43], called "UN Model Double Taxation Convention between Developed and Developing Countries"[44] (UN-MC) and its updated version is also currently in use.

The above two Models are the most influential international taxation regulations aiming at the elimination of double taxation from a multilateral and global perspective. Also, of crucial importance to our investigation is the fact that the current conceptual delimitation of Permanent Establishment developed by either

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[38] OECD, *OECD 60th anniversary*, https://www.oecd.org/60-years/.

[39] OECD, *The Secretary-General's Strategic Orientations for the 2023-24 Biennium*, 2022, https://www.oecd.org/mcm/2022-OECD-SG-Strategic-Orientations-EN.pdf.

[40] OECD, *Draft Double Taxation Convention on Income and Capital 1963*, OECD Publishing, Paris, 1963, https://doi.org/10.1787/9789264073241-en.

[41] OECD, *Model Double Taxation Convention on Income and Capital 1977*, OECD Publishing, Paris, 1977, https://doi.org/10.1787/9789264055919-en.

[42] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017,* OECD Publishing, Paris, 2017, https://doi.org/10.1787/mtc_cond-2017-en, (hereinafter: OECD, *OECD-MC*, 2017).

[43] The UN, *UN Model Double Taxation Convention between Developed and Developing Countries (1980)*, 1980, https://digitallibrary.un.org/record/13957.

[44] *Id*, *UN Model Double Taxation Convention between Developed and Developing Countries (2021)*, 2021, http://www.un.org/development/desa/financing/document/un-model-double-taxation-convention-between-developed-and-developing-countries-2021.

one of the Models is also incorporated into the European Union's terminology, which uses it as a reference concept in its legal acts.[45] Thus, we take Permanent Establishment defined by the Models as conceptual basis of the present study and its definition will be explored next.

1.3. Defining Permanent Establishment under OECD-MC and UN-MC

This section's focus is to provide a general definition of the concept of Permanent Establishment as well as to offer a closer insight into the differences between the conditions for Permanent Establishment qualifications compared to those the UN requires.

1.3.1. Definition of the common core concept of Permanent Establishment

The current definition of Permanent Establishment is a result of regular updates of the Models. The notion is characterized by constant evolution over the decades, but the different stages share a generally accepted core concept. Similarly, as for today, different versions of the Permanent Establishment concept can be delineated, allowing for some degree of divergence among the definitions.

When considering business conduction sites as Permanent Establishment, some models are stricter while others less so, but the core concept remains the same, which considers 3 crucial characteristics: first, a Permanent Establishment must be a physical site or place (that is to say, it must be established), such as an office or a firm; second, it must be related to, as well as is crucial for the business itself, where certain commercial activities are carried out, essential to successful

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[45] See, for example: The Council of the EU, *Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market*, 2016, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32016L1164; as well as Id., *Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States*, 1990, https://eur-lex.europa.eu/EN/legal-content/summary/common-taxation-of-parent-companies-and-their-subsidiaries.html.

business conduction;[46] and last but not least, such physical business-related site must be fixed both in terms of location (in a country different from the company's "home"), as well as in terms of minimum duration.[47] This latter aspect is also the reason the concept was named using the title "permanent" establishment.

Furthermore, additional negative requirements need to be met in order for a fixed place of business to be considered as Permanent Establishment, such as those relating to the activities being carried out: a fixed place of business cannot be considered as Permanent Establishment when activities are only auxiliary or preparatory to a main activity, which is not intended to be carried out at that site; or when the use of the establishment regards only its utilization for storage or conservation purposes for later direct remittance to consumers (such as certain instances of warehouse facilities).[48]

Frequent examples might be listed as well for indicating concrete instances of Permanent Establishments so as to facilitate a common and clear understanding about the type of entities or activities considered as such. These may include a branch of the company (which by definition does not make up a separate legal entity such as the subsidiary does); warehouses in cases where the storage facility is not used for direct shipment to consumers; production as well as extraction sites where manufacturing of goods or mining activities, respectively, take place; and, last but not least, frequent examples of Permanent Establishments are those installations where managerial activities take place.[49]

All this considered, a generic definition of the concept of Permanent Establishment might be formulated as follows: a fixed place of business in a jurisdiction different from that of the enterprise's origin, where specific economic, manufacturing, or financial activities are carried out with a certain level of

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[46] Centre for Tax Policy and Administration - OECD*, Essential activities for business conduction are also referred to as "activities that have a productive character*", 2011, https://www.oecd.org/tax/treaties/48836726.pdf.

[47] R. O. ASOREY, *Tributación de la economía digitalizada*, Aranzadi/Civitas, 2021, (hereinafter: ASOREY, *Tributación de la economía digitalizada*, 2021).

[48] *Ibidem*

[49] *Ibidem*

frequency or continuity, which significantly contribute to the overall profit of the enterprise.

Next, a comparison will be made between two of the most influential and important Model Conventions regarding the regulation of Permanent Establishments: the OECD-MC and the UN-MC.

1.3.2. <u>Comparative analysis between OECD-MC and UN-MC, Article 5</u>

Starting from the core concept, it was essentially due to the official Commentaries on the Models (COECD-MC and CUN-MC – OECD, and UN, respectively) that suggested slight yet significant changes in the Models. These progressively have been apported over time to the Models, whose most recently updated versions are in use today. These are adopted not only by OECD Member Countries but competent international entities in the area of international tax regulation as well, including the European Union (EU).

The official positive definition of Permanent Establishment is reported in both Models in Paragraph 1 of Article 5, whereafter both Models establish a list of additional conditions that, if met, the fixed place of business qualifies for the Permanent Establishment.[50] As it will be shown, some of the articles of the two Models are the same or similar, while others differ in certain specific aspects. Let us have a look first at Article 5 of the OECD-MC, according to which:

The concept of Permanent Establishment may refer to a fix location of ongoing business activities that are being conducted, either partly or entirely, in that jurisdiction (Paragraph 1).[51] Such commercial activities may be through the existence of:

Managerial activities, branches, offices, manufacturing sites, workshops, or excavation activities of natural resources (such as oil, gas or minerals)

[50] OECD, *OECD-MC*, 2017, cit. note 42.

[51] *Ibidem*

(Paragraph 2);[52] such location must be fixed, and even if put in place in different sites, in them operations must be carried out with a certain level of continuity.[53] For instance, the term may indicate an installation or construction site provided that activities last a minimum of 12 months (Paragraph 3);[54]

Also, paragraph 4 establishes a negative list that disqualifies entities for Permanent Establishment. Those include establishments where business activities are supplementary or preliminary, such as committed solely to "*storage, display or delivery*".[55] On the contrary, activities which may be considered as complementary operations of major business processes are excluded from the exceptions (Paragraph 4.1).[56]

Paragraph 5 considers Permanent Establishment a person who is representing a firm through regular conclusion of contracts or by assuming the role of negotiator ("*dependent agent*");[57] however, paragraph 6 excludes from the concept of PE a person who is considered to be an "independent agent" such as a person acting for the company in accordance with its normal course of business;[58]

Finally, in Paragraph 7 and 8 the differences between "*subsidiary*" and "*branch*", as well as the notion of "*closely related*" enterprises are defined.[59]

As alluded earlier, these requirements in Article 5 by the OECD-MC differ in some of their points from those of the UN-MC.[60] To begin with, the first difference

[52] *Ibidem*

[53] *Ibidem*

[54] *Ibidem*

[55] *Ibidem*

[56] *Ibidem*

[57] *Ibidem*

[58] *Ibidem*

[59] *Ibidem*

[60] Department of Economic & Social Affairs of the UN, *Model Double Taxation Convention Between developed and developing countries*, 2021, https://financing.desa.un.org/sites/default/files/2023-05/UN%20Model_2021.pdf, (hereinafter the UN, *UN-MC*, 2021).

appears in Paragraph 3(a), where the OECD-MC establishes a minimum of 12-month test for a building or construction site to be considered as Permanent Establishment, while the UN-MC brings down this criterium to 6 months.[61] Furthermore, the latter explicitly includes "supervisory activities" and "*assembly projects*" related to building and construction locations as Permanent Establishment.[62]

Next, the UN-MC explicitly includes in the definition of Permanent Establishment "*furnishing of services*" (in cases where activities extend to "more than 183 days in any 12-month period"), like consulting, even when there are no traditional "brick-and-mortar" establishments present; the OECD does not make any reference to such activity.[63]

Third, for what concerns "*preparatory and auxiliary activities*" given in Paragraph 4, a "*delivery activity*" is explicitly considered as an exception from an activity qualifying as PE, while it is not stated as such by the UN-MC.[64]

Also, the UN-MC makes precisions regarding the case of insurance companies in Paragraph 6, while the OECD-MC does not establish specifications; this implies a higher probability that, for instance, insurance companies will be considered as Permanent Establishment under UN regulations than under OECD approach.[65]

Lastly, an interesting difference refers to certain activities related to "*independent agents*". Article 14, referring to professional services of independent character, such as "*scientific, literary, artistic educational or teaching activities [and] activities of physicians, lawyers, engineers, architects, dentists and accountants*"

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[61] *Ibidem*

[62] *Ibidem*

[63] Archipel Tax Advise, *Side By Side: Oecd-M & Un-M Tax Conventions*, November, 2022, pg. 6, https://www.archipeltaxadvice.nl/wp-content/uploads/2022/11/20221128-Comparison_OECD_UN-Archipel-NL.pdf.

[64] *Ibidem,* pg. 6

[65] *Ibidem,* pg. 7

has been cancelled from the OECD-MC, while it remains included in the UN-MC.[66]

Other Articles of both Models address different taxation-related issues, which are, however, less pertinent to the present investigation and are not going to be discussed. From a practical point of view, what may be concluded from the analysis of the two Models is that the existence of the differences in the Models highlight the importance for any given state to choose wisely the treaty it wishes to be part of; for example, grounding such decision on where the country in question is located on the scale of its development.

All this considered, most relevant to our investigation is the fact that Article 5 of both Models establish necessary conditions for determining the existence of Permanent Establishment status in a detailed manner, constituting for detailed and descriptive frameworks on which jurisdiction can multilaterally rely.[67]

Let us now have a more detailed look on what the Models establish regarding taxation rights of a state on profits of Permanent Establishments.

1.4. Interpreting the concept of Permanent Establishment in light of Article 7 OECD-MC and UN-MC

As we have previously seen in Article 5 of the OECD-MC and UN-MC, the definition of Permanent Establishment requires the existence of a fixed place of business with ongoing economic activity. In the same manner as individuals pay taxes on the salary they earn; enterprises have to pay taxes as well on the amount of profit they generate. In other words, whenever enterprises create economic value – profit –, it is liable to taxes. This is commonly called corporate income tax.

[66] *Ibidem*, pg. 17

[67] P. UPADHYAY, *UN Model Tax Convention Vs. OECD Model Tax Convention: Significance of Distinction*, Tax Guru, 2021, https://taxguru.in/custom-duty/model-tax-convention-vs-the-oecd-model-tax-convention-significance-distinction.html.

These, if not regulated in fiscal terms, may lead to double taxation on one hand, while on the other, double non-taxation due to arbitrary tax planning by enterprises in order to significantly reduce or evade taxes – neither of which is a desirable outcome for global welfare. Therefore, regulations are crucial, which, furthermore, must be comprehensive in a way that, from one hand, oblige enterprises to pay their fair share of taxes and that, from the other, only one of the contracting states may have the authority for receiving them.

Considering current global general knowledge on international taxation, if an enterprise has a Permanent Establishment in a given foreign state, the value it creates – sources – there will be liable to taxes to that jurisdiction only, which is also called the Source State. To date, this has been so mainly because a Permanent Establishment situated in the territory a given state benefits from infrastructure, services just as much as it does from the state itself, whose constitution guarantees legal security for the enterprise.[68]

In international law, corporations' tax obligations are regulated in the two models considered in the present investigation. This paragraph will deal with the respective articles, namely Article 7 of both OECD-MC and UN-MC. These have generally similar approaches to the challenges but considering specific scenarios, they may address them differently.

Under Articles 7 of both OECD-MC and the UN-MC, in order for a Source State to impose taxes on profits of a foreign enterprise, it must create the economic value within the territory of the Source State, and it must do so directly through a Permanent Establishment.[69] Both Models say that "*Profits of an Enterprise of a Contracting State shall be taxable only in [the Residence] State unless the Enterprise carries on business in the [Source] State through a permanent establishment situated therein*."[70]

Then the OECD-MC goes on to say: "*If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in*

[68] ASOREY, *Tributación de la economía digitalizada*, 2021, cit. note 47.

[69] Archipel Tax Advise, *Side By Side: Oecd-M & Un-M Tax Conventions*, 2022, cit. note 63.

[70] *Ibidem*

accordance with the provisions of paragraph 2 may be taxed in [the Source] State".[71] Put differently, this means that under OECD-MC, a Source State's authority to tax profits generated in their territory applies only to the amount of revenue that had been made directly through the Permanent Establishment; any business activity by an enterprise that is being conducted in the Source State but that cannot be considered as such being done directly in its Permanent Establishment, the Source State is not authorized to impose taxes on its profits.

On the other hand, the UN-MC proves to be slightly more indulgent towards Source State taxation, since it gives taxability rights not only to activities that are (a) directly attributable to the Permanent Establishment, but also to *"(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment*".[72]

Thus, it is evident that the OECD-MC is generally more Residence State taxing right preserving, while the UN-MC is more open to attribute authority to taxes in the Source State. That being said, it may be deduced that the former might be a better fit for developed countries, generally speaking, while the latter can favor developing countries more.[73] However, the reasoning behind this point falls out of the interest of the present investigation and, therefore, will not be further elaborated.

Instead, next, we will focus on the most relevant implications of PE-based taxation regime, especially in light of the modern global economy.

[71] OECD, *OECD-MC*, 2017, Article 7, cit. note 42.

[72] The UN, *UN-MC*, 2021, Article 7, cit. note 60.

[73] UPADHYAY, *UN Model Tax Convention Vs. OECD Model Tax Convention*, 2021, cit. note 67.

1.5. Implications of taxing Permanent Establishments

The whole point of Permanent Establishments is that it makes possible to collect taxes of enterprises' profit in any source jurisdiction; in other words, without the Permanent Establishment's figure, it would be impossible to carry out such tax imposition.

As it has been commented before, the OECD and the UN Models of Convention both try to tackle double taxation by establishing a detailed framework for multilateral use on which any state may rely. Regular updates of the Models demonstrate that both organizations make continuous efforts so as to keep up with the pace of the global, drastically changing economic scenario, which lead to the conclusion that both are works of excellency that have undoubtedly proved their effectiveness and served their purposes in a number of international tax-ambiguous occasions.

Even so, the concept of Permanent Establishment and the regulating Models seem to show a certain and ever-growing degree of incapacity in covering modern global economy's newly introduced challenges; new ways of doing business brought about changes that traditional-minded models are not able to tackle. These need innovative solutions.

Most importantly, when it comes to the digitalization of the economy, the concept of Permanent Establishment proves completely irrelevant: taking physical presence as the basis of taxable economic activity, when digitalized commercial activities are conducted virtually, clearly, is not a good way to go.

Thus, digital economy's international tax regulation becomes a rather complex issue to tackle. As a matter of fact, debates are open on whether new terminology should be introduced with regard to digital economy, or just amendments be made in the current Models just like it has always been done since the creation of the tax treaties.[74]

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[74] J. EISENBEISS, *BEPS action 7: evaluation of the agency permanent establishment, Intertax*, 44(6/7), 2016, pp. 481 – 502.

However, before entering into describing in greater detail the challenges that digital economy's taxation poses, first let us discover digital economy itself.[75]

[75] The challenges that digital economy poses on international tax regulations will be addressed in Chapter 3

Chapter 2

The Digital Economy – evolution, characteristics, and its taxation

This chapter will be focusing on describing the digital economy; first its evolution will be briefly introduced, while the next paragraphs will explore the concept itself in greater detail, paying attention to its beneficial as well as less advantageous sides. Finally, the chapter will look at the main challenges it brings to authorities in terms of its taxation.

2.1. The evolution of the digital economy

The early 20th century has impacted global economy with an intensity that had never been seen before (Second Industrial Revolution).[76] The opening of markets allowed the appearance of the first multinational enterprises (MNEs), which have quickly expanded their presence in many economies globally, giving birth to a phenomenon which is known today as globalization.[77] The promising profitability

[76] B. HOFFART, *Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through an Access to Markets Proxy Approach*, 6 Nw. J. Tech. & Intell. Prop. 106, 2007, https://scholarlycommons.law.northwestern.edu/njtip/vol6/iss1/6.

[77] Globalization is a term commonly referring to a phenomenon of an increasing global interconnectedness among states, regions and continents regarding economies, cultures and populations. Most relevant to the present investigation is to consider the economic perspective, where an ever-growing number of countries from the developed and developing world establish and maintain strong commercial relations with each other, often in the form of export-import and trade of goods and services, investment or information and people that travel freely across borders. Globalization appeared at the end of the 19th century, experienced a boom during the 1990's, and has reached its so-far-highest point today, particularly thanks to digitalization – a concept that is addressed in this Chapter. See: M. KOLB, *What Is Globalization? And How Has the Global Economy Shaped the United States?*, Peterson Institute for International Economics, 2018, https://www.piie.com/microsites/globalization/what-is-globalization.

of bringing business operations on an international level was a huge incentive for corporations to start externalizing commercial activities not only to neighboring states but also to farther locations.

This was, in fact, the most important determining factor of a globalizing economic system, which have introduced significant political as well as economic transformations across the globe. The encouraging nature of globalization induced drastic changes in business conduction strategies. It contributed to the evolution of new business models, consisting of the elaboration of improvements in logistics of product distribution so as to obtain the greatest efficiency, as well as in marketing strategies which started to play an ever growingly important role in reaching potential customers on a global scale.

