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Digital Permanent Establishment

(Updated Blueprints)

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Content

1. Introduction

The Multilateral Convention to Implement Amount A of Pillar One will very likely not be ratified by a sufficient amount of countries. The goal of this article is to outline how the UN could approach the topic of a digital presence test as one option for the First Protocol under the UN Framework Convention. Such a move back to square one is of course for the involved people highly frustrating as a lot of work has been invested, however, on the other hand it also creates chances to approach the topic in a different form and based on a different rationale.

This paper aims at assessing whether Pillar 1 has been perceived to be a just and fair solution mainly among academics but also among the public and based on such analysis new proposals could be developed. So, we will also outline how a just international regime could be designed. To do so, the focus is on principles used in the international debate about changing the international tax regime. These policy principles are more important in the international sphere than they are at a domestic level. We will discuss the reasons for this in the following.

Lastly, I will critically assess our own proposal (written together with Pasquale Pistone) stemming from 2015 on how to define a digital nexus considering the academic and political debate in the last 10 years.[1] Therefore, the goal is to develop an amended version of blueprints on how to tackle the very disputed task of taxing the digital economy in a globalized economy.

2. Back to the future

Please allow me to do a short introduction based on some famous statements derived from the movie *"Back to the Future".* The following sentence should serve as a starting point:

"Your future is whatever you make it, so make it a good one."[2]

[1] P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, 2015(15) WU International Taxation Research Paper Series.

[2] S. Holleran, *Brain Storm: An Interview With Bob Gale 18 Nov. 2003*, Box Office Mojo. Archived from the original on 6 Dec. 2008, (accessed 8 Sept. 2020).

This is exactly what international tax policy is all about. We should now think how the economy will look like in 20-50 years to design a tax regime that is able to cope with future business developments.

International tax policy is here different than domestic tax policy. International tax rules are even more difficult to change as they are based on thousands of treaties and multilateral consensus. Future developments need to be considered even more extensively than in a mere domestic tax policy situation as it is difficult to adapt to new challenges. We have seen this in an intense manner over the last 15 years as the most important part of the BEPS project, i.e., the question of whether digital services shall be taxed in the market state has (still!) not yet been answered as policy makers have been unable to find an effective consensus.

However, if one would have suggested to the experts of the League of Nations in the late 1920s that they should already consider digital business models, they would have had extreme difficulties to understand what the future will bring. The same is true for us today. If someone would explain to us how economies will look like in 100 years, we would also have huge difficulties just to understand it.

So, coming back to the movie, the task of international tax policy is perfectly reflected by the scene in which Marty, the key character from Back To the Futures plays the song "Johnny B. Good" (published in 1958) to an audience in 1955, i.e., an audience not yet be prepared for Rock N'Roll. The same is true if a digital permanent establishment would have been proposed in the 1920s, i.e., an audience not yet be prepared for the digital economy. The reaction by the person proposing it, would probably have been *"I guess you guys aren't ready for that yet. But your kids are gonna love it".*[3]

So why referring to the movie "Back to the Future"? It leads us to the (probably) strongest argument in favor of changing the current nexus and allocation rules. If we were again sitting at a table in the 1920s and 1930s and discussing how to draft a model tax convention, however, being aware of the current digitalized and globalized economy, it seems obvious that the outcome would not be that taxation of business income requires a fixed place of business. I simply do not see anyone agreeing on the current OECD MC (i.e., Art. 5 and 7 OECD MC) appreciating that enterprises can significantly penetrate a market without

[3] The scene can be watched for free online https://www.youtube.com/watch?v=T_WSXXPQYeY .

physical presence. It seems very difficult to come up with a position why the market state should get a taxing right if a product is sold through a physical intermediary but not if the product is sold online. Value creation would be another potential justification which we will address below in a specific chapter.[4]

The goal of this paper is to discuss the arguments in favor and against a Pillar 1 solution, i.e., a new taxing right for the market states based on a new definition of the nexus in tax treaties and a new allocation method. Of course, there are also arguments against changing the current system. One is enforcement. Enforcement without a physical presence is difficult. However, times are different in the 1920s and the extraterritorial enforcement is possible if there is the political will. So, it is not an enforcement argument but more an argument whether there is a political will. There has been a tremendous amount of literature published in the last years. We will try to consider various opinions to allow an impartial debate.

3. The experiment

In the past 7 years I have done the following example or experiment with more than 12 cohorts of students. Probably between 300-400 students have provided answers to such experiment.

We have a group of companies' resident in various jurisdictions all belonging to the same MNE. The group has an overall profit of a 1'000 (i.e., net consolidated income). The currency does not matter. The students are asked to allocate the profit (i.e., 1'000) to various countries involved for tax purposes. The group structure should reflect a very basic (but aggressive) tax planning structure used in a pre-BEPS world for tax planning of a US MNE. The group provides digital services such as advertising services or streaming services, i.e. we assume it has no physical presence in the market states. Here are the main elements of the group structure:

- The parent company is in the US where basically all the development activities happen and where the management of the group is. The domestic revenue (i.e. services sold to US customers) in the US is 5'000.

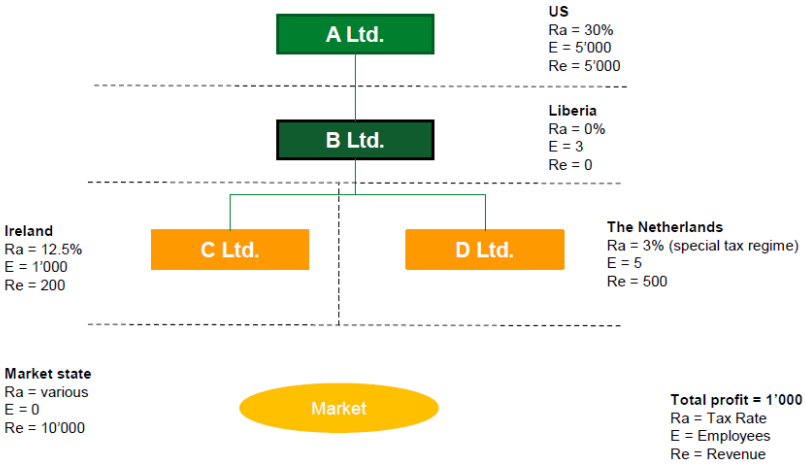
[4] See below section 5.2.