By the second half of the 1900's century globalization has become a phenomenon of a consolidated character: most big corporations were already present internationally and a growing number of smaller businesses considered doing so as well (Third Industrial Revolution).[78] Then, thanks to major advancements in information and communication technologies (ICTs) during this period, including the foundation of Intel Corporation in 1968, that of Microsoft in 1975, the appearance of the first personal computers developed by IBM in 1982 and the advent of the first version of the internet in 1983, globalization received a further, second boom, which was even much more intense than the first.[79] The introduction of a virtual world led to historic changes affecting everyone, private life as well as the professional sphere.

In the field of economics these advancements in ICTs allowed corporations to translocate economic activities on a virtual level, which meant never-seen-before consequences.[80] The world started to witness the birth of another phenomenon of global impact: the digitalization of commercial activities (Fourth Industrial

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[78] M. XU, J.M. DAVID, & S. H. KIM, *The fourth industrial revolution: Opportunities and challenges* in *International Journal of Financial Research* 9.2, 2018, pp. 90-95, (hereinafter: XU, et al., *The fourth industrial revolution, 2018).*

[79] Z. J. ÁCS, ET AL., *The evolution of the global digital platform economy: 1971–2021,* in *Small Business Economics* 57, 2021, pp. 1629-1659.

[80] *Ibidem*

Revolution).[81] By the end of the 20th century, through a rather sophisticated fusion of the two major "components" making up the concept – namely, economics and new information technologies – digital economy was born and has been evolving ever since.

First the term digital economy was officially used in 1996 by Don Tapscott in his book called "The Digital Economy: Promise and Peril in the Age of Networked Intelligence".[82] In his work the author tries to shed light on the way digitalization would change global economy more or less the way it actually did acknowledging that:

"*We are at the dawn of an Age of Networked Intelligence – an age that is giving birth to a new economy, a new politics, and a new society. Businesses will be transformed, governments will be renewed, and individuals will be able to reinvent themselves – all with the help of the new information technology*".[83]

One business following the other, whether small or multinational, computer-based business activities started to become more and more incorporated into their management structure. Digitalization has created new ways of advertisement that took over former magazines and catalogues, subscription, product delivery, introduced new meaning to concepts such as services and intangible goods, as well as developed new forms of monetary transactions, and many more novelties, inventing and reinventing the meaning of all of these concepts. As of today, particularly due to the constrictions the COVID-19 crisis caused, digitalized activities – whether commercial or not – have become an essential part for everyone's lives, including businesses, as well as customers.

In fact, most, if not all, today's corporations would face critical challenges without the possibilities that information technologies provide, leading to the assumption

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[81] XU, et al., *The fourth industrial revolution, 2018*, cit. note 78.

[82] J. P. BOWMAN, *The Digital Economy: Promise and Peril in the Age of Networked Intelligence*, in *The Academy of Management Executive, 10(2)*, 1996, pp. 69-71, https://www.proquest.com/scholarly-journals/digital-economy-promise-peril-age-networked/docview/210528916/se-2.

[83] *Ibidem*

that digital economy has diffused within the whole economy to the degree, where separating it as well as its consequences from those of the economy itself can reasonably be considered impossible.[84] Francesco Boccia in his book about the digital economy emphasized that “[digital economy] can no longer be described as a separate part, or subset, of the mainstream economy”.[85]

In the same vein, digital economy is certainly going to be the future of economy itself, as it is noted by numerous experts’ predictions[86]. They argue that digital economy has already taken over the economy as a whole and has many yet-to-be-discovered possibilities to offer – whether when it comes to areas of healthcare, education, or economics itself.[87]

2.2. What is exactly intended by Digital Economy?

As the previous paragraph states, digital economy has completely diffused into global modern economy, where it is hard if not impossible to imagine a business that has not, to a varying degree, “digitalized itself” by incorporating ICTs in their everyday activities. This paragraph explores in greater detail what digital economy consists of.

Even though international organizations like the European Union or the United Nations do not provide an official definition for the digital economy, the European

[84] OECD Publishing, *OECD/G20 Base Erosion and Profit Shifting Project 2019: Addressing the Tax Challenges of the Digitalisation of the Economy*, Paris, 2019, https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf.

[85] H. Lee-Makiyama & B. Verschelde, retracted chapter: *OECD BEPS: Reconciling Global Trade, Taxation Principles and the Digital Economy*, in F. Boccia & F. Leonardi, (eds) *The Challenge of the Digital Economy*, Palgrave Macmillan, Cham, 2016, pp. 55–68, https://doi.org/10.1007/978-3-319-43690-6_4.

[86] S. Paz, *Economía digital: El futuro ya llegó*, 2021; V. M. Bondarenko, *Digital economy: a vision from the future*, in the *Journal of Economic Science Research, Volume*, *3*(01), 2020; W. B. Arthur, *Where is technology taking the economy*, *McKinsey Quarterly*, *697,* 2017.

[87] *Ibidem*

Union refers to the term as "businesses that sell goods and services via the internet, and digital platforms that connect spare capacity and demand".[88] It further goes on to say that there is not just a single way of doing business that would constitute for digital economy, rather it is a concept that englobes different procedure and a combination of actions that take as a basis the internet.[89] Furthermore, as an overall consideration, the EU regards digital economy as "the single most important driver of innovation, competitiveness and growth in the world".[90] Apart from the European Union's view on digital economy,[91] for many, the concept of digital economy is understood as a network of different business activities that are realized through the involvement of information technologies (ICTs).[92]

For some authors digital economy constitutes a particular subclass of economy lying within the scope of the traditional economy: a normal economic process that is characterized by an extensive amount of information that is being processed at a very high speed, 'enabled by the rapid and significant advancements in

[88] European Observatory of Working Life (EurWork), *Digital economy,* 2018, https://www.eurofound.europa.eu/observatories/eurwork/industrial-relations-dictionary/digital-economy.

[89] The EU Commission Press Release, *Taxation: Commission sets out path towards fair taxation of the Digital Economy*, Brussels, 2017, https://ec.europa.eu/commission/presscorner/detail/en/IP_17_3305.

[90] A. M. A. MUSLEH AL-SARTAWI, *Assessing the relationship between information transparency through social media disclosure and firm value* in *Management & Accounting Review (MAR)*, *18*(2), 2019, pp. 1-20.

[91] Regarding EU's extensive work on the digitalization of the economy, noted must be its efforts for establishing a well-functioning European Digital Single Market. The topic is introduced in Paragraph 3.2.

[92] R. BUKHT & R. HEEKS, *Defining, conceptualising and measuring the digital economy* in *Development Informatics working paper*, 2017, pg. 68; G. GOLOVENCHIK, *Theoretical approaches to the digital economy definition* in *Science and Innovation*, *1,* 2019, pp. 54-59.

technology and a „dematerialization”[93] of classic economic processes.[94] Other experts, instead, see digital economy as a different business model – with a set of very different characteristics.[95]

Talking about dematerialization, it is essential to highlight the fact that the digital economy relies prevalently on intangible assets and goods. Such intangible assets may take the form of software, specific knowledge or intellectual property, or patents and licenses that protect such intellectual properties. They all are intangible, simply because they are not physical in nature, in comparison with tangible goods.

It is also important to note, that digital economy does not necessarily mean an exclusively digital conduction of business. In general, digital economic business models may be divided into two major categories.[96] The first class of businesses in the digital economy are those that are exclusively digital.[97] In the other class there are those businesses that are conducted only partially in the digital reality (these are also called hybrid business models); these mainly use and benefit from the Internet and, in general, from ICTs only for certain operations.[98]

Thus, when talking about digital economy it is important to note that regardless of whether a given enterprise also has physical economic presence or not, once it conducts economic activities also in digital form, it constitutes part of digital economy.

[93] The term dematerialization should be intended as the process by which intangible services and goods became progressively the prevalent form of product (such as is the case of renting services, online audiovisual and music streaming platforms), taking over of traditional tangible (physical) goods.

[94] L. HRABČÁK & A. POPOVIČ, *On certain issues of digital services taxes*, in *Financial Law Review 17.1*, 2020, pp. 52-69.

[95] M. KAŹMIERCZAK, *EU Proposal on Digital Service Tax in View of EU State Aid Law*, in *Financial Law Review* 25.1, 2022, pp. 93-109.

[96] *Ibidem, pg. 95*

[97] *Ibidem, pg 95*

[98] *Ibidem, pg. 95*

To better illustrate this latter consideration, let us take as example the different business conduction strategies that distinguish an exclusively digital enterprise to a MNE that conducts only a portion of its activities online: consider e-Bay and contrast it to Lidl's commercial activities.

As it is known, both corporations allow customers to select, order and eventually purchase products online, on their respective websites which are then going to be delivered to the address provided by the customer. However, it is also known that anybody can also walk in the stores of Lidl check out the enormous range of product offer and eventually pick the products they wish to purchase, which, in the case of e-Bay product selection and purchase is only possible virtually; as a matter of fact, e-Bay does not even own any physical real estate property that accessible for customers. Lidl, therefore, is to be considered a MNE, which also offers digital commercial activities, while e-Bay is exclusively a digital corporation. Yet, both corporations constitute for a part of the digital economy as they both conduct digitalized commercial activities.

As of today, due to ICTs' near-unlimited capacities, almost any business activity may be of digital character. These can be corporate operations in different areas, such as in customer service, in accounting, in marketing, or in education; financial transactions, understood as the effective payment for products or services – whether received or executed; or professional interactions like entities' strategic communications, be them business to business (B2B), business to employees (B2E), business to government (B2G) or to consumers (B2C). Such commercial activities, and many more, which take information technologies as means of execution, makes up a part of digital economy.

But what does digitalization of the economy actually mean something for our already globalized world; is it something positive; even if it generally is, what might be the downsides? The following paragraph will look at such questions, as it attempts to delineate potential benefits as well as negative side of digitalization.

2.3. <u>Advantages and drawbacks that digitalization brought about</u>

A world which is characterized by information overload and an ever-growing necessity to process that information within the shortest possible amount of time, digitalization proves to be a great alternative. Digital economy is information driven, highly mobile, immediate, and individualizable – enough to think of e-mail marketing strategies, for instance.

Through digitalization businesses can easily deal with an overload of data and information; store and process that information in an efficient way, as well as make complex calculations under thousandth of seconds. Information technologies solve tasks better, faster, and often by a different logic than in traditional ways; not to mention the fact that often in a financially more convenient manner, as well.[99]

The growing trend of markets relocating on-line offers innovation, new opportunities, alternative business models and not only constant but exponential evolution.[100] Hyperconnectivity, being one of the pillars of the digital economy, assures growing interwovenness among governments, organizations, machines, businesses and consumers.[101]

Since it relies mostly on intangible assets that do not face geographical barriers, digital economy has easily obtained global reach, which in turn encourages itself for further evolution.

With all this in mind, we can conclude that it is in digital economy's efficiency and effectiveness that evidences the vast number of advantages it can provide for

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[99] M. K. PRATT, *Digital Economy*, September 2017, TechTarget, https://www.techtarget.com/searchcio/definition/digital-economy.

[100] J. POTTS, *Evolution of the Digital Economy: A Research Program for Evolutionary Economics*, in *The Research Agenda for Evolutionary Economics, Kurt Dopfer (ed)(Edward Elgar)*, 2020.

[101] Deloitte, *What is digital economy? Unicorns, transformation and the internet of things*, https://www2.deloitte.com/mt/en/pages/technology/articles/mt-what-is-digital-economy.html.

both corporations and (potential) customers. However, cyberization of economies also comes with a less favorable side.

First and foremost, since consumer data collection, storage and use are at the heart of digital economy, privacy concerns must be brought up as one of the most important challenges that arise.[102]

Second, a closely related issue has to do with the data stored and protected being subject to cyberthreats by attackers.[103] Thus, cybersecurity concerns pose serious threats which need sophisticated regulation in order to reach higher digital safety.[104]

Third, but not less importantly, since the offer of online services are not delimited by geographic constraints, consumers can easily confront prices, products' quality as well as other necessary aspects and choose the best option available on the market. Such a phenomenon raises concerns related to abuse of dominance and competition rights: providers that are already in dominant position in a given market may rigidly hold onto their status.[105] Thereby, they may cause insuperably challenging circumstances for new businesses to enter or, for already functional traditional businesses to keep up, which, in turn, reduces legitimate competition rights for the smaller enterprises.[106]

Fourth, digitalization gave rise to the circulation of intangible products, such as ideas, formulas, to which access is usually highly protected. Therefore, determining the value of such non-physical assets can be tricky; such unclarity and lack of reference on valuing intangible assets leaves opportunities for big corporations to manipulate prices, and eventually to "play with" huge amounts of

[102] C. A. WANG, N. ZHANG & C. WANG, *Managing privacy in the digital economy* in *Fundamental Research*, *1*(5), 2021, pp. 543-551.

[103] L. CHEN, ET AL., The digital economy for economic development: Free flow of data and supporting policies, *Policy Brief* 4, 2019, pg. 12.

[104] *Ibidem*, pg. 13

[105] R. A. CASTELLANOS PFEIFFER, *Digital economy, big data and competition law* in *Mkt. & Competition L. Rev.*, *3*, 2019, pp. 53-89.

[106] *Ibidem,* pg. 78

money, allowing them to carry out internal transfers for self-benefiting purposes.[107]

As a consequence, abusive arbitrary pricing behaviors – whether intentional or unintentional – gives space for abusive tax planning tactics.[108] Thus, most inherently to the present investigation, digital economy poses significant challenges to governments and international actors regarding effective tax regulations.

Let us now have a detailed look on the current relationship between digital economy and taxation.

2.4. Digital economy and fiscality

This paragraph looks at how the digital economy and taxation interact. It discovers in greater detail which are the major challenges that digitalization poses to fiscality, as well as gives an insight of what might be the most suitable solutions.

2.4.1. New tendencies introduced and enhanced by digitalization: Profit shifting and transfer pricing

As mentioned in Paragraph 2.1.2., corporations' delocalization of activities was a very common example of their attempts aimed at lowering costs, including taxes; however, there is a related practice that is brought about by digitalization, which is although different in nature, is very similar in its objective.

In this scenario an enterprise may "transfer" its profits without moving production or any related activity; it does so simply by registering their presence in jurisdictions that "offer" more favorable fiscal conditions and books their profit

[107] Y. HOLTZMAN, & P. NAGEL, *An introduction to transfer pricing* in the *Journal of management development*, *33*(1), 2014, pp. 57-61.

[108] The challenges about value assignation to intangibles is better addressed and further elaborated in Paragraph 2.4.1.

there. This “moves” also the rights to tax to that jurisdiction – depending on the national standards on taxation of the jurisdiction concerned. Such action is commonly known as profit shifting. But how does profit shifting occur?

The practice that enables profit shifting is called transfer pricing. Transfer pricing, primarily, is a non-abusive, moreover, obligatory commercial transaction that requires entities to assign a value on intra-corporate transactions (business entities within the same multinational group). It should be done exactly the way as if the same transaction was carried out on an inter-corporate level, that is to say, which is, in reference to the Arm’s Length Principle[109] where assets are priced to fair market value. An arm’s-length price for a transaction, would be the same price as if the transaction was carried out in the open market.[110]

Relatively easy to determine for tangible goods, such as apples or books: one entity may refer to the price a non-related entity assigned to the same good; but considering intangible assets, like intellectual property, arriving at an arm’s length price may be a more complex task.[111] A possible way to measure the value of intangible assets would be to on basis on the costs that it requires to protect the production, such as licenses or patents.[112]

However, since intangible assets’ value are hard to estimate, the international community lacks intercorporate price references and, thus, control is inefficient. This leaves open doors for malicious strategies and corporations are often enthusiastic to exploit such scenario.

In “BEPS-terms”, thus, transfer pricing is an exploitative strategy, where companies assign artificially high cost to certain operations or products that in

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[109] The “*Arm’s Length Principle*” as applied in transfer pricing rules says that the value charged between related parties for a given asset must be the same as if the entities were not related. OECD, *The Arm’s Length Principle* in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010*, 2010, https://doi.org/10.1787/tpg-2010-4-en.

[110] *Ibidem*

[111] COSTANZA ORTIZ, *Systems of Preferential Tax Treatment in the EU: A Case Study of Apple*, Inc. *Hastings Int'l & Comp. L. Rev.*, *vol. 43*, 2020, pp. 365-385, (hereinafter: ORTIZ, *A Case Study of Apple,* 2020*).*

[112] *Ibidem,* pg. 371

reality did not have such high value, (for example, under the excuse of Research and Development (R&D)), purposefully to shift profits from higher to lower taxing jurisdictions.

Thus, the transfer pricing system along with digitalization give wide span of opportunities for MNEs to use transfer pricing methods to shift profits using mysterious internal prices and, eventually, register earnings in their offices located purposefully in jurisdictions where taxes are low or none.

Competent fiscal authorities, therefore, face particular challenges in determining whether transfer pricing has occurred under fair conditions (at “arm’s length) or has been used for exploitation: base erosion and profit shifting (BEPS) purposes. BEPS is a very important term in this context, since, as will be shown in Chapter 4, it is regarding such practices that international organizations, such as the OECD, develop countermeasures.

BEPS, thus, are corporate tax planning strategies, that refer to all the creative strategies that tax planners of MNEs suggest carrying out in order to “erode” the “tax base” in high tax countries. While not always illegal, in most of the cases unethical, unfair, and potentially detrimental for fair competition.

2.4.2. <u>The issue with the principle of physical presence as taxable nexus</u>

In reference to what has been said so far throughout the present investigation, current international tax regulations require corporations to pay their taxes to the state where they source their profit from, provided that they maintain physical presence in that jurisdiction through a Permanent Establishment. If they do not dispose a Permanent Establishment in the state, the taxable nexus – “linking” the enterprise’s profit to a state responsible for imposing taxes – is missing; that jurisdiction, according to current regulations, is not authorized to impose taxes on revenue, even if it was its very citizens who paid for services and products.

As it is known, commercial transformations that came hand-in-hand with the digitalization of economies gave rise to the scenarios where enterprises are not physically present in a country yet carry on commercial activities – may them be in sales, marketing, or other. Whether we talk about exclusively platform-based businesses or multinational corporations (MNEs) operating only partially in the digital economy, they both easily generate profit by selling services and products to customers in different parts of the world, despite not being physically present in all those jurisdictions.