- The US owns an intermediate holding company in Liberia. Of course, this does not reflect reality as the holding company would have been more likely in Bermuda or a dual-resident company. However, the goal is to introduce the students to the topic based on an easy fact pattern but at the same time triggering all relevant questions (incl. questions of distributive justice between poor and richt countries).

- The holding company in Liberia again holds two companies. A Dutch company owning IP rights (for the rest of the world) and benefiting from a special IP regime. There are only very few employees in the Netherlands (5) and there is a domestic revenue of 500.

- And finally, a company selling services (rest of the world) with 1'000 employees (E) is resident in Ireland. However, domestic revenue, i.e., revenue from customers in Ireland is only 300.

The number of employees is rather different with the US and Ireland having most of the functions in their territory. Also, the tax rates are different as outlined in the graphic (and they do not reflect reality!). Besides the corporate structure, the group of course sells services in various markets and these markets have different tax rates. There are no employees in the market states. The structure looks as follows:



As mentioned, the question students have been asked is how the income of a 1'000 should be allocated for corporate income tax purposes if any allocation is required.[5] Some of the students had no knowledge in international taxation others were already more advanced. The students are asked to do the exercise before any discussion of what are the arguments in favor and against a certain allocation. This is done in order not to influence their decision by group biases. Here is some anecdotal evidence:

The result is quite astonishing as the average of income to be attributed to the market states (all the market states together) in each class is in general between 20-40% of the overall income. Therefore, significantly deviating from the current system since in the current system there would be no allocation to the market states according to Art. 7 OECD MC or Art. 7 UN MC (if no Art. 12B UN MC has been implemented and all states have signed tax treaties).

The reason that I do not provide any empiric data beyond mere anecdotes is that we should not take the numbers all too serious (as it is only a survey in a non-ideal setting[6]) so I am not claiming that there should be an allocation to the market state in the range between 20%-40% based on such experiment. However, it is quite an obvious sign that people with no deep international tax expertise seem to see a strong case for a taxing right for the market states.

Another anecdotal evidence is that there is very few students overall arguing in favor of non-allocation to the market states or an exclusive allocation to the market states. Moreover, of course, it is very disputed how much income should be attributed to any of the involved states (i.e., not just the market states) and the deviations are rather extreme. This is exactly the case I would like to outline in the following when discussing a fair allocation.

There is not the perfect allocation key, but international tax policy should at least follow some fundamental rationale, and this might also be a reason why Pillar 1 has failed. Likely Pillar 1 will not be successful as the focus was too much on aligning it with existing transfer pricing regulations in the sense of a perfect allocation system and not on how to achieve a simple taxing right for the market states.

[5] See on the question whether there is indeed a normative claim for allocating income in perfect pieces below section 5.2.2.

[6] It would probably make more sense to first discuss all existing arguments in a comprehensive form before studens are facing such experiment to allow the unforced force of rational arguments to play (i.e. Habermasian approach).

4. The task and two potential solutions

The task of policy makers is to design an international tax regime[7] that enables a fair taxation of, inter alia, the above mentioned MNE group. To design a just and fair international tax regime, there are two main options to enhance fairness and justice. One is a **substance-based approach** focusing on the outcome of a certain legal regime and the other one is a **procedure-based approach** focusing on the decision-making process. The two can of course be combined.

4.1. Procedure-based approach

One way of achieving a fair and just international tax regime would be to have a more inclusive negotiation and decision body, i.e., focusing on a fair negotiation process. Moreover, there are other legitimacy enhancing instruments such a transparent and open debate about the topic.

However, both has largely been missing in the context of Pillar 1. The debate has neither been open and transparent nor inclusive – e.g., it is not even disclosed which representatives have argued in favor of what kind elements of Pillar 1. The Two Pillar consensus has been agreed behind closed doors.

The Inclusive Framework and the OECD have organized public hearings, which is very important and finds my full support. However, the impression remains that these public hearings aimed at solving technical elements but not the most important questions of the proposal. Moreover, the interaction between the Inclusive Framework and the OECD has not been fully disclosed. With the incorporation of the Inclusive Framework, the OECD has aimed at an ex-post legitimization: the main decisions were already made before the Inclusive Framework was incorporated. Therefore, it is also not a surprise that many authors have criticized the procedural aspects of the Inclusive Framework.[8]

The procedural question – although addressed by many academics,[9] is still not debated as a primary problem among politicians. Moreover, it is highly questionable whether the Inclusive Framework is indeed inclusive or whether it is

[7] For terminology *see* Y. Brauner, *An International Tax Regime in Crystallization*, Tax Law Review, 259 et seq (2003).
[8] *See* e.g. A. Christians & L. van Apeldoorn, *The OECD Inclusive Framework*, 226.
[9] See e.g. I. J. Mosquera Valderrama, Output Legitimacy Deficits and the Inclusive Framework of the OECD/G20 Base Erosion and Profit Shifting Initiative, Bulletin for International Taxation (2018) 160 et seq.

rather non-inclusive framework.[10] Of course, I appreciate the most recent initiative to agree on a Framework Convention for International Tax Cooperation but we are still far away from a new governmental structure. And moreover, the First Protocol is not yet negotiated under this new umbrella but under an ad-hoc structure.

4.2. Principle-based approach

Principle-based approaches require that international tax policy proposals are discussed based on their compatibility with some valid principles. The test scheme for Pillar 1 or the First Protocol thus could consist of principles that are considered valid (i.e., persuasive from a normative standpoint). However, what kind of principles could be used to suggest one or the other international tax policy proposal? And why are principles so important in international tax policy? It seems they are even more important than for domestic tax policy questions.

One reason that policy principles might be more important is that the international legal framework does not provide policy makers with legal guidelines as a domestic constitution would do so. There is no international constitution[11]; not in general and not in particular as there is neither an international fiscal constitution.[12] For a domestic tax policy question one would e.g., refer to the equality principle, a due process clause or an ability-to-pay principle derived from the constitution to suggest a certain policy proposal. However, at an international level such legal guidance does not exist. Of course, some of the (domestic) constitutional principles might have an impact on cross-border situations, however, it is far from clear whether these principles apply in the same form. We will refer to this specific topic while discussing the ability-to-pay principle.[13]

Therefore, in the international field policy makers might need to refer to unwritten normative principles to suggest a certain policy. However, it is far from

[10] A. Christians & L. v. Apeldoorn, *supra* n. 8, 226.