Such scenarios made it clear that current taxation standards are no longer adequate for today's global reaching modern economy, due to the impossibility of using the principle based on physicality for the determination tax duties of virtual operations, unrestricted by physical obstacles such as frontiers.

The need for the development of new framework models, adequate for regulating the modern economy became clear for competent authorities on a global level, which still face the challenges of the complex and time-consuming task that are still ahead of them (despite evident progression in the matter)[113].

New framework models, thus, must be based on a principle that is different from physicality, and that take into consideration the unbounded nature of modern economic transactions. In other words, the most important task is to identify a new taxable nexus, so that enterprises' online generated profit can be linked to the state where it genuinely generated its income, and thus attribute to that state the authority to tax.

2.4.3. <u>Identification of a new taxable nexus, apt for the digital economy</u>

Since most of the products are hard-to-value intangible assets, capturing digital economy's footprint is difficult.[114] However, there are two general understandings by today regarding tax regulations for the digital economy.

[113] The most important international global initiatives and multilateral agreements on taxing the digital economy is discovered in Chapter 3

[114] European Parliamentary Research Service (EPRS), *Taxation of the digital economy: Latest developments*, 2020,

First, the solution must be found internationally that establishes common rules for every actor so that corporations as well as single states can no longer develop exploitative tactics for self-benefiting purposes. It is, therefore, crucial that states that host and tax the largest corporations be in agreement with jurisdictions where these enterprises source their value from.[115]

Second, the new taxable nexus for the digital economy shall be oriented to the destination of products and services.[116] The reason that lies behind this assumption considers basically two major factors.

First and most importantly, it must be noted that it is consumers – buyers and users of digital services and products sold digitally – that generate the income of the enterprise by purchasing the offered goods. Thus, the location of value creation shall be considered equal to consumers' location, which, itself would be a sufficient reason to allocate taxation rights to product destination states. But there is another factor for doing so.

Product offer, consumers and purchasing transactions all heavily rely on the provision of infrastructure: electricity, financial and banking services, internet providers, and in certain cases delivery – all of which are granted by the destination country. [117] Clearly, the use of these services must be compensated for, making that state be most deserving of taxes also for this reason, regardless of the firms' own physical location.[118]

Considering all the aforementioned, two main conclusions can be made: on one hand, given digital economy's global reach, it is clear that digital taxation requires an international solution in order to assure coherence and harmony of taxation standards.

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https://www.europarl.europa.eu/RegData/etudes/ATAG/2020/659414/EPRS_ATA(2020)659414_EN.pdf.

[115] *Ibidem*

[116] *Ibidem*

[117] Á. G. J. REQUENA, *Adapting the concept of permanent establishment to the context of digital commerce: from fixity to significant digital economic presence* in *Intertax*, *45*(11), 2017.

[118] *Ibidem*

On the other hand, such global solution shall be oriented to giving tax authority for product-destination states in order to obtain a more equitable distribution of taxes on a global scale that reflect the nature and complexity of digital economic operations.

2.4.4. The urgent need for a multilateral and comprehensive solution

Current estimates of the European Commission show that digital enterprises, generally speaking, pay lower rates of taxes than their traditional business counterparts[119]. According to a 2018 European assessment, digital businesses paid an around 9.5% of taxes on average that year, while for traditional businesses the average tax rate was around 23.2%.[120] This might have happened, and similar tendencies continue to happen for two major reasons.

First, as it has been mentioned, digital taxation is still unclearly and ineffectively regulated, and many businesses can just get along without paying their fair share of contributions. Second, because digitalization itself fuels economic growth, some governments are rather reluctant in imposing reasonable tax rates on digital services – like those they do on traditional firms –, thereby encouraging their diffusion.

Clearly, if taxation of digitally operating firms remains unregulated at an international level, it can lead to further propagation of unjust distribution of taxes, mainly through planned tax elusion and evasion strategies on one side, and through double taxation on the other – among the most possible negative consequences.

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[119] M. SZCZEPAŃSKI, *Taxing the digital economy: New developments and the way forward*, *EPRS*, 2021, http://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698761/EPRS_BRI(2021)698761_EN.pdf.

[120] The EU Commission, *SWD(2018) 82 final, Executive Summary Of The Impact Assessment, Accompanying the document Proposal for a Council Directives(..)*, 2018, https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SWD:2018:0082:FIN:EN:PDF.

There was, therefore, and continues to be, an obvious need to invent solutions that guide governments around the world in taxing online economic activities of not only enterprises that conduct all their activities exclusively through information technologies, but also of any MNEs, that carry on only a part of their commercial operations digitally.

So far, several international actors, including the OECD and the EU, have addressed the question, and proposed different potential alternatives, which generally agree on the main principles addressed.

Yet, developing functional regulations is itself a sophisticated task, while reaching agreement is just as much difficult - especially speaking for the EU, which would require Member States to be unanimously concordant. Clearly, all of them have different points of view, as well as different interests. Therefore, none of the initiatives has managed to become the definite solution so far, neither at EU nor at G20 level. The following chapter will take a look on such initiatives, developed by the OECD and by the EU.

Chapter 3

International initiatives on the regulation of digital taxation – the OECD and the EU

As it has been mentioned in paragraph 3, digitalization of the economy poses real challenges on the regulation of international tax systems. Even though the Model Conventions by the OECD and by the UN have been trying to make effective regulations by providing multilateral solutions for the harmonization of national tax systems, digitalization came in the way as a “virtual reality”, where, from one side, classic “brick-and-mortar” businesses are less-and-less in number and in economic significance, and, from the other, national borders cease to pose any obstacle for international commerce to take place. Digitalization itself is the number one factor that, even unwantedly, lead to a border-independent diffusion of profit-creation.

Bearing this in mind, particular attention must be paid to MNE’s malicious tax planning strategies, in which they register their businesses to jurisdictions that require significantly less amount of impositions, also called tax havens, thereby taking advantage of illegitimate fiscal benefits. Clearly, the existence of differences in taxation systems, along with the lack of regulation on such corporate behaviors pose real challenges to international policymakers for the creation of harmonized international fiscal regulations. However, such an instrument is crucial in order to put an end to enterprises’ tax elusion and tax evasion strategies – as it is also highlighted by the OECD.[121]

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[121] The OECD highlights that malicious tax-planning strategies are allowed mainly because of the lack of a single, global tax-regulating framework system; it further argues that it is only such system that could impede that enterprises find fiscal gaps among unilateral tax rules and take advantage of them by “moving” their profits to low- or no-tax locations, thereby avoiding the payment of the due fair-share of taxes, which is to say, “eroding the tax-base".

In this matter efforts have already been made by international governmental as well as non-governmental organizations, such as the European Union and the OECD, respectively, whose models are considered in the present chapter. First, the OECD's initiative, the so-called Base Erosion and Profit Shifting (BEPS) Project will be shown, while later the Chapter will look at EU's attempts through Directive Proposals on regional regulations.

3.1. OECD's attempt to regulate digital taxation – the BEPS Project

As early as in 1998 the OECD started to develop a "Taxation Framework Conditions" for "Electronic Commerce"[122]. Ever since then, it has been a continuous and never-ending work on the development of necessary instruments in order to tackle the challenges of digital taxation. Since their Summit in 2008 in Washington[123], G20[124] countries have been supporting OECD's initiatives, including a then-future project, namely the Base Erosion and Profit Shifting Project[125], (hereafter BEPS Project), which would constitute for a common international framework on which states can multilaterally rely that specifically addresses the regulation of exploitative tax planning strategies.

OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, 2015, Paris, https://doi.org/10.1787/9789264202719-en.

[122] OECD, *Report by the Committee on Fiscal Affairs*, 1988, https://www.oecd.org/ctp/harmful/1904176.pdf.

[123] OECD, *The 2008 G20's Declaration of the Summit on Financial Markets and the World Economy*, Washington DC, 15 November 2008, https://www.oecd.org/g20/summits/washington-dc/.

[124] The Group of Twenty or G20 countries are a group of states, represented by their financial leaders, whose most important objective is to promote the internationalization of economy, inclusive economic development, and financial cooperation among its members as well as on a global level. The G20 comprises 19 countries (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Türkiye, United Kingdom and United States) as well as the European Union; see: https://www.g20.org/en/about-g20/.

[125] J. C. PEDROSA LÓPEZ, *El plan de acción BEPS de la OCDE: pasado, presente y futuro*, in *Actualidad jurídica iberoamericana*, Nr. 2, 2015, pp. 689-706, http://hdl.handle.net/10550/43205.

Mindful of such objectives, and in response to the G20's request, in 2013 the OECD published a report addressing an actual Action Plan on BEPS[126] that, in line with previous considerations on the topic, would eventually make up for a coordinated framework model on international taxation. After two-year-long detailed analyses on jurisdictions' diverging systems of tax regulations on the digital economy, in October 2015, G20 countries came to agreement on the development of the actual BEPS Project.[127]

The project's major overall aim is to put an obstacle for internationally present enterprises, trying to escape due taxes or obtain illicit benefits through the abuse of fiscal gaps, diverging unilateral regulations or policy contradictions.[128] Through the BEPS Project the OECD establishes new global standards, apt for multilateral use, that OECD jurisdictions can adopt. As such, the Project is an attempt to ensure transparency, economic substance, and major level of coherence in taxation matter, while eradicating instances of double taxation as well as hidden opportunities for double non-taxation.[129]

The BEPS Project is divided into "15 focus areas" all-together forming a set of relevant tax-regulatory framework.[130] The Actions can be regrouped according to the 3 core concepts the BEPS Project tries to achieve, which are the following:

Coherence: regulating hybrid mismatch activities (Action 2), designing transparent corporate tax rules (Action 3), introducing interest deductions and other monetary payments (Action 4), contrasting dangerous tax operations (Action 5);[131]

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[126] OECD, *Action Plan on Base Erosion and Profit Shifting*, 2013, https://www.oecd.org/tax/action-plan-on-base-erosion-and-profit-shifting-9789264202719-en.htm.

[127] OECD, *BEPS Final Reports*, 2015, https://www.oecd.org/tax/beps-2015-final-reports.htm.

[128] *Ibidem*

[129] M. XERRI, *Selected BEPS Action Plan: countering harmful tax practices more effectively, taking into account transparency and substance, how is it likely to change the international tax landscape*, Master's thesis, University of Malta, 2016.

[130] OECD, *Action Plan on Base Erosion and Profit Shifting*, 2013, cit. note 126.

[131] *Ibidem*

Substance: impeding the abuse of the of treaty benefits (Action 6), preventing the avoidance of PE status (Action 7), regulations on transfer pricing (Actions 8–10);[132]

Transparency: follow-up and monitor BEPS (Action 11), disclosure policy (Action 12), indications on the documentation of transfer pricing and other reports (Action 13), effective conflict-resolution guidance (Action 14).[133]

Of these groups remain Action 1 and Action 15, each of which make up for a category themselves due to their specific nature: Action 15 aims to establish guidance on how jurisdictions can overcome previous bilateral treaties (in force since 1st July 2018), while Action 1 addresses a broad range of fiscal challenges, specifically those that economic digitalization brought about.[134]

In order for the tool to be adaptable worldwide, in 2016 the OECD developed an Inclusive Framework[135] model on BEPS for minimum standards, so that not only OECD and G20 jurisdictions, but any state that wishes to sign the agreement can as well rely on the instrument on an egalitarian basis. Till date, more than 140 countries joined the Inclusive Framework.[136]

Furthermore, in July 2021 the OECD updated the BEPS Model, in particular its Action 1, and developed a new version of the initiative, referred to as BEPS 2.0.[137] The new model is split it into two Pillars, namely Pillar One, whose focus is the

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132 *Ibidem*

133 *Ibidem*

134 *Ibidem*

135 OECD, *Inclusive Framework on BEPS Progress report July 2016-June 2017*, 2017, https://www.oecd.org/tax/beps/inclusive-framework-on-BEPS-progress-report-july-2016-june-2017.pdf.

136 OECD, *Developing Countries and the OECD/G20 Inclusive Framework on BEPS*, 2021. https://www.oecd.org/tax/beps/developing-countries-and-the-oecd-g20-inclusive-framework-on-beps.pdf.

137 OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy,* 1 July 2021, https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.htm.

redistribution of taxing rights and rules as well as the determination of specific proportions of taxable profits, and Pillar Two, which introduces a global minimum tax rate to be levied on major MNEs' profits.[138] The BEPS 2.0 is the focus of the following section.

3.1.1. The two pillars of BEPS 2.0 Project

Continuous works, drafts, proposals, and official commentaries led the OECD to commit particularly to the issue of global taxation with particular consideration of the digital economy. Years of speculations on a how to develop an even more effective instrument resulted in an amendment that took place in 2021.

In July as well as in October 2021, 134 and 139, states' representatives met in order to close an agreement to continue implementing the recommendations of Action 1 of the BEPS Plan, respectively.[139] The aim of the meetings was to further alleviate the challenges posed by international taxation concerning the digital economy. This new agreement between the OECD, G20 and 139 other states[140] resulted in a radical change in the structure of the BEPS Project, giving birth to a new phase of BEPS' evolution.

3.1.1.1. BEPS 2.0. Pillar One

Pillar One of BEPS 2.0 aims to redistribute international fiscal rights and rules in a more equitable and fair way, so that, from one side, new global fiscal rules would discourage the displacement of MNEs activities for fiscal purposes as well

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[138] *Ibidem*

[139] OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy,* 8 October 2021, https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf, (hereinafter OECD, *Two-Pillar Solution*, 2021).

[140] Today, as of 2023, the total number of countries that joined the Inclusive Framework has risen to 143. See: OECD, *Members of the OECD/G20 Inclusive Framework on BEPS*, Updated: 9 June 2023, https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf.

as attempts profit shifting, and, from the other, increase taxing rights of states where those are clearly justified.[141]

Pillar One addresses a substantial change with respect to MNEs' residency and consumers location: it reassigns tax obligations of firms from the place of their residency to the state where their consumers are located where there is evidence of important and ongoing engagement with the market, regardless of the company's physical presence.[142] The logic behind this decision lies within the fact that today's MNEs communicate, advertise and sell products in a digital format, involving and benefiting from consumers from various jurisdictions. Thus, profit generated from customers or customer data extracted from any given country will be liable to taxes to that jurisdiction, regardless of the existence of physical presence of the company in that jurisdiction.[143]

According to Pillar One, the new taxable nexus shall be determined through either of the following two different rules: Amount A and Amount B.[144] According to Amount A, which constitutes for a quantitative nexus test for MNEs, enterprises regarded are those whose annual revenue exceeds 20 billion Euros (which after 7 years are to be reduced to 10 billion), with a minimum of 10% of profit per total revenue ratio (also called profit margin).[145] Such MNEs shall be subject to new regulations.

Amount B, in turn, refers to a different approach, addressing principally smaller internationally operating firms (even though it does not delimit the eligibility of enterprise on the basis of how much revenue they make).[146] Determines tax obligations on "*in-country baseline marketing and distribution activities*" through

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[141] OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS*, in *OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing, Paris, 2020, https://doi.org/10.1787/beba0634-en.

[142] *Ibidem*

[143] *Ibidem*

[144] *Ibidem*

[145] *Ibidem*

[146] *Ibidem*

the application of the arm's length principle, unlike the more complex Amount A.[147]

All in all, Pillar One addresses a solution for a new taxable nexus of digitalized enterprises, as well as establishes quantitative measures that determine the ratio of the revenue to be taxed. As such, Pillar One helps determine which operations shall be taxed, where, and how much. Concerning the EU, although efforts are made, it has not yet been incorporated into its legislation and it is still uncertain whether in the future it will be implemented or not.[148]

3.1.1.2. BEPS 2.0. Pillar Two

On the other hand, Pillar 2 establishes minimum global tax standards that ensure that MNEs cross-border economic activities pay a minimum amount of taxes on the revenue they make to jurisdictions, where there is a demonstratable important and ongoing engagement with the market.[149] More specifically, Pillar Two would ensure that the concurrence between states in offering the lowest possible amount of taxes so as to attract foreign investment comes to an end: it establishes a 15% of corporate tax that must be levied on MNEs profits in every jurisdiction where the company sells as a global minimum standard.[150]

This rule to be applied is referred to as the GloBE (Global anti-Base Erosion) regulation and further specifies that MNEs, whose annual overall revenue exceeds 750 million Euros are subject to this global minimum tax in every state they conduct commercial activities, as long as in each of those jurisdictions the total revenue created exceeds 10 million Euros and the profit exceeds 1 million

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[147] *Ibidem*

[148] The EU Commission, *COM(2023) 377 final*, *Report from the Commission to the Council – Progress Report on Pillar One*, 2023, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023DC0377.

[149] OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, in *OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing, Paris, 2020, https://doi.org/10.1787/abb4c3d1-en.

[150] *Ibidem*

Euros.[151] Furthermore, jurisdictions are allowed to apply a so called “top-up” tax when their previous regulations required a lower rate of tax than 15%.[152]

One of the most important elements of Pillar Two is that it requires multinational corporations to prepare documentations on their operations for each country. This requirement is a so-called Country-by-Country Reporting (CbCR).[153] This contributes significantly to transparency of global taxation, since through clear documentation every operation is traceable *a posteriori*.

In consideration of the Two Pillars altogether, according to OECD’s estimates, BEPS 2.0 would contribute to a potential increase in global fiscal revenues of a minimum of 4% and would most significantly affect countries who receive the highest amount of direct investment – typically states that have been “offering” advantageous tax conditions for MNEs, such as Ireland, the Netherlands or Singapore.[154]

The BEPS Package, and in particular the BEPS 2.0 is a fundamental initiative by the OECD that can be considered as an important milestone in the development of a comprehensive fiscal regulating framework, also useful considering the digital economy. However, since the Package does not address specifically digital enterprises and, thus, digital taxation, it is not sufficient for that purpose.