[11] On this topic from an international law perspective, *see* e.g B. Fassbender, *The Meaning of International Constitutional Law*, in *Towards World Constitutionalism* (R.S.J. Macdonald & D.M. Johnston Douglas eds, Nijhoff 2005); From an international tax law perspective *see* P. Hongler, *Justice in International Tax Law* (IBFD 2019), 244 et seq.

[12] Some countries have specific fiscal constitutions or at least a specific section in the constitution devoted to fiscal questions. *See* e.g. Art. 126 et seq of the Swiss Constitution.

[13] See below section 5.1.

clear whether principles used in the current debate have a normative content. Or as it was famously argued by Graetz:

"many authors simply assume that the normative basis for international income tax rules is widely understood and enjoys universal agreement"[14]

A famous example of a principle-based approach is the Ottawa Taxation Framework which provided in 1998 for some principles that were deemed to be appropriate to approach the taxation of e-commerce. These principles include:[15]

1. Neutrality
2. Efficiency
3. Certainty and simplicity
4. Effectiveness and fairness
5. Flexibility

One of the ideas was to align the taxation of e-commerce with these principles to achieve a fair solution (i.e., a principle-based approach) – although fairness was only one but probably the main goal. And a fair allocation might again become a committement in the Framework Convention on International Tax Cooperation.

Some of these principles are undisputed. A solution should of course lead to legal certainty, and it should be as simple as possible (principle no. 2) to reduce compliance costs. Moreover, the solution should be flexible enough to consider future developments (principle no. 5).[16] In the following we will focus on the question of whether a new proposal should be neutral and efficient (principle no. 1 and 2) and what fairness means (principle no. 4). These questions are connected as we will outline in the following. After having reviewed the normative content of these principles, we will discuss further what this means for international tax policy.

[14] M.J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26(4) Brooklyn Journal of International Law 1357-1448 at 1363 (2001).
[15] *See* OECD, *Electronic Commerce: Taxation Framework Conditions*, 8 October 1998.
[16] *Ibid.*

5. The main design principles

I strongly believe that we need a clear assessment of what policy principles do have a normative content at an international level and how they should be understood. This means which policy principles should guide decision makers while designing the international tax regime.

We will in the following address some design principles which could be used as justifications for one or the other allocation system and one or the other nexus definition. At a different instance,[17] I have discussed the normative content of these principles in detail so that I will only provide the reader with a summary:

- the ability-to-pay-principle;
- the principle of inter-nation equity;
- the principles of neutrality and efficiency;
- the benefit principle; and
- the source principle.

5.1. The Ability-to-Pay principle / the equality principle

5.1.1. Overview

Often in the political sphere it is argued that large multinationals are not paying their fair share in our societies and, therefore, the international tax regime needs to be reformed.[18] These and similar statements refer to the ability-to-pay principle and/or to a more generic equality principle.[19] In the following we limit ourselves to the ability-to-pay principle. Some authors do no not see that the ability-to-pay principle is of use for allocating income but at least for defining the taxable income. For instance, Schön argues that: *"[a]bility to pay helps*

[17] P. Hongler, *supra* n. 11 at 383 et seq.

[18] *See* in favor of the application of the ability-to-pay principle e.g. L.F. Kjærsgaard, *The Ability to Pay and Economic Allegiance: Justifying Additional Allocation of Taxing Rights to Market States*, 49(8/9) Intertax 2021, 636 et. seq.

[19] Of course in domestic settings there might be a detailed discussion about the relation between the equality principle and the ability-to-pay principle. However, we will not further address such topic in the following.

to define the cake, but it does not help to slice it".[20] Others highlight the fact that the ability-to-pay principle might at least help to justify more extensive taxing rights for the market state in case these states are left with *"too little revenue"*.[21]

It is very challenging to develop a clear understanding of whether the ability-to-pay principle does really apply as a normative principle and whether it can be used for a fair share argument (i.e. that MNEs should face a higher tax burden in our societies).[22] In order for this claim to be valid, i.e. that we should change something in the current taxation of multinational enterprises, three separate questions need to be answered:

(i) Does the ability-to-pay principle indeed require that we treat multinationals and individuals equally?

(ii) Is the ability-to-pay principle applicable at an international level?

(iii) Does the ability-to-pay principle indeed lead to more justice?

We will briefly address these three questions in the following. As we will argue, the ability-to-pay principle is not applicable as a policy principle an international level[23], the comparison between corporate and individual taxpayers is not persuasive and the ability-to-pay principle is in general a flawed principle to achieve more tax justice.

5.1.2. Does the ability-to-pay principle indeed require that we treat multinationals and individuals equally?

The question whether multinationals and individuals should be treated equally has a legal and normative part. Of course, depending on the concept of law to be applied, the two will be mingled.[24] Moreover, the legal context in which the equality principle applies can be very different. In some states the constitution

[20] W. Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1(1) WTJ 67-114 at 73 (2009).

[21] L.F. Kjærsgaard *supra* n. 18 at 649.

[22] Whether it applies as a legal principle depends on each constitional framework. An interesting example is the ability-to-pay principle within the EU as the ECJ has already rendered some decision applying the ability. Famously in the Schumacker case the ECJ referred to the ability to pay principle – *see* ECJ 14 Feb. 1995, Case C-279/93, *Finanzamt Köln-Altstadt v Roland Schumacker*, in particular para. 41.

[23] *See*, however, M. Valta, *Das Internationale Steuerrecht zwischen Effizienz, Gerechtigkeit und Entwicklungshilfe* (Mohr Siebeck 2014), 74, on the question of horizontal and vertical equity as a goal of international tax policy.

[24] Especially in legal systems in which the impact of moral considerations is high.

contains an explicit equality principle in other states such principle has been developed by the judicial bodies through case law. We see some major concerns:

- **What is the right comparable?** First, it is important to note that some courts have already quite clearly stated that individuals and legal persons are not in a comparable situation.[25] But also from a normative perspective, is it really justified to compare corporate taxpayers to individual taxpayers e.g., by arguing that those individuals face an income tax rate of 30% and corporate taxpayers of only 15%? It does not seem persuasive as a valid claim as corporates are not the same moral agents as individuals and to be considered the same moral agent is a condition to ask for a just equal treatment. For instance, corporates are not part of the social contract and do also not face the same personal liabilities in case of moral wrongdoings.

- **How to we deal with the tax incidence?** One problem for the application of the ability-to-pay principle in tax matters is that it is sometimes not clear who really pays the tax, but this is key to discuss a fair distribution of the tax burden. One very persuasive reason which is commonly used in the debate is that at the end tax payments made by multinationals are born by individuals - be it the shareholder, the employees or the investors. It just depends on the incidence of the corporate income tax payment and, therefore, it would be wrong to just compare individuals and corporate taxpayers without considering who bears the tax cost. The fair share argument only holds true if we can really prove which members of the society (i.e., individuals) pay how much of the tax cake.

- **How to apply the equality principle in a multiple-tax state?** A last problem that we face relates to the fact that taxpayers (depending on whether they are corporate or individual taxpayers) face very different other burdens in a society (i.e., other taxes but also other levies). Therefore, if we are indeed interested in comparing taxpayers, we would need to render a detailed assessment of the entire burden of two taxpayers.

For the purpose of the present article, it seems persuasive to argue that it is far from clear whether multinationals and individuals should legally and/or morally be treated equally. The question of tax incidence but also the different moral agency attached to individuals and corporates lead to this conclusion.

[25] *See* e.g. the Swiss Federal Supreme Court in the following decisions BGE 102 Ia 468; BGE 109 I 312; BGer 02.02.2022, 2C_911/2021; BGer 13.06.2000, 2P.130/1999.

5.1.3. Is the ability-to-pay principle applicable at an international level?

As we have seen, there are strong reasons that the ability-to-pay principle does not require that we compare corporate and individual taxpayers and, therefore, the fair share debate is wrongly placed. In the following we will nevertheless further review whether the ability-to-pay principle is at all applicable in an international sphere.

First, it is key to understand that equality concerns in tax matters (incl. the ability-to-pay principle) are traditionally used in basic structures in which specific moral duties apply. The basic structure is in general the state.[26] Therefore, the debate about a fair allocation of the tax burden in general is limited geographically. Therefore, it is a completely different debate whether there is tax justice within a state or even beyond state borders.

The underlying philosophical explanation is that the belonging to a certain basic structure such as the state triggers specific moral duties among the members of such basic structures. Basic structures are characterized by a coercive framework, shared institutions, and cooperation among members, e.g., through the free movement of persons within the basic structure.[27] From a fiscal perspective, the residents of a basic structure are usually within the same tax system and within an expenditure framework that is intended to lead to distributive justice. As an intermediate conclusion this means that the applicable principles of justice are also different within and outside a basic structure.

For the purpose of this article, however, it should be emphasized that basic structures are subject to dynamic developments, so that basic structures can emerge or disappear. An important example is the European Union. The more integrated the European Union becomes the more equality concerns are also relevant in cross-border circumstances. This also means that people might more often apply the ability-to-principle in cross-border situations. There is already some evidence in the case law of the ECJ.[28]

However, for the international sphere and for international tax policy it means that – unless one follows a cosmopolitan rationale[29] – that the ability-to-pay

[26] *See* e.g. J. Rawls, *A Theory of Justice*, Revised Edition (Oxford University Press 1999), 7.
[27] *See* for a dynamic understanding of the term basic structure P. Hongler, *supra* 11 at 349 et seq.
[28] E.g. ECJ, C-279/93, Schumacker.
[29] As far as it can be observed neither the OECD nor the Inclusive Framework has committed itself to a cosmopolitan understanding of global justice (on cosmopolitanism *see* e.g. C.R. Beitz, *Cosmopolitanism and Global Justice*, 9(1/2)

principle does not have a normative validity as an international tax policy principle. Therefore, the international tax regime can legitimately be considered fair although not all individuals and all corporate taxpayers face the same tax burden. This is an important conclusion also for tax policy makers.

5.1.4. Does the ability-to-pay principle indeed lead to more justice?

The most difficult and abstract question is whether the ability-to-pay principle is justice-enhancing per se. This is the debate which is being held in a domestic setting. We focus here on the horizontal element, i.e., the person with the same ability-to-pay principle shall be taxed equally. In a domestic setting such approach has come under attack in various jurisdictions. The main positions are the following:

- The ability-to-pay principle too vague for anything to be derived from it.[30]

- The ability-to-pay principle is not justice-enhancing.[31]

Of course, within the present article we cannot fully explore such question of domestic justice. However, it should briefly be highlighted that one of the main concerns about the application is that taxing persons on the same net income (i) ignores the spending side, (ii) assumes that the market income is just and (iii) does not consider the impact other taxes have in states with a variety of taxes.[32] The ability-to-pay principle faces significant challenges if understood in the form that the same net income shall be treated equally.

5.1.5. Intermediate results

These remarks have shown that we need to be careful to initiate a "fair share" debate without a detailed understanding of what it means at an international level. We have outlined that we see strong arguments against the application of the ability-to-pay principle as a "fair share" rationale in international tax policy.

The Journal of Ethics 11-27 (2005); T.W. Pogge, *The Incoherence Between Rawls's Theories of Justice*, 72(5) Fordham Law Review 1740-1759 (2004)).

[30] *See* e.g. W. Gassner & M. Lang, *Das Leistungsfähigkeitsprinzip im Einkommens- und Körperschaftssteuerrecht*, Österreichischen Juristentages (MANZ Verlag Wien 2000), 121.

[31] *See* e.g. L. Kaplow, *The Theory of Taxation and Public Economics* (Prinction University Press 2008), 404. *See* for a very pursuasive argumentation in relation to the horizontal equity question *see* J. Repetti & D. Ring, Horizontal Equity Revisited, Florida Tax Review 2012, 135 et seq.