3.1.1.3. BEPS 2.0’s impact on European Union’s tax regulations and on those of its Member States

With the European Union being one of the pioneers in developing regional-international tax regulation initiatives, in December 2022 Pillar Two was officially

[151] *Ibidem*

[152] *Ibidem*

[153] *Ibidem*

[154] I. FAROOQ & U. JAVED, *BEPS 2.0: Pillar 1 and Pillar 2 Update*, Rödl and Partner, 2022, https://www.roedl.com/insights/beps-pillar-update.

incorporated into its fiscal policy.[155] Foreseeably, the implementation of Pillar Two in European Union's Member States' legislations will have taken place by the end of 2023.[156] Accordingly, this would consist of the introduction of a minimum 15% tax of annual income of largest multinational enterprises whose annual turnover is at least 750 million euros. Since European countries' tax legislations are widely varying, it would mean drastic changes to the different jurisdictions. For example, as for 2021, Portugal required the highest rate of corporate taxes on income between 31,5%, which were followed by Germany at 29,8%, and Italy at 27,8%; while the lowest tax-imposing jurisdictions were Lithuania, Ireland and finally Hungary with 15%, 12,5%[157] and 9%, respectively.[158] On average, European countries' corporate tax rates are currently between 20-25%.

3.2. European Union's Digital Single Market

For almost a decade as for 2023, the European Union has started working on the development of a European Digital Single Market (DSM), consisting of a comprehensive and extensive market, just like the traditional European Single Market.[159]

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[155] The Council of the EU, *(EU) 2022/2523*, *Council Directive of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union*, 2022, http://data.europa.eu/eli/dir/2022/2523/oj.

[156] *Ibidem*

[157] In 2021, Ireland joined the BEPS 2.0 agreement for imposing a 15% minimum corporate tax rate, and thus it put an end on its 18-year-long (2003-2021) tax rate of 12.5%. See, Irish Department of Finance Press Release, *Ireland joins OECD International Tax agreement, Department of Finance*, 7 October 2021, https://www.gov.ie/en/press-release/59812-ireland-joins-oecd-international-tax-agreement/.

[158] S. BRAY, *Corporate Income Tax Rates in Europe*, Tax Foundation, 2022, https://taxfoundation.org/corporate-tax-rates-europe-2022/.

[159] The EU Commission, *COM/2015/0192 final*, *Communication From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Regions, A Digital Single Market Strategy for Europe*, 2015, https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52015DC0192.

The DSM is an EU initiative, whose first official strategy plan for its development was communicated on the 6th of May in 2015 by the European Commission.[160] It aims at the unification of Europe's diverse digital systems by removing virtual frontiers, by encouraging online connectivity as well as by boosting digital commercial activities so as to make Europe's Single Market fit for the digital era.[161]

It also tries to ensure that individuals and businesses can, without any obstacle, access and conduct online activities under egalitarian and just conditions of competition, while also guaranteeing a high level of customer and personal data protection.[162] In other words, the DSM is an initiative aimed at providing inclusive and stable virtual business environment that encourages participation and innovation by offering equal footing and, not less importantly, opportunities for businesses to grow. As such, it would regulate principally "intermediary services," such as social media, online marketplaces, as well as search engines.[163]

The European Parliament and the Commission have been, ever since, playing key roles in its realization by advocating for and encouraging its advancement. Between 2014 – 2019 the development of the strategy plan for a European DSM was among the ten priorities of the European Commission.[164] During the current period, 2019 – 2024, the DSM is still among the six priorities of the European Commission's work, namely referred to as creating "A Europe fit for the digital age" that targets the empowerment of today's European digital society.[165]

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[160] *Ibidem*

[161] *Ibidem*

[162] *Ibidem*

[163] *Ibidem*

[164] European Sources Online (ESO), *Digital Single Market – Bringing down barriers to unlock online opportunities*, 2017, https://www.europeansources.info/record/digital-single-market-bringing-down-barriers-to-unlock-online-opportunities/.

[165] The EU Commission Strategy and Policy, *The European Commission's priorities*, 2019, https://commission.europa.eu/strategy-and-policy/priorities-2019-2024_en#ref-6-commission-priorities-for-2019-24.

For a perfectly functioning DSM, the European Union also understands that the DSM needs to be supported by adequate fiscal system whose policies and regulations cover all necessary areas of digital taxation: assuring a just and legitimate taxation system is an essential prerequisite for businesses to gain trust in the framework.[166] For that, the European Commission's attempt to develop a fair taxation system assures compatibility with the DSM, so that it can be operational on its maximum potential.[167]

3.2.1. <u>European Union addressing digital taxation</u>

At the European Union's level, as well as internationally, challenges concerning the regulations of the digital and digitalized economy have started to be addressed more than a decade ago. Till date, although there is significant progression on a global level to find and implement solutions, a definite alternative that would serve on the long run has not been elaborated yet.

The European Union on many occasions expressed its clear will to eventually cooperate with new global tax regulations specifically tailored for the digital economy, yet it considers important to undertake its own path for the sake of Member States wellbeing at least as long as definite global solutions do not come

[166] *Ibidem*

[167] Compatibility of the EU Commissions' initiatives on digital tax regulation is assured also by the OECD's current and eventual regulations on digital economy's taxation, i.e. the BEPS 2.0 Package. See: *COM(2017) 547 final*, *Communication From The Commission To The European Parliament And The Council A Fair and Efficient Tax System in the European Union for the Digital Single Market*, 2017, https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A52017DC0547, (hereinafter, the EU Commission, *COM(2017) 547 final*, 2017).

into force.[168] The EU wishes to do so in a way that, although being independent, its future regulations could be easily adapted to eventual global solutions.[169]

One of the pioneering steps towards the regularization of digital taxation at a European level was marked by a multilateral announcement addressing a political statement requesting the EU Commission for the introduction of a so-called "equalisation tax" was signed by a number of EU Finance Ministers.[170]

Another fundamental event took place in the Estonian capital in September in 2017: the first ever European Digital Summit, organized by the European Council together with the Commission, where European leaders discussed their points of view and considerations about the digital economy, including its taxation.[171]

In his conclusions of the Tallin Digital Summit, ex-prime Minister of Estonia, Jüri Ratas, left a clear message on the importance of a "Europe [to] function as a single European cyberspace" and emphasized "the need for a stronger and more coherent Digital Europe".[172]

Parallel to the Summit, the EU Commission in an official Communication called "A Fair and Efficient Tax System in the European Union for the Digital Single Market" also addressed the importance of digital taxation.[173]

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[168] The EU Commission, *COM(2018) 146 final*, *Communication From The Commission To The European Parliament And The Council, Time to establish a modern, fair and efficient taxation standard for the digital economy*, 2018, https://taxation-customs.ec.europa.eu/system/files/2018-03/communication_fair_taxation_digital_economy_21032018_en.pdf.

[169] *Ibidem*

[170] Political Statement, *Joint Initiative On The Taxation Of Companies Operating In The Digital Economy*, submitted by Germany, France, Italy and Spain to the Estonian Presidency of the Council in September 2017, http://www.mef.gov.it/inevidenza/banner/170907_joint_initiative_digital_taxation.pdf.

[171] The EU Commission, *Tallinn Digital Summit – factsheets*, 2017, https://commission.europa.eu/publications/tallinn-digital-summit-factsheets_en.

[172] Council of the EU, *13239/17, Tallinn Digital Summit (29 September 2017) - Information from the Presidency*, 2017, https://data.consilium.europa.eu/doc/document/ST-13239-2017-INIT/en/pdf.

[173] The EU Commission, *COM(2017) 547 final*, 2017, cit. note 167.

Also, in the written summary of the Summit, published the same year in October, the European Council declared that "[it] is ready to do what it takes for Europe to go digital".[174] In the same document, the EU Council emphasized the importance of an "effective and fair taxation system fit for the digital era", that is in line with the global-scale regulations under development by the OECD.

Still in 2017, in december, Economic and Financial Affairs Council of the European Union (ECOFIN), similarly to other EU institutions highlighted in their reflections regarding digital taxation, from one side a clear preference for global solutions, from the other, the importance it has for Member States to implement interim measures to cover the interval until those come in force.[175]

As an attempt to answer such "calls for action", the EU Commission took the initiative: in early 2018, the Commission published a package of "Fair Taxation of the Digital Economy" consisting of two initiatives to be proposed for Council legislation, a Communication providing contextual information about the Proposals, as well as a Recommendation to Member States to contemplate regarding future regulations with non-EU jurisdictions.[176]

The two Proposals both take into account Member States' existing national tax systems as well as current double tax treaties between them.[177] Also, the initiatives are consistent with the provisions and aims of the Digital Single Market, while being ready for eventual adaptations for consistency with eventual long-term global solutions.[178]

One of the Proposals for Council Directive regards a temporal solution for as long as regional or global long-term solution does not come in force, while the other

[174] Council of the EU, *EUCO 14/17*, *European Council meeting (19 October 2017) – Conclusions*, 2017, https://www.consilium.europa.eu/media/21620/19-euco-final-conclusions-en.pdf.

[175] Council of the EU, *15305/17*, *Outcome of the Council Meeting, Economic and Financial Affairs Brussels*, 5 December 2017, https://www.consilium.europa.eu/en/meetings/ecofin/2017/12/05/.

[176] The EU Commission Taxation and Customs Union, *Fair Taxation of the Digital Economy*, 21 March 2018, https://taxation-customs.ec.europa.eu/fair-taxation-digital-economy_en.

[177] *Ibidem*

[178] *Ibidem*

represents a long-term Europe-wide solution regulating Member States' right to impose taxes on MNEs' digitally obtained income, regardless of their physical presence.

Parallel to these initiatives, it is appropriate to mention that the European Union also proposed for EU Regulation a Digital Package consisting of two separate legislative Acts,[179] namely the Digital Service Act (DSA)[180] and Digital Market Act (DMA),[181] on both of which agreement by the EU Council and the EU Parliament was reached and were adopted in 2022.[182] The Acts mainly update the regulations addressed by the previous e-Commerce Directive,[183] since this latter had been in effect for more than two decades; clearly, much has changed in the digital reality since then. The DSA and the DMA provide regulations on such newly presented issues of the digital environment.

Thus, the two Acts mainly address the importance of a safer digital space for service providers and for users, where information, and fundamental rights are protected. The DSA and the DMA are useful tools for supporting the realization of the European Digital Single Market and contribute to the creation of a European cyberenvironment that foster innovative ideas, development while also protect competitivity rules. However, since neither of the two Acts address fiscal

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[179] European Economic and Social Committee, Summary information about the *Digital Services Act and Digital Markets Act – Stepping stones to a level playing field in Europe*, 2021, https://www.eesc.europa.eu/sites/default/files/files/qe-03-21-260-en-n_0.pdf.

[180] Council of the EU, *Regulation (EU) 2022/2065 of the European Parliament and of the Council of 19 October 2022 on a Single Market for Digital Services and amending Directive 2000/31/EC (Digital Services Act), 2022,* http://data.europa.eu/eli/reg/2022/2065/oj.

[181] Council of the EU, *Regulation (EU) 2022/1925 of the European Parliament and of the Council of 14 September 2022 on contestable and fair markets in the digital sector and amending Directives (EU) 2019/1937 and (EU) 2020/1828 (Digital Markets Act)*, 2022, http://data.europa.eu/eli/reg/2022/1925/oj.

[182] *Ibidem*

[183] Council of the EU, *Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market ('Directive on electronic commerce')*, 2000, http://data.europa.eu/eli/dir/2000/31/oj.

issues of digitalization, these will not be further elaborated in the present investigation.[184]

Next, the two aforementioned European Commission Proposals for Council Directive will be given a detailed insight.

3.2.1.1. **Proposal for Council Directive laying down rules relating to the corporate taxation of a significant digital presence – COM 2018 147**[185]

The first Proposal for Council Directive that is contained in the Commission's package of fair taxation aims at serving as a long-term comprehensive solution for digital taxation. Principally it targets the EU level, but it also grants the possibility to extend its viability to non-EU states, where currently there exists a double tax agreement.[186]

At its core, the Proposal introduces a concept, called "Significant Digital Presence", which would eventually constitute for a new taxable nexus apt for digital businesses, tackling challenges that cross-border online commerce have been causing in recent decades.[187]

Also, this Proposal lays down rules for profit attribution of digitalized enterprises, as an attempt to catch more accurately how value creation occurs for online businesses that rely principally on hard-to-value intangible services and goods.[188]

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[184] For more consultory information is available, see: EU Commission, *Questions and Answers: Digital Services Act*, 25 April, 2023, https://ec.europa.eu/commission/presscorner/detail/en/QANDA_20_2348

[185] The EU Commission, *COM/2018/0147 final*, *Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence*, 2018, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52018PC0147&qid=1686326163256, (hereinafter, *COM/2018/0147 final*, 2018).

[186] *Ibidem*

[187] *Ibidem*

[188] *Ibidem*

Once the Directive is incorporated into Member States' legislations, it would be applicable to cross-country digital commerce, regardless of whether the enterprise is established within the EU or in a non-EU country, given that it sells online services in the EU and qualifies for other conditions that the Proposal establishes.[189]

The Proposal clarifies that Significant Digital Presence shall not be considered as a substitution of the former concept of PE, but rather as its complementation.[190] With the introduction of this concept, the Proposal tries to capture the "digital footprint" that any given enterprise has in different EU jurisdictions and eventually determine their taxability on that basis.[191] Significant Digital Presence shall serve, therefore, as a tool for tax authorities to determine, first of all, which State has the authority to impose taxes, second, which activities shall be considered as taxable and, last, how much taxes shall be levied on them.[192]

Since digital business models may be of very divergent nature and of different types, a comprehensive criteria system is needed in order to ensure that the concept captures all the different types of digital activities: one business model may rely largely on users' activity, while others do so less, yet generate large revenues.

For that, the Proposal establishes a list of qualifying criteria to determine whether there exists Significant Digital Presence of an enterprise in a given jurisdiction. These criteria consider, broadly speaking, revenue- and user-related factors and address three key aspects in a given time period; more specifically, these consider the overall amount of digital profit the enterprise made, the quantity of its users per service, and the number of commercial contracts it closed per service.[193]

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[189] *Ibidem*

[190] *Ibidem*

[191] *Ibidem*

[192] ASOREY, *Tributación de la economía digitalizada*, 2021, cit. note 47.

[193] *Ibidem*

In order to attribute Significant Digital Presence status to a company in a given Member State, at least one of the following qualifying conditions shall be met: in any tax period (a) an enterprise has generated a revenue of over 7 million Euros through the supply of digital services to users that are located in that Member State; (b) at least one of the services provided in the Member State counts for more than 100.000 users; or the number of successfully closed business contracts in that Member State regarding digital services surpasses 3000.[194]

Furthermore, specific to digital presence, the Proposal also establishes a list of activities that are attributable to Significant Digital Presence. Such activities are "collection, storage, processing, analysis, deployment or sale" of user data; "collection, storage, processing and display" of content generated by users; "providing and selling [virtual] space for digital advertisement" as well as "display of content created by third parties", among other digital operations.[195]

The Commission established the 1st of January 2020 as provisional entry-in-force date of the Proposal, however, it reached an impasse in 2019 due lack of unanimous agreement. Yet, the initiative serves an important conceptual basis for future works in this matter, since they will presumably address the issues by similar principles.

3.2.1.1.1. Conceptual reflection considering potential differences between Significant Digital Presence and Significant economic presence

An interesting terminological difference can be noted between the term Significant Digital Presence that the European Commission uses in the present Proposal, and the term Significant Economic Presence which is used by the OECD in Pillar One of the BEPS 2.0.

One might think that the two concepts refer to exactly the same concept, that being taxable economic activities on foreign jurisdictions; however, we thought it

[194] *COM/2018/0147 final*, 2018, cit. note 185.

[195] *Ibidem*

might be interesting to not take such an assumption for granted and make some conceptual reflections: why the EU calls it “SDP” while the OECD “SDP”? Is there a well-articulated reason behind? Do the two refer to slightly differing concepts?

As it is known by now, there are two “ways” to do sales (make revenue) for a company outside its residency state: through Permanent Establishment, or digitally. If the firm generates income through Permanent Establishment, OECD Model Convention’s regulation (Article 5 and Article 7 of the MC) on Permanent Establishments will apply and taxes will be paid to that state on income generated therein. On the other hand, when there is no Permanent Establishment and the company generates revenue digitally this is where the two concepts enter: /this is the problem/: the term “significant economic presence” does not implicate that revenue was created in a digital form, while “significant digital presence” – judging from the three words as they are – does not imply economic activity.

However, a hypothetical company having a significant digital presence in a given state but is not present economically (in a sense that it does not generate revenue), one might ask: what does the company do then there? Following this line of reasoning, establishing a “taxable” nexus for digital presence without economic activity does not serve any purpose: if the company did not generate revenue, it will not pay taxes. Clearly, this is not a real-life example, and thus, this consideration was discarded.

On the other hand, questions arose regarding significant economic presence: does the term also imply that significant economic presence is also digital? Following a pure semantic interpretation of the term, it does not. If so, it might as well indicate that it is useable / used as a taxable nexus also for revenues created in traditional ways, through physical presence. However, in that case, what is its relationship with the classic taxable nexus for enterprises’ abroad-obtained income: Permanent Establishment? Does significant economic presence substitute the relevance of Permanent Establishment status?

The “perfect” term that precisely indicates the (supposed) target concept might be the combination of the two: “economically significant digital presence”, or such, that includes both crucial components – digital and economic.

It is important to note that what has been discussed in the present section has a purely conceptual and semantic nature. Criteria for qualification for either of the two concepts are described in the respective articles.[196]

3.2.1.2. **Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services – COM/2018/0148**[197]

In its package of "Fair Taxation of the Digital Economy", the EU Commission also proposed for Council legislation a short-term solution for as long as global comprehensive measures do not enter into force. This Proposal is principally an attempt, from one side, to fill such temporal gap, and, from the other, to harmonize already existing unilateral solutions by Member States on taxing digital services.[198] The latter is a critical issue, since the presence of divergent regulations among EU countries contribute to fragmentation of the European Single Market and impede the development of new innovative digital solutions.[199]

Therefore, while considering the challenges that digitalization of the economy brought about, this Proposal addresses taxation regulations exclusively of those

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[196] For more information on significant economic presence, see: OECD, *Base Erosion and Profit Shifting Project Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy*, 2019, https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf; for more information on significant digital presence see: EU Commission, *C(2018) 1650 final*, *Commission Recommendation of 21.3.2018 relating to the corporate taxation of a significant digital presence*, 2018, https://taxation-customs.ec.europa.eu/document/download/17a4bb60-011b-4c5e-9d0a-bfe7277cd5ba_en?filename=commission_recommendation_taxation_significant_digital_presence_21032018_en.pdf.

[197] The EU Commission, *COM/2018/0148 final*, *Proposal for a COUNCIL DIRECTIVE on the common system of a digital services tax on revenues resulting from the provision of certain digital services*, 2018, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2018%3A148%3AFIN, (hereinafter: *COM/2018/0148 final*, 2018).

[198] *Ibidem*

[199] *Ibidem*

services, which result from digital activities. In order to do so, it introduces a fundamental reference concept, the so called “Digital Service Tax” (hereinafter referred to as DST).[200]

The DST is a specific tax that shall be imposed only on revenues obtained from certain types of online services, particularly regarding those, where users’ value creation plays a key role, since it is these business models that are accountable for the great and still growing mismatches between where taxes are currently imposed and where value creation occurs.[201]

Users’ involvement may contribute to an enterprise’s value creation in very different ways. In generic terms, the activities referring to users’ participation are what the Proposal calls “taxable services”, which must then be translated into financial terms: what is subject to taxation, clearly, is not users’ involvement itself, but the financial benefits the enterprise obtains from it.[202] The amount of profit that these services bring to the enterprise will be subject to taxes, which the Proposal calls “taxable revenue” of the given enterprise.[203]

In order to determine the taxable services, the Proposal establishes a positive list of online services. These include: (a) the collection of data about users’ online activity, which is then used for targeted marketing and advertising; (b) the offering of virtual space through which users may build networks with other users increasing thereby the value of the service, as well as also allowing the exchange of services and products directly between users; (c) the further transmission of user-activity data.[204] Taxable revenue, or profit to which the DST is applicable, is the amount of financial benefit that derives from any of the services listed above.[205]

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[200] *Ibidem*

[201] G. KOFLER, & J. SINNIG, *Equalization taxes and the EU’s ‘digital services tax*, in *Tax and the Digital Economy: Challenges and Proposals for Reform*, Ch. 6, 2019, pp. 101-146

[202] *COM/2018/0148 final*, 2018, cit. note 197.

[203] *Ibidem*

[204] *Ibidem*

[205] *Ibidem*

Further criteria the Proposal establishes regard the enterprises themselves: the DST shall apply to enterprises with digital presence regardless of whether it is established within the EU or outside.[206] The fundamental criterion, as stated previously, is whether the company creates value through user participation within the EU.

To determine whether the firm is liable to DST or not on the basis of the economic significance and calibration, the Proposal also establishes specific criteria considering the amount of annual revenue it creates. According to them, an enterprise would be subject to the DST, only when its global annual revenue surpasses the 750 million Euros, and, of which, a minimum of 50 million Euros were generated (sourced) at EU level, regionally.[207] Such qualifying conditions have the aim to limit the imposition of the DST only to MNEs above a certain size – in other words, those that are most probable to obtain huge benefits from users' networking activities.

The Proposal establishes a general EU-level imposition on gross revenue at a special tax rate of 3%, which is due to be imposed by single EU jurisdictions, where conditions dictate so.[208] Thus, the DST shall be paid to all Member States where the enterprise made income with qualifying conditions.[209] It also shall be emphasized that it is Member States' responsibility to ensure that the enterprise has correctly documented and reported in the financial statements the amount of revenue earned through users located therein, and eventually that the due sum was effectively paid.[210]

Identically to the first Proposal, the provisional entry-in-force date of this initiative, too, was supposed to be on the 1st of January 2020; however, in March 2019 it was withdrawn by the Council due to lack of Member States' consensus. Regardless of this, more enthusiastic Member States in this respect started to

[206] *Ibidem*

[207] *Ibidem*

[208] *Ibidem*

[209] *Ibidem*

[210] *Ibidem*

implement regulations in their national legislations based on the principles of the Proposal on DST. The following section takes a detailed look at them.

3.2.1.3. EU Member States' independent regulations on digital taxation

Given the fact that no European agreement has been reached on digital taxation and that solutions of some sort were needed, some EU Member States as well as numerous other countries of the world have started to develop and implement their own, unilateral solutions for the taxing of the digital economy to protect their own public income.

It is important to note that global pandemic scenario that the COVID-19 caused and contributed to a great extent to the development of such unilateral measures, since it dragged many traditional businesses, institutions, and other entities into the digital economy, significantly accelerating its development and increasing its global footprint.[211]

As stated previously, unilateral solutions are not ideal for a world that prioritizes international cooperation and multilateral development. This creates space for international inconsistencies, possibilities for enterprises to find better-or-worse scenarios, favors traditional businesses over digital ways and vice-versa[212] and, overall, contributes to regional and global market fragmentation.

However, finding solutions on a global level is a complex task that can require years to develop: a world-wide solution in a sense is a compromise for single states, and reaching agreement in order to obtain the most globally beneficial possible outcome is time consuming.

[211] J. AMANKWAH-AMOAH, et al., *COVID-19 and digitalization: The great acceleration*, in the *Journal of Business Research*, Volume 136, 2021, pp. 602-611, https://doi.org/10.1016/j.jbusres.2021.08.011.

[212] R. Á. CERRILLO, *La Tributación de los Servicios Digitales ¿Aplicación del Principio de Neutralidad o Suficiencia?*, In *Tributación de la economía digital*, 2020, pp. 177-196.

Unilateral solutions in digital taxation are growing in number among EU states, with some states that already implemented them into their legislations, while others are waiting for approval of the proposals submitted. Among the states that already implemented digital taxes are Austria, France, Hungary, Italy, Poland, Portugal, Spain, and Turkey; while those where proposals are waiting to be accepted and legislative processes to be finished are Belgium, Cyprus, the Czech Republic, Denmark, and Slovakia. States like, Finland, Germany, Ireland, Luxembourg, the Netherlands, Sweden, Switzerland, among others have not implemented unilateral measures on taxing digital services.[213]

The anatomy of the regulations varies significantly among different states, giving rise to the aforementioned concerns on the European market. Specifically, Austria and Hungary (as well as Cyprus but its proposal is waiting for approval) impose taxes only on profits resulting from online advertisements, while other countries such as Czech Republic, France, Italy, Spain, among others, include in the taxable revenue those deriving from sale of data, from intermediary services, or from the users' data transmission.[214] An interesting example is Denmark, whose proposal only targets taxing online streaming services.[215]

The enterprises targeted by the unilateral measures are generally those in conformity with BEPS 2.0 on the minimum tax as well as with what the EU Commission proposes for its regional DST, that is, enterprises whose annual overall revenue exceeds 750 million Euros, but with very diverging million Euros domestic revenue criteria ranging from 3 million Euros (in Spain) to 50 million Euros (in Cyprus).[216]

Just like the structure and targeted enterprises, also the proportion of profit to be taxed differ significantly among unilateral regulations. Poland imposes taxes (on audiovisual media and marketing services) only at a rate of 1,5%, while other

[213] D. BUNN & E. ASEN, *What European OECD Countries Are Doing about Digital Services Taxes*, Tax Foundation, 2022, https://taxfoundation.org/digital-tax-europe-2022/.

[214] *Ibidem*

[215] *Ibidem*

[216] *Ibidem*

states, like Belgium (waiting for the approval of the proposal), France, Italy, and Spain has set the digital tax rate on 3%, in line with the EU Commission's Proposal.[217] Others still, such as Austria, Czech Republic, Denmark, or Hungary has programmed the specific public income on rates between 5% and 7,5%[218] – even though the latter country has temporarily set the tax (called "Reklámadó") in 2019 on 0%, which continues to be in force until 31 December 2023.[219]

In the majority of the cases the measures were (or are to be) implemented on a transitional basis, until global regulations come in force.

3.3. Summary of past and current initiatives

So far proposals have been various but achieved little success and the road to go is still long until a definite solution will come. As it has been seen, the OECD operating on global scale tries its best to make regulations through the BEPS 2.0 Project, but for some, like the European Union it is not sufficient.

The EU, indeed, wants to go beyond what the BEPS proposes. It wishes to do so because, as an important global actor, it must have a cohesive system on fiscal matters, exactly the way it does financially through the Single Market and the common currency (Euro).

The two proposals of the Commission for Council Directive have been refused, yet their considerations addressing issues of digitalization remain important for future initiatives. For example, although DST may not continue to be called so, digital economic transactions will definitely be imposed taxes on.[220] In other

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[217] *Ibidem*

[218] *Ibidem*

[219] "Az 5. § (1)-(2) bekezdésekben foglaltaktól eltérően az adó mértéke 2019. július 1-jétől 2023. december 31-ig az adóalap 0%-a.", Jogtár, *2014. évi XXII. Törvény a reklámadóról*, Wolters Kluwer, https://net.jogtar.hu/jogszabaly?docid=a1400022.tv.

[220] J. MANUEL VÁZQUEZ, *Digital Services Taxes in the European Union: What Can We Expect?*, in Kluwer Tax Blog, 2023, https://kluwertaxblog.com/2023/02/14/digital-services-taxes-in-the-european-union-what-can-we-expect/.

words, the terminology used in future proposals might not be the same, the issues they will provide regulations on will continue to be the same. Current and possible future initiatives on behalf of the European Union will be addressed in Chapter 5. Instead, Chapter 4 will demonstrate a case study about a MNE that used corporate tax tactics to avoid taxes.

Chapter 4

A Case study on Apple’s tax avoiding strategy between 1991 and 2014

As it has been elaborated throughout the present work, such tax-reduction and tax-avoidance strategies used to be and some continues to be legal due to loopholes, inconsistencies, and specific agreements between certain jurisdictions; however, they are certainly not fair, neither for governments and citizens around the world, nor for any other enterprise.

In order to better illustrate international tax avoidance strategies, a real-life example will be reported in the present chapter. More specifically, one of the most commonly used tax arbitrage strategies will be described that was frequently applied by the biggest MNEs, such as Google.[221] This is known as the Double Irish Approach.[222] Moreover, a particular case of Apple Inc.’s tax strategy will be demonstrated, which based its tax planning strategies on an alternative version of the Double Irish Approach. On the case, the European Commission launched an investigation in 2014 that provoked a long sequence of legal litigations that has still not been closed.[223]

Apple’s case is important because, the company is one of the biggest unfairly playing multinational entity in fiscal terms. Thus, it exemplifies very clearly the huge monetary benefits a corporation of such caliber can under legal terms obtain

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[221] P. SIKKA, *No accounting for tax avoidance* in *The Political Quarterly*, 86(3), 2015, pp. 427-433.

[222] J. B. DARBY & K. LEAMASTER, *Double Irish More than Doubles the Tax Savings - Hybrid Structure Reduces Irish, U.S. and Worldwide Taxation,* in *Practical US/International Tax Strategies,* 2007, pp. 2-16.

[223] The case was first appealed by Apple at the General Court of the European Union with a final sentence provided in 2020; the EU Commission decided to appeal the verdict eventually brought the case to European Court of Justice for judgement in 2023. These points are further elaborated under Paragraphs 5.3.

and, thus, "gain" billions of dollars yearly still in the 21st century. By doing so, it deprives not only concerned states from their otherwise-due public income, but also harms substantially other legal aspects, such as fair-competition.

First, the Double Irish Approach will be discovered, after which the rest of the chapter will deal with Apple's case, including the description of Apple's corporate strategy as well as a follow-through on the EU Commission's investigation regarding the case.

4.1. Summary of background information about using BEPS tools – Research and Development activities, licensing, royalty payments and taxes

It is well known that Ireland has had a lower-than-global-average corporate tax rate than most jurisdictions.[224] Although Ireland is the primary focus here, note there were many other jurisdictions in the European Union that provided low tax rates for companies and in certain cases offered comparable treatment to U.S. based multinational corporations.[225] As a matter of fact, until 2021 the corporate tax rate in Ireland summed up to historic 12,5%, in comparison with, for example, the United States' 35%.[226] No doubt that companies, whenever they can, try to take advantage of the differences.

[224] EY (Ernst & Young), *The historical development and international context of the Irish corporate tax system,* 2014*,* https://eyfinancialservicesthoughtgallery.ie/history-context-irish-corporate-tax-system/.

[225] "Seven EU countries (Belgium, Cyprus, Hungary, Ireland, Luxembourg, Malta and The Netherlands) display traits of a tax haven and facilitate aggressive tax planning." See: European Parliament Press Release, *Tax crimes: special committee calls for a European financial police force*, February 27, 2019, https://www.europarl.europa.eu/news/en/press-room/20190225IPR28727/tax-crimes-special-committee-calls-for-a-european-financial-police-force.

[226] C. ENACHE, *Corporate Tax Rates around the World*, TaxFoundation, 2022, https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/.

The Double Irish arrangement is a basic BEPS method, that was frequently used by US-based MNEs, typically by corporations where Intellectual Properties (IP) play a fundamental role, so as to reduce taxes on foreign-generated profit. Its name arises from the fact that the given US company establishes two subsidiaries in Ireland, each of them "used' for a different purpose.[227] The word *used* is in parenthesis because it does not refer to the primary purpose, but rather to the derivative gains that the parent company can obtain from operating it.

This tool so far had contributed to US-based MNEs to save on average 100 billion US dollars yearly by 2010, which continued to accumulate during the following decade.[228] Even though by today the arrangement is no more used due to various changes in legislations of the Irish and U.S. governments[229], past occurrences still have a significant effect today: some cases went before international courts and still are unresolved – such as the current example about Apple –, while other cases reportedly include MNEs that still have untaxed profit kept outside fair taxing states' registration, for example, by not repatriating earnings to U.S.[230]

When considering the approach, crucial importance must be given to corporations' Research and Development (R&D) activities. Normally, R&D is the name given to the operations corporations carry out for innovation and consequently for the introduction new goods and services. This may be software development, product design, engineering, and so on.[231] The primary economic

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[227] S. C. LOOMIS, *The double Irish sandwich: Reforming overseas tax havens, Mary's LJ, 43, 825*, 2011.

[228] M. HYNES, *The Digital Behemoths*, in *The Social, Cultural and Environmental Costs of Hyper-Connectivity: Sleeping Through the Revolution*, Emerald Publishing Limited, Bingley, pp. 19-37, 2021, https://doi.org/10.1108/978-1-83909-976-220211002.

[229] N. SAMARAKOON, *The Effect of the Closure of the Double Irish Loophole on the Location of US Multinational Companies' Profits*, 2023, https://ssrn.com/abstract=4285001.

[230] J. G. GRAVELLE, *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service, US Congress, Washington, DC, 6 January 2022, https://sgp.fas.org/crs/misc/R40623.pdf.

[231] W. KENTON, *Research and Development (R&D)*, Investopedia, June 25, 2019, https://www.investopedia.com/terms/r/randd.asp.

goal of R&D is to improve technology or develop new models, which, in turn, gives the company a competitive advantage on the market.[232]

However, R&D turned out to be very often exploited by MNEs, since it became a frequently used item for transfer pricing and profit shifting: intellectual property being transmitted may be referred to be done so for R&D purposes, but only to cover the inevitable transactions that follow for avoiding taxes.[233] R&D, thus, became a perfect „excuse" to be used to transfer large amounts of profit from high to low tax states. This was particularly true in 2004 when Ireland implemented an "R&D credit", allowing numerous companies to reduce their overall taxable corporate income.[234]

The IP transfer consists of the following: whenever a company licenses a subsidiary with IP property, a payment must be made for the rights to use the intangible asset – called a royalty fee.[235] When such payments are made, these are may or may not be subject to taxes, depending on both paying and receiving jurisdictions.[236] When untaxed, since such payments are intra-corporate, the capital received still remains within the large circle of the parent company. These passages are at the core of corporations' BEPS tools.

It was essentially thereby that the so-called Double Irish Arrangement allowed numerous MNEs (Such as Airbnb, IBM, Pfizer, Starbucks, among others)[237] to

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[232] A. KHURANA, *Strategies for Global R&D: A study of 31 companies reveals different models and approaches to the conduct of low-cost R&D around the world*, 49 RES.-TECH. MGMT. 2006, *See also Research and Development*, INC., https://www.inc.com/encyclo pedia/research-and-development.html.

[233] ORTIZ, *A Case Study of Apple,* 2020, cit. note 111.

[234] KPMG, *The research and development tax credit in detail*, 15 February 2023, https://kpmg.com/ie/en/home/insights/2023/03/rd-tax-credit-detail-research-development.html.

[235] S. JURANEK, D. SCHINDLER, & G. SCHJELDERUP, *Transfer pricing regulation and taxation of royalty payments*, in the *Journal of Public Economic Theory* 20.1, 2018, pp. 67-84.

[236] *Ibidem*

[237] C. BARBIÈRE, *Low Irish taxes boost Airbnb profits*, Euractiv. 22 July 2014; C. FARIVAR, *IBM gooses its sales numbers thanks to overseas tax tricks*, Ars Technica, 4 February 2014; R. CHITUM, *How 60 billion are lost in tax loopholes*, Bloomberg, 2007; J. DRUCKER, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes, Bloomberg*, 21 October 2010.

operate in Ireland, generate profit in the EU and declare that profit in a tax haven where taxes are null (or near) while staying in line with U.S., EU, Irish as well as tax havens' tax rules; it consisted of the following scenario.