[32] For details see P. Hongler, *Das Leistungsfähigkeitsprinzip im Vielsteuersystem, in:* Zukunftsfragen des Steurrechts IV (W. Schön & J. Starck, eds.) 157 et seq.

We need to be careful to suggest allocation rule A because it is in line with the ability-to-pay principle as part of an international tax policy debate.

5.2. The source principle

5.2.1. Overview

Probably the source principle has been the most disputed one among academics in the past decades.[33] It is undeniable that the source principle was the key rationale not just behind Pillar 1 but behind the BEPS project in general. That taxation should happen where value is created (i.e., following source principle) is a key claim against aggressive tax planning, base erosion and profit shifting. But none of the BEPS documents or any later publications of the Inclusive Framework contain further explanations of why the source principle understood in the above manner is such a persuasive policy goal.

The question with respect to the application of the source principle as a policy principle to redefine international tax rules mainly boils down to whether the demand side or only the supply side contributes to the value creation of an enterprise.[34] This means whether the customers do contribute to the value of an enterprise or whether only the enterprises itself (i.e., the employees but also the assets of an enterprise). Concerning the taxation of the digital economy a further complexity relates to the fact that it is not quite clear what the supply side is.[35]

Looking at some of the business models it becomes obvious that the demand side is of great importance for value creation. The most obvious example is Tinder[36] – i.e., a dating platform without user content has zero value although the matching algorithm is very sophisticated. But also, more sophisticated platforms such as ChatGPT[37] rely on data provided by users to enhance their product. Therefore, if one agrees that taxation should be where value is created, it

[33] See already P.B. Musgrave, *Pure Global Externalities: International Efficiency and Equity*, in *Public Economics and the Environment in an Imperfect World* (S. Cnossen ed., Kluwer 1984), 241.

[34] See already P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, 2015(15) WU International Taxation Research Paper Series, 33 et seq.

[35] See with a detailed analysis I. Grinberg, *User Participation in Value Creation*, British Tax Review (2018).

[36] http://www.tinder.com.

[37] https://chat.openai.com/.

seems conclusive that the market state should receive a taxing right. We will in section 5.2.2, however, address whether the claim is indeed true.

In literature, several authors have already highlighted specific issues in relation to the application of the source principle. The main critic relates to the uncertainty linked to the application of the source principle as an allocation key. For instance, Schön argues that the value creation is a *"fuzzy notion"* and "*unhelpful when it comes to developing a coherent concept of the international taxation of the digital economy*"[38]. Another part of the debate in literature relates indeed to the mentioned demand vs. supply side dispute.[39] Dourado for instance argues that:

"Value creation is inappropriate as a principle for justifying the attribution of taxing rights to the market state, and such inadequacy goes beyond the binomial OECD countries' v. developing countries' interests. Value creation is inapplicable as a basis for attributing taxing rights to the market state from the moment the latter is thought to be different from the source state. In the context of the digital economy, value creation cannot go beyond determining the beneficial owner's automated digital business segment; functions, assets and risks (FAR); and development, enhancement, maintenance, protection and exploitation (DEMPE)."[40]

Others have opined that the supply side should be decisive, but this does not necessarily imply that there needs to be personnel in the market state.[41]

5.2.2. My own position

Before discussing the potential meaning of the source principle as a policy principle, it is important to understand the rationale behind the source principle. This means we need to answer the difficult question of why taxation should be in the state where value is created? The question is quite challenging to answer, and surprisingly enough, authors are very reluctant to address the question.[42] It is often taken as an axiomatic claim.

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[38] W. Schön, *Ten Questions About Why and How to Tax the Digital Economy*, 2017(11) Bull. Int. Taxn., 288.

[39] *See* e.g. S. Buriak, *A New Taxing Right for the Market Jurisdiction: Where Are the Limits?,* 48(3) Intertax 2020, 305.

[40] A.P. Dourado, *The OECD Report on Pillar One Blueprint and Article 12B in the UN Report*, 49(1) Intertax 2021, 4.

[41] V. Chand, *Allocation of Taxation Rights in the Digitalized Economy: Assessment of Potential Policy Solutions and Recommendations for a Simplified Residual Profit Split Method*, 47(12) Intertax 2019, 1027.

[42] As far as it can be observed there is no detailed discussion among international tax law scholars to why the source principle should per se have a normative value. It is regularly just accepted as a valid principle.

One potential justification is the principle of fiscal self-determination and the sovereignty principle.[43] Therefore, taxation should be where value is created because this is in line with state sovereignty and fiscal self-determination. The latter meaning that a state should be competent to tax what happens in its territory. Understanding it in such a way there seems indeed to be a normative base for the source principle as it seems persuasive to claim that states should be competent to subject something to their tax legislation if there is such territorial link as value creation.

A second argument which supports the normative validity of the source principle is its link to the benefit principle. The argument goes as follows: Value creation by an enterprise requires support from governmental bodies and as a consequence taxation is justified in the state where value is created.[44] This means e.g., in case of the digital economy, value creation requires that states operate and ensure a certain IT infrastructure and, therefore, these states shall have a taxing right as market states. Considering these two arguments one could conclude that there is indeed a normative claim to apply the source principle in international tax policy debates.[45]

However, probably the most important misunderstanding of the source principle is that it should somehow allow us to attribute income in a perfect manner. If this is the goal, the source principle indeed becomes a "*subjective arbitrary concept*".[46] If we understand the source principle as an allocation principle, it might lead to rather strange results as states should only be able to tax what they deserve through value creation. However, depending on how value creation is measured, this might lead to an unjust result. So, an allocation based on value creation could theoretically lead to a situation in which more productive countries can tax more income which seems to follow a libertarian logic (i.e., you should keep what you have created). But libertarianism is not a compelling justification for an allocation rule at an international level.

Therefore, the source principle cannot serve as an allocation rule since this might lead to unjust results. However, if we understand the source principle as a rough reference point for allocating taxing rights, it has indeed a normative value. This means for instance, that if there is obviously value creation in a

[43] For details *see* P. Hongler, *supra* n. 11 at 436 et seq.
[44] *See* also I. Benshalom*, The New Poor at Our Gates: Global Justice Implications for International Trade and Tax Law*, New York University Law Review (2010), 75 et seq.
[45] For a comprehensive analysis see P. Hongler, *supra* n. 11 at 436 et seq.
[46] S. Buriak, *supra* n. 39 at 304.

state, such state shall have a taxing right, but it shall not be understood that if in state A the value created is 20 and in state B 40 that state B should be allowed to tax twice as much income as state A.