4.1.1. <u>The Double Irish Approach – corporate organization</u>

A non-EU MNE that wants to sell products in Europe, usually already having a fully owned subsidiary (S) in a tax haven, such as Bermuda, creates a subsidiary in Ireland (I1) to conduct operations in Europe. Why in Ireland? Because (until 2021, when Ireland also implemented an OECD-minimum 15%)[238] general corporate tax rates amounted to 12.5%[239], which was, even then, lower than in most EU countries.[240]

Considering U.S. tax regulations applicable to U.S. corporations, it is the Internal Revenue Code (IRC) that lays down the relevant rules in its Subpart F addressed explicitly to foreign subsidiaries, so called Controlled Foreign Corporations (CFCs). This is a fiscal tool that apply to U.S. corporations abroad and set out criteria for when and under which circumstances the U.S. shall impose taxes on a given enterprise's foreign subsidiaries.

Without going too much into details, CFC rules establish that a U.S. enterprise's foreign subsidiary is subject to taxes in the jurisdiction where it is located. In other words, American law built its tax policy based on the establishment's geographical location.[241] More specifically, Until Tax Cuts and Jobs Act came into force under the Trump administration, as long as a subsidiary was located in a

[238] Irish Department of Finance Press Release, *Ireland joins OECD International Tax agreement, Department of Finance*, 7 October 2021, cit. note 157.

[239] EU Taxation and Customs Union, *TAXUD/2016/DE/319*, *Aggressive tax planning indicators – Final Report*, 2017, pg. 37, https://taxation-customs.ec.europa.eu/system/files/2018-03/taxation_papers_71_atp_.pdf.

[240] E. ASEN, *Corporate Tax Rates around the World*, TaxFoundation, 2020, https://taxfoundation.org/corporate-tax-rates-around-the-world-2020/.

[241] The U.S. Internal Revenue Service, *LB&I International Practice Service Transaction Unit*, 2016, https://www.irs.gov/pub/int_practice_units/DPL9412_03_04.pdf.

foreign subsidiary and the income it made was not repatriated or sent elsewhere, U.S. taxes were not applicable. On the contrary, if profit was shifted, it was subject to U.S. taxes.

Thus, in terms of the Double Irish, if a subsidiary was located in Ireland and the income obtained there remained within Irish territory, it was not subject to U.S. taxes.[242] Such a phenomenon is commonly known as tax deferral. On the other hand, if the capital was transferred to a foreign-to-subsidiary (third) state or repatriated back to the U.S., it was obliged pay full taxes in the U.S., that is: 35%.

MNEs intending to eliminate even those 12,5% of Irish taxes, here, it is crucial to consider one specific aspect of the Irish law, on which tax advisors in corporations used to rely.

Until 1 January 2015, Irish law considered an enterprise to be tax resident of Ireland if its central management was reported to be located in Ireland.[243] In other words, taxation of a given enterprise would not fall within the authority of the state where enterprise itself was located but was given to the jurisdiction where managerial activities took place.

Therefore, even if an entity was situated in Ireland but was controlled by managers that, instead, were reported to be located in a foreign country, taxes on profits would be to be paid to that jurisdiction. Thus, if management was reported to be conducted in a tax haven: taxes were zero (or close to zero).

This is where the twist came in with the establishment of the second Irish subsidiary (I2). In order to avoid U.S. taxes, therefore, it was necessary that the income remained within the same foreign country where it was generated. Instead, in order to avoid Irish taxes as well, it was necessary that central management be reported in a foreign country, preferably in a tax haven.

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[242] ORTIZ, *A Case Study of Apple,* 2020, pg. 379, cit. note 111.

[243] A. TING, *iTax - Apple's International Tax Structure and the Double Non-Taxation Issue*, in *British Tax Review*, 2014, pp. 40-71, https://ssrn.com/abstract=2411297, (hereinafter: TING, *iTax*, 2014).

Thus, I2 has the following characteristics under the Double Irish method: it is a subsidiary of the U.S. parent company, incorporated in Ireland (just like I1) but has central management in a tax haven, for example, in Bermuda. This way, under U.S. law, both I1 and I2 were Irish, and therefore ignored by the U.S. for fiscal matters; meanwhile, under Irish law, although the subsidiaries being both Irish, I2 would be subject to taxes in the tax haven due to the "place of management" principle. Tax havens being tax havens, the fiscal rate is near 0%.

Such fiscal differences create loopholes in taxation, which are clear at this point, which can easily get exploited by tricky corporate maneuvers. In fact, this is the essence of the Double Irish: neither government know about both being exploited. Presumably, the U.S. might have had more motive to be more careful since it did not have any interest in establishing companies specifically in Ireland. This is, however, not true for Ireland: it encouraged and has continued to encourage many U.S. giant corporations to settle therein, and therefore, it might have turned a "blind eye" on some of the twist-minded corporate strategies.

Consequently, after the parent company opened a subsidiary in a tax haven (S) and two subsidiaries in Ireland (I1 and I2, the latter under S's management), the Double Irish scenario translates into the operations described in the following paragraph.

4.1.2. <u>The Double Irish – its operative characteristics</u>

The parent company's subsidiary S in the tax haven holds all the necessary intellectual property rights (IPRs) such as licenses, patents, a newly developed software, etc., granted at cost-identical price (X) by the parent company in the US (most commonly a Holdings Company[244] or Holdco).

[244] A corporation is referred to as holding company when it owns, buys and sells, and generally exercises control over its subsidiaries, tangible and intangible assets and financial operations, among which, investments.

Consequently, this subsidiary S in the tax-haven revalues the assets it received from parent company at a higher price (for instance from X to 50X) and licenses the subsidiary I2 in Ireland for operational use. Next, I2 (with management in the tax haven) licenses I1 with the use of IP, while I1 delivers products to stores across the EU.

Eventually, the stores sell products to final consumers at the same price at which S valued IP (50X). Stores deliver the income from sales to I1, which, then, uses the money to pay royalties for IP use to subsidiary I2. Eventually, I2 that is managed by S accumulates income: for the U.S., it reports income in Ireland – given the subsidiary's location –, while for Ireland, it books profit in the tax haven – given its management by S. Last, subsidiary S may (or may not) redistribute 50X to parent corporation or other subsidiaries.[245] *Figure 1* depicts the main features of the Double Irish Arrangement.

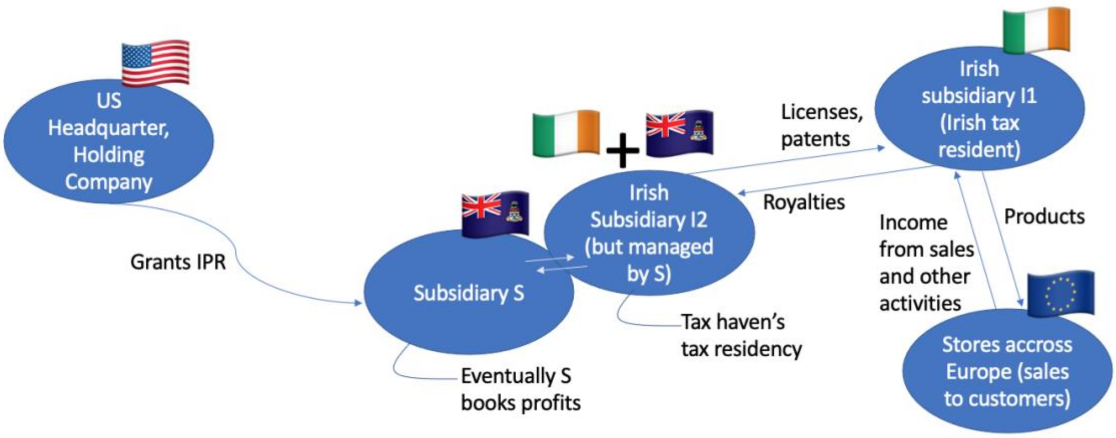

Figure 1 – The Double Irish Arrangement[246]

[245] J. MERCILLE, et al., *Taxation: Redistribution Upwards* in *Deepening Neoliberalism, Austerity, and Crisis: Europe's Treasure Ireland*, 2015, pp 146-166.

[246] Self-made illustration, based on International Monetary Fund (IMF), *World Economic and Financial Surveys – Fiscal Monitor*, *figure 5.1.* "*Tricks of the Trade*", 2013, pg. 47, https://www.imf.org/-/media/Websites/IMF/imported-flagship-issues/external/pubs/ft/fm/2013/02/pdf/_fm1302pdf.ashx.

As stated previously, the most crucial element of the Double Irish arrangement is that Ireland considers I2 to be a tax resident of Bermuda (due the place of management principle), while the country where the company is originally from (most cases U.S.), sees it as tax resident of Ireland. Thanks to this structure, when royalty payments are made between these entities, unless or until the money is transferred back to the parent company, they will be tax-free – except for one step between I2 and I1.

4.1.3. The Double Irish with Dutch Sandwich Approach

Pursuant to Irish law, royalty payments are subject to 20% of withholding tax when these are made towards a tax haven. Thus, concerning the passage where I1 pays I2 for IPRs, Ireland would withhold one-fifth of the amount as royalty fee. In order to annul obligatory contributions also at this step, an additional, Dutch subsidiary (D) might come into play. This accounts for a version of the arrangement that is known as Double Irish with Dutch Sandwich.

In this arrangement, instead of the Irish subsidiary I1 transferring profits under royalty payments directly to subsidiary I2, it sends them first to the Dutch “shell company” (D), which, in turn shifts profits to subsidiary I1 tax free. *Figure 2* shows the Double Irish – Dutch Sandwich arrangement.

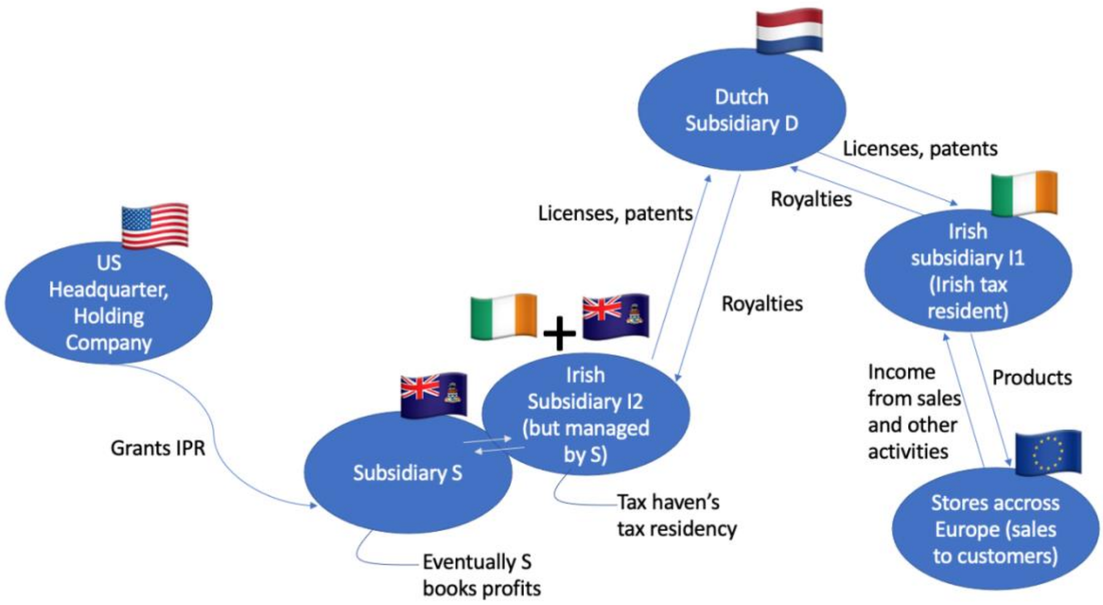

Figure 2 – The Double Irish with Dutch Sandwich Arrangement[247]

But why does this approach erase taxes on the transactions concerned? For two reasons: first, because pursuant to European Council Directive 2003/49/EC, a royalty payment carried out by a company in a given EU Member State to a related entity in a different Member State are exempt of withholding taxes.[248] Thus, the royalty payment made from Ireland to the Netherlands will not be taxed.

Second, Dutch tax law also allows royalties to be paid to various foreign tax havens (such as Bermuda) without incurring Dutch withholding taxes.[249] Therefore, Dutch law plays the role of a little getaway – another exploited gap among the different tax regimes.

[247] *Ibidem*

[248] Council of the EU, *Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States*, 2003, http://data.europa.eu/eli/dir/2003/49/oj.

[249] C. JONES, Y. TEMOURI, & A. COBHAM, *Tax haven networks and the role of the Big 4 accountancy firms* in the *Journal of world business*, *53*(2), 2018, pp. 177-193.

4.1.4. Brief recapitulation and the most important takeaways

Altogether, this structure with protagonist Ireland allowed U.S. based MNEs to transfer huge amounts of earnings created in EU countries to Ireland and to a tax haven, where it eventually booked profits – with full tax exemption.

First, The US would not impose taxes on any of these transactions because neither I1 nor I2 fell under CFC rules, given that both subsidiaries were located in Ireland and that earnings generated through these subsidiaries had not left the country. Thus, for the US, it was sufficient.

Nor would taxes be imposed on the transactions by the EU, due to the fact that it allows royalty payments to be sent tax-free from one Member State to another (i.e.: Ireland and the Netherlands). Also, Dutch law allows money to be transferred to tax havens, similarly, tax free. Last, the very final transaction would occur completely under the tax haven's jurisdiction, where I1 transferred profits back to S: would any tax be imposed? None.

The company eventually booked profits in the tax haven and redistributed money to parent corporation or subsidiaries – as it may wished. Only then would U.S. tax rules apply, which, similarly, in certain cases could get exploited – such as the case of Apple, as it will be shown next.

Considering the entire structure of the Double Irish, whether with or without the Dutch Sandwich, the payment of royalties required the use of intangible assets, i.e., intellectual property (IP) licensing or patents. Therefore, the arrangement was limited to particular industrial areas operating with great deals of IP. This was most common in technology, pharmaceutical companies, medical devices, and other specific patent-requiring sectors.

The case of the Double-Irish was relevant until 2015, when Ireland made an amendment in its law not allowing anymore a scenario where a company was incorporated therein but paid taxes elsewhere (which it did basing taxation on the place of management principle). Finally, it is worth mentioning that, although the Double Irish with Dutch Sandwich was a commonly used tax-reducing strategy, the latter part has nothing to do with Apple, as it is shown next.

4.2. Apple's altered version of the Double Irish arrangement

Between 1991 and 2014 Apple developed and had perfected a tax-eroding strategy that was similar to that of the Double Irish approach but was completely individualized in certain aspects.

Starting the explanation from the commonalities with the traditional Double Irish, it is Apple Incorporation (Inc), similar to many other MNEs of such caliber, made the majority of its income through the manipulation of transactions regarding its IPR: under the coverage of R&D, the company grants its Intellectual Property Rights (IPR) to entities situated low-tax jurisdictions (intra-group operations) and make use of transfer pricing to shift profits and eventually exploits gaps in tax regulations in order to make those profits go untaxed.

Apple did not do otherwise: in order to lower its reported profit in the US, a high tax jurisdiction (corporate tax rate being precisely at 35%), it offered the economic rights for IP use to its entities in Ireland. The latter being a low tax jurisdiction with corporate tax rate at 12,5% during the period concerned, Apple managed to further lower such rate as it booked income in entities that did exist on paper, but not in reality. But how did it do so?

4.2.1. Apple's operative organization and functioning

Apple's organizational structure looks like as follows. The parent company, Apple Inc., headquartered in California, U.S. set up a chain of branches in Ireland. Its first, directly and fully owned entity is known as Apple Operations International (AOI).[250] In turn, AOI owned itself another subsidiary, called Apple Operations Europe (AOE), which, again, owned another entity: Apple Sales International (ASI).[251] All of these entities were incorporated in Cork, Ireland.[252] These entities,

[250] TING, *iTax*, 2014, cit. note 243.

[251] *Ibidem*

[252] *Ibidem*

as said above, were granted exclusive licenses for IP use due to a cost sharing agreement with parent company, allowing the subsidiaries not to pay royalties for IP.[253]

A further peculiarity of Apple's structure can be found in the it set up AOE and ASI: each of these two were further divided into two branches, creating an Irish branch for AOE, an Irish branch for ASI, a so called "Head Office" for AOE and another "Head Office" for ASI.

The major *bravura* in its organization lied in the fact that while the two Irish Branches for AOE and ASI were legally Irish residents (including their management), the Head Offices were so called "ghost Companies".[254] While these were reported to be having an address in Cork, Ireland, first, they had no physical location, no employees and no buildings, and, second, were claimed to be managed by executives in Cupertino, California.[255] One might wonder: what did I just read? How is that even possible? Well, as absurd as it sounds, Figure 3 illustrates Apple's organizational structure.

[253] *Ibidem*

[254] ORTIZ, *A Case Study of Apple,* 2020, pg. 373, cit. note 111.

[255] J. STIGLITZ & E. SIU, *The Apple tax tussle shows the need for a new way of taxing profits,* Columbia University, Sept. 15, 2016, https://www8.gsb.columbia.edu/faculty/jstiglitz/sites/jstiglitz/files/Apple%20Tax%20Tussle_0.pdf.