If we indeed understand the source principle in such a more limited manner, it has also a negative component in the sense that there should be no taxation in a state if there is no value creation.

5.2.3. Intermediate conclusions

These remarks have shown that the source principle is omnipresent in the discussion on changing the international tax regime. The entire BEPS project was launched based on the idea that taxation should be in the state where value is created. As it was argued, we support the claim that the international tax regime should be in line with the source principle, however, understood only as a rough reference point and not as an allocation key. This means that justice does not require that the income of a taxpayer is sliced into perfect pieces following the source principle, but it means that if there is significant value creation in certain state, such state shall have a taxing right. This is an important difference. To determine whether there is value creation both the supply and the demand are relevant.

5.3. The benefit principle

5.3.1. Overview

The benefit principle is traditionally used for the determination of how high a levy shall be in a state, but it can also serve as a principle justifying taxation. There has been a lot of writings about the benefit principle both as principle to allocate income among several jurisdictions but also as a justification to tax principle.[47] The logic of the benefit principle was already used by Schanz in the late 19th century when he claimed that anyone having a relation to a society and receiving benefits from the public community should also contribute to the costs of such community.[48]

[47] See e.g. E. Escribano (2019), *Jurisdiction to tax corporate income pursuant to the presumptive benefit principle: a critical analysis of structural paradigms underlying corporate income taxation and proposals for reform,* Wolters Kluwer (2019).

[48] G. von Schanz, *Zur Frage der Steuerpflicht*, Finanzarchiv 1892, 372.

In very generic terms and for corporate income tax purposes, the benefit principle says that an enterprise should be subject to taxation if it receives benefits from a state. However, it is claimed that the benefit principle has its limits as a design principle as it does not consider the ability-to-pay a taxpayer has. I.e., a tax system relying only on the benefit principle would be unfair.[49] Already very early in the debate on the taxation of the digital economy, Pinto has outlined the main benefits received by the digital economy going beyond the digital infrastructure. These benefits include:[50] (i) legal system in general, (ii) enforcement of customer's payments, (iii) protection of IP rights, (iv) maintenance of digital environment, (v) supply of energy, (vi) waste recycling and (viii) infrastructure in general.

Less disputed compared to the source principle is the application of the benefit principle as it seems undisputed that the sale of digital services requires a certain digital infrastructure in a market state and such digital infrastructure is in general provided by the government. Therefore, it seems uncontroversial that if the benefit principle shall serve as an allocation principle, the market states should get a taxing right. In other words, if there is no digital infrastructure, a company selling digital services will not have any revenue in a state. Though, again there is no detailed debate about the question of why taxation should indeed be in the state in which an enterprise obtains benefits. It is in often just assumed that his is a normatively justified claim.

We will in the following try to provide a more detailed explanation of why it seems indeed justified that the state from which you obtain benefits shall have a taxing right.

5.3.2. Our own position

Before discussing the application of the benefit principle, we will again briefly elaborate on its potential justification, i.e., why should we apply it in international tax policy?

There are very persuasive reasons to claim that states shall have a right to coercively govern their territory and derived from that, states shall be able to tax

[49] *See* the decision of the Swiss Federal Supreme Court, BGE 133 I 206, 1 June 2007, cons. 7.1. We have already outlined above, however, that the ability-to-pay does not have a normative validity at an international level.

[50] *See* D. Pinto, *The Need to Reconceptualize the Permanent Establishment Threshold*, 60(7) Bull. Intl. Taxn. 266-279 at 268 et seq.

what happens in their territory (fiscal self-determination). If we take such starting point, the benefit principle seems to be justified if it is indeed aligned with such claim. Therefore, if we can prove that the benefit principle aims at taxing income that was created in a territory by using benefits from the government of such territory, it leads to just results. Such view has also been shared by many academics. For instance, Vogel writes: It *"cannot convincingly be denied that providing a market contributes to the sales income at least to some extent as providing the goods does. There is no valid objection, therefore, against a claim of the sale state to tax part of the sales income".*[51] This is again only demonstrating, that a country shall have a taxing right if an enterprise obtains benefits from a state. Therefore, it should only serve as a rough reference point. However, similar problems arise as with the source principle. Does the benefit principle also have a normative content as an allocation principle?

Valta, for instance, arguing in his seminal work in favor of an "*extended benefit principle*" understood as a principle requiring that the taxing rights are allocated in a horizontal manner based on the benefits obtains in the various states.[52] Thus, as it was argued with respect to the source principle, the benefit principle should neither serve as an allocation principle. The main reason is that it will lead to a counter-intuitive allocation. Allocation will be higher to richer states. The following example demonstrates it:[53]

A Haitian professional boxer earned USD 10,000 in 2012 as a salary, which he receives from the national boxing federation. He earns very little income from sponsors. In 2012, he attended the Olympic Games and stayed in London for 3 weeks. The tax rate in London is presumably 30%, but only 10% in Haiti. Let's assume that the received benefits in the year 2012 are equal between Haiti and the United Kingdom, as the security and building of the specific Olympic premises were very expensive and, therefore, even though he stayed only a few weeks in London, the UK benefits have the same value as the Haitian benefits for the rest of the year. This would mean, following the benefit principle as an allocation principle, that London could tax USD 5,000 at 30%, i.e. USD 1,500 and

[51] K. Vogel, *Worldwide v. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part III),* 16(11) Intertax 1988, 401. *See* also e.g. P. B. Musgrave, *Consumption Tax Proposals in an International Setting*, 12(2) Intl. VAT Monitor, 57 (2001). *See* for a recent contribution E. Escribano (2019), *Jurisdiction to tax corporate income pursuant to the presumptive benefit principle: a critical analysis of structural paradigms underlying corporate income taxation and proposals for reform,* Wolters Kluwer (2019).

[52] M. Valta, *supra* 23 at 74.

[53] The example was used in P. Hongler, *supra* n. 11 at 450.

Haiti could tax USD 5,000 at a rate of 10%, i.e. USD 500. This would be a strange outcome and clearly opposing cosmopolitan theories of justice.

It would also be very difficult to allocate income based on the benefit principle as a matter of practicality.[54] This has been argued and shown by various authors. Moreover, there is also no need to allocate income based on a certain all-encompassing principle. As was shown above concerning the ability-to-pay principle such line of argumentation is not persuasive.[55]

However, if one understands it only as a rough reference point, everyone will agree that there should be taxation in the market states even without physical presence. Therefore, the benefit principle should be used both as a limitation-to-tax and a justification-to-tax principle (i.e., as should the source principle). Again, we should not underestimate what this means. States should have the right to tax (i.e., coercively govern) their territory and this involves taxing income that was created by using the benefits in a certain state.[56]

5.3.3. Interaction with the source principle

These remarks have shown that both the source and the benefit principle have a normative value in the sense that the international tax regime should be designed in line with these principles as rough reference points. Far more unclear is the question of whether there are any relevant discrepancies between the two principles that will have an impact on how the international tax regime is shaped.

It is impossible to define an international tax policy that follows both the benefit principle and the source principle.[57] Let us take the example of passive income received by an individual and let us assume the person receives more than 90% of his income from passive income. However, he does not receive any direct benefits from the source state besides the benefits obtained for generating the income. In this case the source state could claim that the entire income was created in its jurisdiction, but the residence country could argue that the

[54] W. Schön, *supra* 20 at 93. *See* also N.H. Kaufman, *Fairness and the Taxation of International Income*, Law & Policy in International Business, 183 (1998). But *see* for deviating opinion on the feasibility of an allocation based on overall benefits obtained, M. Valta, *supra* 23 at 48 et seq.

[55] See above section 5.1.

[56] P. Hongler, *supra* n. 11 at 453.

[57] For details *see* P. Hongler, *supra* n. 11 at 455.

person mainly receives benefits in the resident state *(i.e., infrastructure, legal protection, security).*[58]

To achieve a stringent policy, we would recommend aligning the benefit principle with the source principle. This would mean that the market state should have a taxing right if both principles are fulfilled. This is effectively achieved if only benefits (for the benefit principle) are considered which are relevant for generating the income (understood for the source principle).[59] And, most of the issues triggered by the overlap of the two principles are solved if both principles are not understood as allocation principles but as mere justification-to and limitation-to-tax principle as argued in the present paper.

5.3.4. Intermediate conclusion

As it was outlined above, we support the view that the benefit principle shall serve both as a limitation- and justification-to-tax principle. So, it should serve as a rough reference point to determine whether there ought or ought not to be a taxing right. This means that in case an enterprise is receiving benefits in a certain state and generates revenues in such a state, such state shall have a taxing right and if this is not the case, the solution is unjust. Transferred to the current tax regime, it means that the allocation rules according to Art. 7 OECD MC and Art. 7 UN MC are considered to be unjust as they disable the source state to tax income unless there is a permanent establishment. As it was shown above, such permanent establishment does very often not exist in the digital economy. However, the benefit principle shall not serve as an allocation principle to allocate income between various jurisdictions. This would lead to highly unjust results, i.e., to results in which more income is allocated to countries from which more expensive supplies are obtained.

5.4. Neutrality and efficiency arguments

5.4.1. Overview

Probably the most disputed question is whether the international tax regime shall be as efficient as possible and whether there is an optimal international tax theory. The latter question has as far as it can been observed not yet been

[58] A very similar example was already used in P. Hongler, *supra* n. 11 at 449.
[59] However, P. Hongler, *supra* n. 11 at 454 et seq.

answered in economics.[60] In the following we will only discuss the former question.

In the last decades there has been an intense and very intriguing debate about whether the international tax regime ought to be as efficient as possible. Historically, the debate aimed at deciding about what kind of policy suggestions lead to more welfare at an international level. And welfare is in simplified terms understood as a higher global GDP. The debate revolved around the question of whether the international tax regime should be in line with capital export neutrality (CEN), capital import neutrality (CIN), and capital ownership neutrality (CON).

Also, in the recent debate about Pillar 1, these efficiency arguments are at the forefront of the debate.[61] Therefore, policy makers heavily rely on efficiency concerns to suggest one or the other proposal. As an example, it is argued that unilateral measures (such as DSTs) would be inefficient and they lead to trade tensions.[62] As part of an efficiency analysis, the ring-fencing argument was prominent before and during the Pillar 1 framework was designed. The argument goes as follows: We should not design a particular rule for the digital economy (i.e., regulatory ring-fence the digital economy). This is true as the digital economy is becoming the real economy and therefore basically the entire business has a digital component.[63] Ring-fencing could cause market distortions as companies will try to escape the scope of new rules for the digital economy. Implicitly, this also means that these measures would lead to less welfare. Some even argue that economic efficiency is *"relatively uncontroversial"* as an evaluative criterion.[64] As an example it is described as follows:

[60] On domestice optimal tax theory see e.g. J.A. Mirrless, *An Exploration in the Theory of Optimal Taxation*, The Review of Economic Studies, 175 et seq (1971).; P.A. Diamond Peter & J.A. Mirrless, *Optimal Taxation and Public Production I: Production Efficiency*, The American Economic Review (1971), 8 per seq; P.A. Diamond Peter & J.A. Mirrless, *Optimal Taxation and Public Production II: Tax Rules*, The American Economic Review, 261 per seq (1971). See for a more pluralist approaches E. Saez, *Using Elasticities to Derive Optimal Income Tax Rates*, Review of Economic Studies, 205 per seq (2001); or E. Saez & S. Stantcheva, Ge*neralized Social Marginal Welfare Weights for Optimal Tax Theory*, National Bureau of Economic Research (NBER) WP No. 18835, 1 et seq (2013).

[61] *See* e.g. M.P. Devereux, A.J. Auerbach, P. Oosterhuis, W. Schön & J. Vella, *Residual profit allocation by income*, WP 19/01; W. Schön, *One Answer to Why and How to Tax the Digitalized Economy*, Max Planck Institute for Tax Law and Public Finance WP 2019 – 10, 7 per seq.

[62] *See* e.g. Question 9, OECD, *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, Frequently asked questions, July 2022.