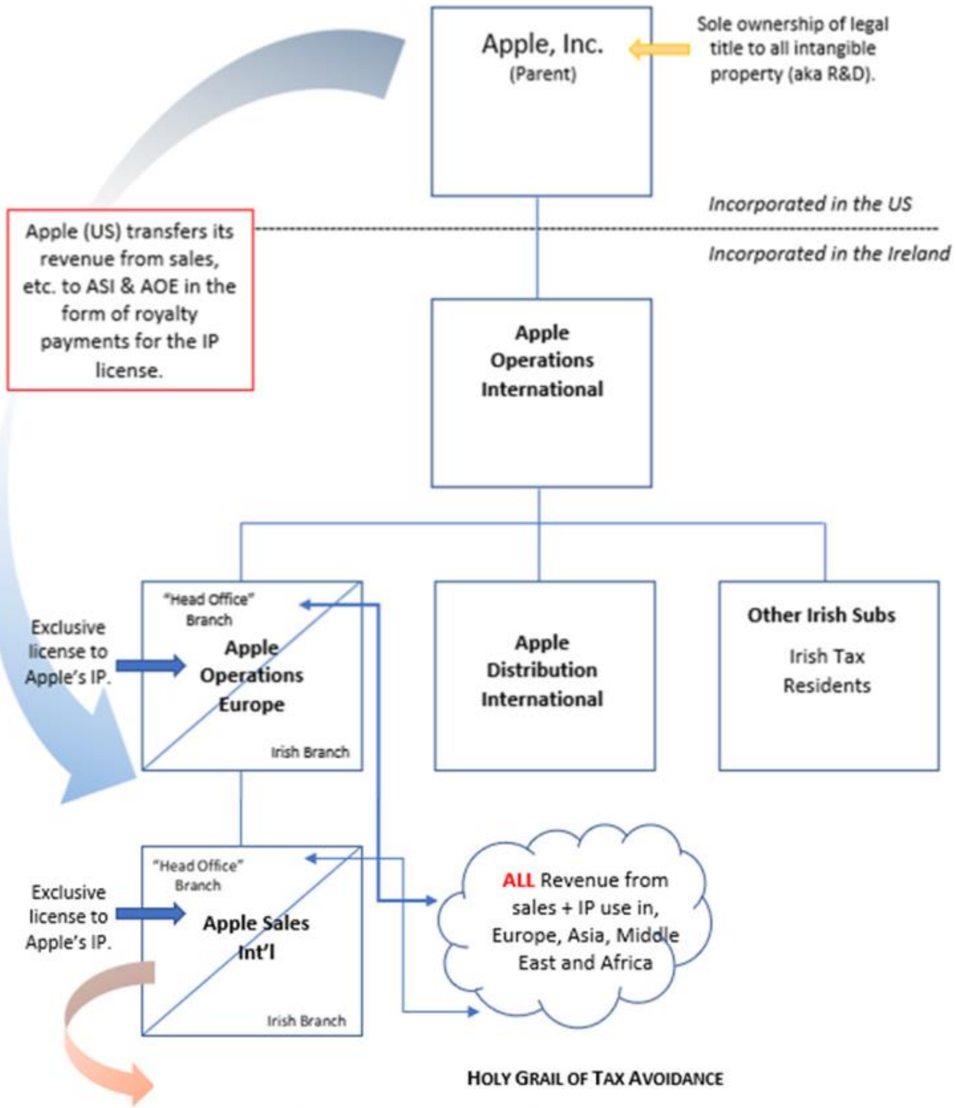

Figure 3 – Apple's altered Double Irish structure[256]

As it can be seen on the illustration, all royalties for granting IP use as well as earnings from sales in Europe, Asia, Middle East, and Africa were all booked in the Head Offices – to those same Head Offices that had no physical location, no employees, with mythical bosses "somewhere" in the US. Were any taxes imposed on them: not at all. This structure helped Apple manage to avoid paying billions of Euros in taxes to either of the jurisdictions.

[256] ORTIZ, *A Case Study of Apple,* 2020, pg. 376, cit. note 111.

However, further questions may arise: for example, how did Apple know how to bypass all the rules, guiding its tax planners to create its own “imaginary” tax haven that, nevertheless, worked very well in practice? To answer that, let us take a brief look, first, at how such an organization allowed Apple escape U.S. taxes, and consequently, consider the Irish fiscal law.

4.2.2. <u>The reason why Apple’s Head Offices were not subject to neither U.S. nor Irish taxes</u>

Given that U.S. law assigns taxability of an enterprise by operational location.[257] Considering Apple’s case it was the hosting jurisdiction that was responsible for tax imposition. With that in mind, both the Irish branches as well as the Head Offices of AOE and ASI was not a concern for the US, given their reported legal presence in Ireland. Additionally, in light of the “check the box regime” in the US, it was no longer its concern.[258] Considering Irish tax law, given that it attributed tax obligations to the jurisdiction where “place of management” took place, in case of the Head Offices it was the US.

Although Irish law attributed tax responsibility of Apple back to the U.S., it did so unavailingly: the U.S., falling outside its tax authority too, it already claimed a “not my business”, and did not initiate any investigation for verification whether taxes were paid to Ireland.

Through the structuration of the ghost companies, thus, Apple managed to guide tax obligations first out of control of US authority, and subsequently, also out of Irish obligations – the latter attributing tax authority back to the US. Maneuvering itself through such tiny gateways between the two tax regimes, the scenario allowed most of Apple’s profits gained through AOE and ASI go untaxed. Even

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[257] TING, *iTax*, 2014, cit. note 243.

[258] *Ibidem,* As provided in the Internal Revenue Service (IRS) of the United States, certain entities may select the way they wish to be regarded for taxation purposes. Given the relative „freedom” to choose, an entity may pick the most beneficial option. In the case of Apple, it managed to pick the „disregarded entity” and thus achieve non-observance by the US. *Ibidem*

though the two Irish branches of AOE and ASI were legally taxed, these booked income only coming from auxiliary operations, such as customer service, making up for only a small fraction of Apple's overall revenue.

Furthermore, since at the time no international regulations on source country taxation were in force,[259] that is to say, in the countries where Apple sold iProducts, Apple's case is not an example of "simple" double non-taxation, rather it is a clear demonstration of triple or even multiple non-taxation. In every country where Apple was present in one way or another – production, sales, marketing, etc. –, none of those jurisdictions received taxes during the time period concerned.

4.2.3. One last crucial factor…

In order to describe the scene from a wholistic perspective, one aspect must not be left unconsidered: Apple's actual arrangement would not have been possible without backing and support from Ireland. The Irish government, indeed, in 1991 made a special agreement with Apple granting the enterprise lower-than-usual tax rates and the applicability of tax obligations only to a limited range of transactions. This agreement later in 2007 was renewed and modified but still guaranteed similarly low rates of taxes for Apple.

It was in these rulings that allowed Apple Inc. to establish a cost-sharing agreement with the subsidiaries AOE and ASI, which permitting the parent company to grant economic rights to these subsidiaries. As a result, AOE and ASI were no longer obliged to pay royalties for IP to Apple Inc., and could book the profits.

[259] Even today, regulations are not in their final evolutionary stage on this matter, even though significant progress have been achieved through global actors, such as the OECD – as it, has been shown in Chapter 3.

These Irish ruling caught the eye of the European Commission, which led to its decision to conduct an investigation on the case. This will be explored next by taking a look at EU law on competition.

4.3. EU Commission's investigation on Apple's taxation between 2003 and 2013

The suspicious nature of Apple's strategy, back in 2013 it was first the U.S. that started an investigation on Apple's corporate strategy with particular attention to its taxation.

Sen. Carl Levin, D-Mich., the subcommittee chairman, called Apple's persuit for lowering corporate tax rates "the Holy Grail of tax avoidance".[260] During the litigations, Apple CEO, Timothy Cook, was invited to speak about the matter before the U.S. court and claimed that Apple has paid all due taxes.[261] Eventually, the U.S. did not find Apple's tax evading structure to be unlawful.[262]

Consequently, since the European Union is also deeply involved in the case through the presence of the company in Ireland, it could not shrug shoulders as if nothing happened. Its institution that is responsible for issues relating to occurrences that impact competition at Community level is the European Commission, more precisely the Directorate General for Competition (DG

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[260] Interfaith Center on Corporate Responsibility (ICCR*), Proxy Resolutions and Voting Guide*, January 20, 2014, page 26, https://www.iccr.org/sites/default/files/2014ICCRProxyResolutionsAndVotingGuide.pdf.

[261] For a brief summary of the story of Apple from its own perspective, see: T. COOK, *Testimony of Apple Inc. Before the Permanent Subcommittee on Investigations US Senate*, delivered on May 21, 2013, http://www.apple.com/pr /pdf/Apple_Testimony_to_PSI.pdf.

[262] „The check-the-box loophole allowed U.S. companies to strip profits from operations in high-tax countries simply by marking an IRS form that transforms subsidiaries into what the agency calls a 'disregarded entity.'" SH. FERRO, *A Popular Irish Corporate Tax Loophole Is Now Dead — Here Are Three Other Loopholes*, Business Insider, Oct. 14, 2014, https://www.businessinsider.com/double-irish-other-corporate-tax-loopholes-2014-10.

COMP)[263], led by Commissioner Margrethe Vestager. Thus, it took its own initiative to verify the correctness of the U.S. allegations, which – if confirmed – would have affected EU fair competition rules. The EU Commission launched its investigation in 2014.[264]

4.3.1. <u>The EU Commission's reasoning</u>

EU's approach on the case was very much focused on one specific matter: Ireland's culpability for potentially granting unique tax conditions for Apple. More specifically, the Commission strongly opposed the rulings of 1991 and 2007; it considered that Ireland gave State Aid to Apple through the rulings, in which a special cost-sharing agreement was established.[265] This, in turn, allowed the two entities in Ireland, namely ASI and AOE.51, to operate through the alternative version of the Double Irish Approach. State Aid, instead, is illegal under most conditions of the EU law – unless it is clearly justified for providing inclusive economic development.[266]

State Aid's definition and regulations are set out in Article 107(1) of the Treaty of the Functioning of the European Union (TFEU). In order to determine whether State Aid was given or not, the following four crucial conditions must be met.

First, the Aid must be financed out of the state's own material resources; second, the Aid must guarantee a competitive advantage for the entity in question, moreover, such advantage must be unique, that is not given to other corporations;

[263] The EU Commission – Directorate-General for Competition, *EU competition policy in action: COMP in action*, 2018, https://data.europa.eu/doi/10.2763/897035.

[264] The EU Commission Press Release, *State aid: Commission investigates transfer pricing arrangements on corporate taxation of Apple (Ireland) Starbucks (Netherlands) and Fiat Finance and Trade,* Luxembourg, 11 June, 2014, https://ec.europa.eu/commission/presscorner/detail/en/IP_14_663.

[265] *Ibidem*

[266] *Ibidem*

finally, State Aid must affect or be a threat for affecting EU internal competition rules, potentially distorting commerce on a Community level.

If the conditions are met, the EU Commission, being the executive authority of the EU, can claim that State Aid was provided by a Member State to the entity in question and may require the repayment of the estimated amount of illegal state aid for a 10-year period prior to first request of information.[267] Thus, after the U.S. Senate's investigation, on June 11, 2014 the Commission made a decision to request Ireland to handle it information in this regard.[268] After the conclusion of the investigation in 2016, the following conclusion was made on whether or not Ireland provided State Aid to Apple.

As for the first condition, it was definitely met by Ireland, because without the special agreements made with Apple, the country would have been entitled to receive billions of Euros in taxes during the years concerned.[269]

Similarly, the Second criterion was satisfied as well: Apple gained significant benefits, allowing it to pay lower taxes; furthermore, these advantages allowing tax reductions were unique for Apple.[270]

Concerning the last element, basically any advantage provided to a MNE of such caliber as Apple would affect international markets – not exclusively because of the financial amount of aid provided, but more importantly, because giant entities have obvious and far-reaching influence in the international economic scenario.[271]

Since all the criteria were met in, on August 29, 2016, following the two-year investigation, the Commission concluded that State Aid offered by Ireland was in

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[267] The EU Commission Press Release, *IP/16/2923*, *State Aid: Ireland Gave Illegal Tax Benefits to Apple Worth Up to €13 billion*, August 29, 2016.

[268] The EU Commission – Competition Policy, *Cases SA.38373*, https://competition-cases.ec.europa.eu/cases/SA.38373.

[269] ORTIZ, *A Case Study of Apple,* 2020, cit. note 111.

[270] *Ibidem*

[271] *Ibidem*

fact not justifiable, and that, thus, Apple effectively received illegal State Aid from Ireland.[272]

4.3.2. EU Commission's Decision and its follow-up

As an immediate consequence of the investigation's conclusion, Commissioner Margrethe Vestager announced a Decision in which it ordered Apple to make a recovery payment to Ireland of the estimated amount of Aid it received in order to redeem Ireland for the losses of its public income.[273] The Commission estimated the recovery payment amounting for a total of 13 billion Euros (plus interest) between years 2003 and 2014.[274]

The Decision emphasizes that Ireland granted illegal fiscal advantages to Apple, which allowed it to pay substantially lower taxes than other businesses over many years. It concludes that such a distinguished behavior towards Apple allowed the corporation to pay an average corporate tax rate of 1% on its European profits in 2003, bringing it down to 0.005% in 2014.[275]

Shortly after the Decision, first, Ireland backfired stating that it was not interested in any of the repayments, in the first place. Then, Tim Cook argued that the Commission erroneously interpreted much of the information and that, on top, it the case was not even under its competency, given Ireland's sovereign right regarding its own fiscal policy. Shortly after, Apple wrote a letter to the EU Commission that it would appeal against the Decision. Similarly, Irish finance minister Michael Noonan communicated that, subject to approval of the Cabinet, it would also appeal. In September 2016, the Irish Cabinet approved to appeal,

[272] The EU Commission, *(EU) 2017/1283, Decision of 30 August 2016 on State aid SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) implemented by Ireland to Apple (notified under document C(2017) 5605), C/2016/5605*, http://data.europa.eu/eli/dec/2017/1283/oj.

[273] *Ibidem*

[274] *Ibidem*

[275] *Ibidem*

and so the legal litigations began between Ireland and Apple on one side, and the EU Commission on the other.

The case went before the European General Court in 2018 and took two years until its conclusion. In 2020, the Court, found that the EU Commission's investigation did not meet legal requirements for demonstrating that illegal State Aid was given to Apple; it ended the appeal in favor of Apple, but noted that appeal can be made in the Court of Justice of the European Union.[276]

In fact, the case is still ongoing, since the EU Commission appealed in 2023.[277] In the meanwhile, the 13 billion Euros are held in Ireland in an escrow account for as long as a final ruling is not reached.[278] So far, Apple has only been subject to legal reproaches.[279]

4.3.3. <u>What might have been missing in the EU Commission's reasoning</u>

The EU Commission puts a lot of effort in focusing on Ireland's EU-rules-offending behavior and pays very little attention trying to understand why Apple developed such a tax strategy.[280] In order to be able to bring down an entity for its unfair corporate behavior, its actions first must be completely and well understood. Such an understanding is missing from the EU.[281] So why did apple use the this altered version double Irish arrangement?

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[276] General Court of the European Union, *Press Release No 90/20*, *The General Court of the European Union annuls the decision taken by the Commission regarding the Irish tax rulings in favour of Apple*, 2020, www.curia.europa.eu/jcms/upload/docs/application/pdf/2020-07/cp200090en.pdf.

[277] CCH, *ECJ Hearing Commission's Apple Ruling Tax Appeal*, 2023, https://answerconnect.cch.com/document/gdn01163844/news/ecj-hearing-commission-s-apple-ruling-tax-appeal.

[278] A. LIEBHOLZ, *Apple Could Be Forced to Pay a $14 Billion Tax Bill by EU. Here's Why*, Impakter, 2023, https://impakter.com/apple-could-be-forced-to-pay-a-14-billion-tax-bill-by-eu-heres-why/

[279] ORTIZ, *A Case Study of Apple,* 2020, pg. 367, cit. note 111.

[280] *Ibidem*

[281] *Ibidem*

In order to achieve a better understanding, a careful insight must be done again into US law in light of Apple's strategy. This would involve taking a look into Internal Revenue Code, CFC rules and consider certain specific elements. Back in 2013 when the US Senate was investigating Apple's case, it noted some interesting facts that may bring the understanding of Apple's strategy closer to reality.

Presumably, the reason Apple decided to alter the Double Irish for its structure has to do with one exceptional scenario that U.S. tax rules establish. It is, at the same time, also the reason why the US Senate did not find Apple guilty of tax fraud.[282] In fact, the Senate observed that Apple perfectly implements a principle that exempts its structure from otherwise obligatory taxes: the "same country exception" rule.[283]

As it has already been mentioned, U.S. IRC in Subpart F establishes regulations on U.S. firms' foreign subsidiaries, specifying that profits obtained in CFCs through royalties (resulting from the transfer of IPR or other licenses) had to be reported as revenue to the U.S. on which, in turn, the latter would impose taxes.

However, to Subpart F there are exceptions, one of which being the "same country exception". The rule basically states that if a CFC receives royalty payments from a „related entity" that is also located and economically operant in the same jurisdiction, it will be exempt of US taxes.[284]

Concerning Apple, it did exactly accordingly: it incorporated two related entities in the same country, Ireland, where one received royalty payments coming from the other entity – which, nevertheless, constituted for its total income. Under Subpart F exceptions, thus, US taxes on such transactions were not imposed. Furthermore, the Head Offices perfectly served their purpose of sheltering capital in a virtual space, outside any jurisdictions tax authority.

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[282] *Ibidem*

[283] *Ibidem*

[284] Internal Revenue Service, *LB&I International Practice Service Transaction Unit*, 2016, cit. note 241.

Had it relied on the original Double Irish arrangement, it would have had subsidiary AOI resident and managed in Ireland, AOE and ASI would have been similarly resident in Ireland, but their management activities would have been reported in a tax haven, such as Bermuda. Consequently, the same country exception rule exempting Apple from U.S. due taxes would have not been applicable.

The altered version of the arrangement allowed Apple to report worldwide income from IP use and sales from out the Americas in Ireland's Head Offices, where earnings were left untaxed. With reference to Ortiz (2020), if the EU Commission takes such an understanding and reasoning into account, it might have had better chances of convincing the EU General Court that Apple's behavior in fact was unfair and affected substantially competition.[285]

4.3.4. Current standpoint on the case

Following the European General Court's ruling regarding Apple's case in 2020, favoring Apple and Ireland, the EU Commission has tried to step up again against the decision. Indeed, it was on May 23, in Luxembourg, that the EU Commission made its final appeal at the highest Court of the European Union against the European General Court's ruling in 2020.[286]

The Commission hopes to have convinced the highest Court of the European Union that the General Court had overlooked on some details and was mistaken when gave its verdict stating that Ireland did not provide State Aid to Apple.

Expectedly, Giovanni Pitruzzella (Advocate General of the Court of Justice of the European Union) will express an official non-binding opinion regarding the case in

[285] „ … *in order to stop a behavior from happening it would be efficient to understand why the behavior occurs in the first place*.", see: ORTIZ, *A Case Study of Apple,* 2020, pg. 381, cit. note 111.

[286] CCH, *ECJ Hearing Commission's Apple Ruling Tax Appeal*, 2023, cit. note 277.

November this year, while the Court's final verdict may arrive during the first months of 2024.[287]

4.3.5. Considerations on Apple's case in light of the present investigation

Apple and other entities, if IP was not a virtually transferrable asset, would have not been able to create and take advantage of structural organizations.

A consideration prevalent to the investigation, seen in its entirety, all of the ways according to which Apple organized itself were enabled by the digitalization of the economy – a reflection that is quite paradoxical and interesting to make, since Apple itself was and continues to be one of the biggest pioneers in the evolution of the digital economy itself.

Without the digital economy, none of Apple's structure would have been possible; but similarly, without Apple, very probably digital economy would not be at the point where it currently is. Digitalization's evolution, thus, may be considered as a self-helping process for the digital giants: the more they develop new technologies, products, services, etc., the more they are able and equipped (physically and intellectually) to find ways to make use of the different aspects of the virtual reality – unfortunately, also for purely self-benefiting purposes.

Referring back to what has been said in Chapter 1, digital economy has evolved and has been doing so much faster than regulations addressing it can keep up. Such aspects are very well researched prior to tax planning by MNEs' taxation executives, being it the reason for they actually find such tiny backdoors in tax regulations to exploit. Such a tendency allows them to easily circumvent regulations that unproperly address current issues.

Therefore, it is crucial that such investigations be done adequately on behalf of competent international organizations, too. That way, it is very unlikely that cases

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[287] N. O'Leary, *Apple argues disputed €13.1 billion is being paid in tax to the United States*, in *Irish Times*, 2023, https://www.irishtimes.com/business/2023/05/23/top-european-court-to-hear-appeal-in-13bn-apple-tax-case/

similar to Apple would be given the possibility to persist for years and even decades avoiding taxes; they would be detected and brought down much more quickly.

Chapter 5

Considerations and future proposals on digital taxation in the European Union

5.1. Reflections on the current standpoint

Having seen a concrete case of tax avoidance strategy, it demonstrates clearly how complex the issues are. It is not simply or not always just a corporation that is navigating itself through fiscal inconsistencies and loopholes among different countries' tax policies; sometimes – actually very often – interested governments are involved too, as it was the case for Apple too.

Single states may wish to attract foreign income, and therefore offer beneficial conditions for MNEs, often at potential costs of other entities. This is especially the case with smaller countries, like Ireland, Hungary, Luxembourg, etc. that are less reliant on sources of national income and, thus, strive for foreign investment.

However, illegitimately incentivizing the incorporation of giant MNEs' subsidiaries or branches into their territory has harmful effects on two main levels. First, they can be detrimental for other countries that do not incentivize foreign companies to reside in their jurisdiction, but would, nevertheless, "enjoy" foreign investment. The latter, however, does not arrive since it is provoked by more eager states through unethical and unfair, yet very attractive stimuli.

Second, since incentives are most often given to largest and most successful corporations, any benefit further secures their position in the global market in comparison with other companies. This is, therefore, detrimental for small and medium enterprises (SMEs) as well as for new entrants. Clearly, the incentivizing state wants to attract the biggest corporations with huge amounts of global earnings to "move in", as these would create job opportunities in the country and even if pays a lower percentage of taxes, still the sum in absolute terms remains high – a scenario that is beneficial for the two, but clearly not for any other actor whether they be other jurisdictions or other companies. In other words, such misbehaviors often consist of two parties benefiting each other – a given country and a MNE – to the cost of others' success – other states and corporations.

This is why regulation on a global level is the only solution: in order for fair circumstances to be effectively respected, a harmonized international system must be established that control and govern tax planning. A unified approach, therefore, is fundamental so that similar cases to Apple may not ever occur again.

However, it has been shown throughout the investigation that international action requires a very complex process and takes considerable amount of time till reached, mostly because of the unanimous consensus that such fiscal initiatives require.

Reaching unanimity, in turn, is difficult because each country is different in many respects: economically, socially, geographically, and politically. One state may concentrate more on scientific research, while another on technological development; the third may be specialized in agriculture, while the fourth stands out for its services that it provides. Altogether, all have their own interest and different preferences that wish to protect when it comes to the sovereign right of tax policy.

On the other hand, it is important that eventually each country see the benefits it can gain from giving up "their way of doing" and compromise it for the sake of international fiscal harmony – obtaining advantageous circumstances such as better fiscal security, lower probability to be subject to exploitation by corporations' malicious tax tactics, objectivity, etc.

Although significant advancements have been made during the past two decades by competent authorities such as the OECD or the European Union, so far, these are only the beginning of a longer journey. These accomplishments are generally very broad and address generic issues, such as the minimum corporate tax rate.[288] Further progress is clearly needed in global tax regulations that address more specific areas, whose primary focus shall be the digital economy.

In fact, competent authorities put great amounts of effort in developing new and more effective international standards. Proposals and initiatives are various and promising, but still need concretization. The next paragraph will take a look at these initiatives.

5.2. Potential solutions in the European Union

Concerning specifically the European Union, on 18 May 2021 the EU Commission published a "Communication on Business Taxation for the 21st Century"[289] highlighting issues that originate from the COVID-19 pandemic.[290] It specifies that the health crisis gave space for existent trends in digitalization of the economy to further spread and embraced them to rapidly develop.[291]

It also puts particular emphasis on the fact that the new economic scenario has no centralized tax regulations, addressing the question from two different perspectives[292].

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[288] The EU Commission Taxation and Customs Union, *Minimum Corporate Taxation*, 2022, https://taxation-customs.ec.europa.eu/taxation-1/corporate-taxation/minimum-corporate-taxation_en#:~:text=If%20the%20effective%20tax%20rate,its%20rate%20up%20to%2015%25.

[289] EU Commission, *COM/2021/251-final*, *Communication from the Commission to the European Parliament and the Council – Business Taxation for the 21st Century*, 2021, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0251, (hereinafter: *COM/2021/251-final, 2021)*

[290] Previous to the publication on Business Taxation, the EU Commission in January 2021 published another initiative concerning digital taxation: the EU Commission, *A fair & competitive digital economy – digital levy,* 2021, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12836-A-fair-competitive-digital-economy-digital-levy_en; nevertheless, after the period of public consultation was closed the same year in April, the initiative was apparently abandoned.

[291] *COM/2021/251-final, 2021,* pg. 6, cit. note 289.

[292] *Ibidem,* pg. 1

First, it underlines the fact that current international fiscal regulations were created in the 20th century; and by being designed to address issues of the past, these are inadequate for modern economy.[293] Second, it emphasizes a crucial division between current system of tax regulations and corporate structure: while tax regimes are national, most business models rely on international as well as virtual organization.[294]

The two, clearly, do not match since businesses operating across borders in the EU Single Market must consider single Member State's national tax regulations in each country, they conduct business. This implies costly and difficult tax management for them, while also creates "opportunities" to be taken advantage of for tax evasion purposes.

In the Communication the Commission lists the priorities that the initiative is designed to follow. Overall, it highlights that EU corporate taxation must be incorporated into a wholistic EU tax framework in order to achieve a comprehensive EU-wide structure of public income.[295] Such framework must guarantee fiscal transparency and a well-balanced and efficient single tax regime in Europe that promotes innovation, inclusive growth, and development. It must ensure, therefore, that digital businesses make equal contributions as traditional businesses do.

EU level tax regulations must be fit from two sides in the international scenario: single countries and global initiatives. First, the Commission notes that initiatives at EU level must consider single states' fiscal interests and, thus, back national regimes by allowing a certain grade of freedom in specific matters where own national interest dictate so.[296]

This is important since very strict measures, in a worst-case scenario, would limit disproportionately countries' freedom of national legislation, eliminating even fair levels of competition. On the other hand, the ideal condition for obtaining

[293] *Ibidem,* pg. 1

[294] *Ibidem,* pg. 5

[295] *Ibidem,* pg. 2

[296] *Ibidem,* pg. 6

harmonized and inclusive growth would be if clear rules were established, that also guarantee a certain level of liberty. This may include, for example, allowing single Member States to set minimum tax rates above the internationally agreed level.[297]

Second, EU-wide policy must be in line with already existent global regulations, such as the BEPS Project, as well as with similar future initiatives.[298] In order to be so, such projects will be embedded into EU law, reinforcing their validity. For instance, EU Directives are and will be made that oblige all EU Member States to implement EU-approved global tax regulations.[299]

As for what regards the structure of EU Member States' average tax revenue, the Communication highlights that public income is unequally constituted. For example, labour taxes make up for as much as half of Member States' tax revenue on average, while other types of levies weigh much less, including corporate taxes at approximately 7%.[300] As a consequence, in order to ensure a more balanced outcome, reorganization of EU tax structure is crucial also from this perspective.

Viewing Europe's overall tax revenue from a global perspective, it is already the highest taxing macro-region around the world, amounting for an average of 41,7% of tax per GDP ratio in 2021[301] in comparison with the OECD average of around 33,5%.[302] Yet, considering 2020, EU Member States in total lost an estimated 93 billion Euros in taxes, which would not have taken place if effective regulations had been applied.[303] This means that while taxes generally cannot be

[297] *Ibidem,* pg. 6

[298] *Ibidem,* pg. 7

[299] *Ibidem,* pg. 7

[300] *Ibidem,* pg. 4

[301] Eurostat, *Tax revenue statistics*, 2022, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Tax_revenue_statistics#General_overview.

[302] OECD, *Revenue Statistics 2022: The Impact of COVID-19 on OECD Tax Revenues*, OECD Publishing, Paris, 2022, https://doi.org/10.1787/8a691b03-en.

[303] EU Commission – Taxation and Customs Union, *VAT Gap,* 2022, https://taxation-customs.ec.europa.eu/taxation-1/value-added-tax-vat/vat-

further elevated, instead what can and must be done is to adapt the mixture of different types of taxes so as to assure that they are adequately distributed among states.

Finally, the Communication, under Action 5, mentions that in its agenda it will propose a program for the introduction of an effective EU-wide tax policy regime. The initiative is called “Business in Europe: Framework for Income Taxation”,[304] or BEFIT[305], which – once adopted – will serve as a European Single-Market-wide EU tax rulebook covering all the crucial points that has been mentioned. The proposal is inspired by the BEPS Project but goes further by addressing issues at an even more specific level.[306] This would replace current national corporate taxation rules, while leaving them with a fair margin of autonomy.[307]

The initiative was open for public consultation from October 2022 until January 2023, and now it is waiting for the Commission adoption that is planned to happen during autumn, 2023.[308]

As for the BEPS Project, Pillar Two in December 2022 was incorporated into EU law through the adoption of Council Directive “on ensuring a global minimum level

gap_en#:~:text=EU%20Member%20States%20lost%20an,released%20by%20the%20European%20Commission.

304 Directorate-General for Taxation and Customs Union – the EU Commission, *Commission launches public consultation on BEFIT, a new framework for EU corporate taxation*, 2022, https://taxation-customs.ec.europa.eu/news/commission-launches-public-consultation-befit-new-framework-eu-corporate-taxation-2022-10-17_en.

305 This new proposal will replace the pending proposals for a Common Consolidated Corporate Tax Base (CCCTB)30, which, in turn, will be withdrawn in the future, *COM/2021/251-final,* 2021, cit. note 289.

306 *Ibidem*

307 *Ibidem*

308 For more information see: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13463-Business-in-Europe-Framework-for-Income-Taxation-BEFIT-_en.

of taxation for multinational groups in the Union".[309] The EU plans to incorporate Pillar One as well but there are still uncertainties about its realization.

However, the EU is firm on that it should go beyond the regulations that Pillar Two of the BEPS 2.0 establish in order to ensure a high level of integrity in the EU Single Market. In effect, the EU Council, in the Directive that implements Pillar Two, expresses that regarding the failure of the introduction of the Digital Service Tax (DST) at EU level, new measures must be introduced.[310] Given the uncertainty of the incorporation of Pillar One into EU law, the Council asks the Commission to present a new legislative proposal that addresses digital taxation.

In line with such requests, in November 2022 during a meeting among EU financial leaders, called "EU Tax Symposium: On the Road to 2050", European Union's Commissioner for Economy, Paolo Gentiloni, highlighted in his welcome speech that the issue of EU tax harmonization is of crucial importance and that action must be taken now.[311]

The Commissioner, in reference to the two pillars of the BEPS 2.0, emphasizes that both the reallocation of taxing rights as well as corporate minimum tax play key roles in order to provide an effective global tax regime, and that the Union is committed to implement both of them in EU law.

In this regard, during his speech in EU Tax Symposium, Paolo Gentiloni highlights the importance of the BEFIT initiative and calls it an "ambitious proposal" in which Europe shall have hopes.[312] Eventually, once a Proposal for Directive has been

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[309] Council of the EU, *COM/2021/823 final*, *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union,* 2021, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52021PC0823.

[310] *Ibidem*

[311] *EU Tax Symposium: On the Road to 2050*, November 2022. This conference was presumably only the first of a long sequence of dialogues. https://taxation-customs.ec.europa.eu/road-2050-tax-mix-future/eu-tax-symposium_en#:~:text=On%2028%20November%202022%2C%20European,at%20all%20levels%20of%20governance.

[312] *Ibidem*

approved by the Council, BEFIT would serve as a long-term EU level tax regulatory tool.[313]

Considering the entire picture of Europe's fiscal future on digital taxation we might ask ourselves: what can possibly be expected during the following years and decades? Will the continuation of individual state-wide policies keep maintaining and generating further distortions in an already inconsistent fiscal reality in Europe? Or will the establishment of new and many-state-inclusive fiscal agreement(s) help solve the problem of implementing BEPS Pillar One, thereby introducing a unique tax regulation on MNEs' profits in Europe?

Well, chances are that the eventual outcome will be either one of or somewhere between the two abovementioned scenarios. Now, even though the former as such is very unlikely to continue to happen – due to immense efforts in the international community for its avoidance –, a unique global regulatory framework, ratified by the constituting states of the potential agreement is still just a utopic dream, at least considering the near future.

Nevertheless, the direction is clear, and we may say that creating a new global rulebook on tax regulation is not a matter of "if", rather, a question of time, and multilateral effort.

[313] *COM/2021/251-final, 2021,* cit. note 289.

Final Conclusions

Throughout the investigation one of the most important fiscal challenges of recent years have been addressed from an international perspective: digital economy's corporate income taxes and its regulations.

First, two different scenarios have been explored that led to an international common understanding about the need develop international fiscal regulations: double taxation and double non-taxation or tax elusion. While double taxation is an unintended consequence of the lack of global rules, tax evasion often occurs intentionally and in a well-planned manner, such as, as a result of businesses displacing certain corporate activities in lower tax jurisdictions.

After discovering the importance of international tax standards, it has been shown that these are inadequate for addressing challenges of modern global economy. Although they have been updated numerous times, these regulations originate from the early-mid 20th century and taxation is addressed in an old-fashioned way that fail to capture challenges of today's economic scenario.

The physical nature of Permanent Establishments as taxable nexus has been shown to be an outdated concept that is inadequate for the digitalized economy. A taxable nexus must not be based on principles of physicality in an era where businesses conduct more and more commercial activities virtually without physical presence in all states where they source income from.

Next, the concept digital economy itself was explored, giving a detailed insight into the challenges it causes for the international community in terms of taxation. Given its unique nature of virtual presence and exponentially growing pace of evolution, fiscal authorities face serious difficulties for establishing adequate measures that capture digital economy's footprint.

As a consequence, due to the absence of comprehensive international rules, corporations' attempts to exploit divergent single states' regulations have been identified to be a serious threat for global economy. Given the sovereignty of all jurisdictions in fiscal matter, tax rules in many states differ substantially from others. The different nature of single states' tax regulations, in turn, create loopholes in the international fiscal scenario as well as areas of taxation that are non-properly addressed.

Examples are numerous of giant multinational corporations that have tried to abuse such circumstances as well as succeeded in doing so through the application of different tactics, very often by practicing arbitrary transfer pricing of IPs, allowing the company to transfer profits to no-tax requiring tax havens.

In order to reduce the number of such instances and eventually eliminate the possibility for MNEs to exploit taxation, competent international organizations have been putting huge efforts in the development of multilateral tools on which different jurisdictions may rely. Such international rulebooks would aim at eliminating fiscal gaps, thereby not leaving space for MNEs for tax evasion.

While some of these initiatives failed to be implemented (e.g.: EU Commission's initiative for EU-wide application of DSTs), others achieved more success, such as the BEPS 2.0 Plan by the OECD; some initiatives are regional (such as the former), while others global (the latter); finally, while some address more generic issues, others are more specific (for example, by only addressing digital enterprises). Nevertheless, these are all key to a process leading to an eventual long-term global solution; whether macroregional or global, attempts are being made on a continuous basis and the main direction is well-defined at international level.

Then, in order to demonstrate in concrete terms, the way such tax evasion tactics in the 21st century may look like, some of the most famous strategies of tax evasion have been analyzed. Namely, these were the Double Irish arrangements, the Double Irish with Dutch Sandwich approach and, finally, Apple's real-life example, which relied on an individual version of the former.

As it has been seen, Apple's strategy, too, like many other MNEs', based its tactics on the common core of modern tax evasion: arbitrary transfer pricing methods of IP under the excuse of R&D allowing for shifting profits. Unlike most corporations that rely on tax havens for sheltering capital, Apple shifted its income into a “virtual room”, whose different coordinates allowed for exemption of taxes under otherwise-concerned jurisdictions.

Last but not least, after reporting some reflections on what had been elaborated throughout the investigation, most important current initiatives have been shown in international fiscal regulations at European level. These may potentially be approved and implemented in the near future, preparing the ground for a positive and sanguine outlook in international fiscal regulations.

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