[63] S.V. Kostic, *A Plea for a Workforce Presence PE Concept in a Post-Covid Digitalized World*, 49(10) Intertax 2021, 762.

[64] R. Collier, M.P. Devereux & J. Vella, Comparing Proposals to Tax Some Profit in the Market Country, World Tax Journal 2021, 415. And Devereux et al. (2021), *supra* n. 5 at 55-57 and 123-127.

"Economic efficiency refers to the costs that may be imposed on society by taxation that affects the behaviour of economic agents. If, for example, a more costly approach is taken to implement a business plan because of its tax advantages, the higher costs incurred represent a cost to society as a whole, which will be reflected in higher prices or lower income, or both. Inefficiencies can result from distortions to, for example, the choice of the locations of functions and activities, the scale of investment and competition between firms within specific markets. The costs of administration, including costs borne by both tax authorities and taxpayers, are also a clear cost to society. Robustness against avoidance is included as a separate criterion, although it overlaps considerably with other criteria"[65]

Therefore, one aspect of efficiency is of course that investment decisions, but more general business decisions should not be affected by taxation. If a system is less distortive it means costs "imposed on society"[66] are lower. We will assess in the following whether the principle of efficiency has indeed a normative value.

5.4.2. Our own position

The claim for a more efficient international tax regime has not remained undisputed. The last years have seen a shift from heavily relying on efficiency and neutrality arguments towards a more nuanced reference to a broader variety of normative theory. This is also since international tax law has become a multidisciplinary area. Moreover, already the Musgraves did not follow a consequent efficiency position.[67] Therefore, international tax law has also moved from a field cultivated by lawyers and economist to an area in which political scientists but also philosophers take influential positions. In the following, considering such debate, we will outline whether the efficiency argument has indeed a normative value.

To describe our approach towards the question whether the international tax regime should be as efficient as possible, we need to first deal with the underlying justifications for an efficiency claim. This is a fascinating but underdeveloped topic.

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[65] Collier et al, *supra* 64 at 415.
[66] Collier et al, *supra* 64 at 415.
[67] R. A. Musgrave & P. B. Musgrave*., Inter-nation equity*, in: Modern Fiscal Issues: essays in Honor of Carl S. Shoup (Bird Richard M. & Head John G. [eds.], University of Toronto Press 1972) p. 68 et seq.

First, some argue that other approaches such as referring to the ability-to-pay principle or the benefit principle are not helpful and, therefore, the international tax regime shall be as efficient as possible.[68] Therefore, to aim at an efficient international tax regime is kind of a second-best solution. However, such an approach is not persuasive as we do not see why the mere fact that there are no other (better) policy principles should lead to the application of a non-persuasive principle.

A second and broadly spread argument and this was already mentioned is that efficiency in the international tax regime increases worldwide welfare. Such a claim is obviously driven by economic considerations. Although, it is unclear whether the claim is valid at an international level or whether it would only be a valid claim in a domestic environment. We are again facing the same question as above with respect to the ability-to-pay principle, i.e., whether there is a basic structure at an international level and if not, should we still apply efficiency as a normative goal. Although I run the risk of repeating myself, it cannot be emphasized enough that this is a key to understand that international tax policy should not follow the same rationales as domestic tax policy. The academic task should, therefore, be the following: We should aim at evaluating whether (i) a principle is indeed only applicable in a specific society (basic structure) and (ii) if this is true, we should evaluate whether there is an international society (i.e. basic structure) going beyond national borders. For the efficiency principle this means the following:

As we have seen above, there is no international basic structure requiring the same principles of justice or policy principles in general to apply at an international level.[69] Having this in mind it might also have an impact on whether we apply efficiency arguments in cross-border situations. We would deny such a claim, i.e., we would argue that the international tax regime (compared to a domestic tax regime) ought not to be as efficient as possible.[70] This needs to be explained. The reason why people are in favor of an efficient domestic tax system is because they are either utilitarian (i.e., growing the pie is per se good)[71] or they would at the same time suggest that the larger pie can be distributed (e.g., following a Rawlsian difference principle). However, both lines of argumentation are not persuasive at an international level:

[68] W. Schön, *supra* 20 at 78.
[69] *See Section 5.1.3.*
[70] For details P. Hongler, *supra* 11 at 421 et seq.
[71] Utilitarianism would claim that the more efficient a tax system is, the less distorted business decisions will be and, therefore, the large the economy will grow and the larger the pie will be to share.

First, utilitarianism is a very weak theory to design the international legal sphere. For instance, as it was shown by Rawls, there is indeed some potential to apply utilitarianism as a theory of justice in a domestic setting and the main goal of his theory of justice (which is a "domestic" theory) was even to challenge utilitarianisms in a domestic setting.[72] However, he did not even deal in detail with utilitarianism as theory to achieve a just international sphere in details in his book on the Law of Peoples.[73] This indicates that there are no strong arguments to support utilitarianism as theory to design the international sphere. The justification that might exist for utilitarianism as a goal at a domestic level does not hold at an international level.

Second, one could argue that reducing the costs through an efficient international tax regime is good because we will have a larger pie, i.e., we will have more to share. For instance, the most obvious example would be to ask for a full abolishment of source taxation on passive income (i.e., exclusive taxation in the residence state). This would lead to more efficiency but of course traditional source states (i.e., capital importing countries) would lose out again traditional resident states. But because we have no means to share the pie at an international level (i.e., we have not equalization system such as a fiscal transfer system), we should be very careful to use such efficiency arguments and these arguments are not in the same form persuasive as they are in a domestic setting.

The same problem arises concerning arguments against double taxation. Of course, it is less distortive if we do not penalize cross-border investment through double taxation (i.e., double taxation should be mitigated) but if the taxing right is only with one state (e.g., the resident state), the task of mitigating double taxation has actually led to zero taxation in one of the states which might overall be welfare increasing but welfare decreasing in one of the two states. The situation is different for instance, in the internal market in the EU or also in Federal States such as the US or Switzerland. In these basic structures there are ways to share the pie – be it for instance through an equalization system or through support payments of poorer regions. Such a system does not exist at an international level. As a consequence, it would be perfectly fine to argue that the introduction of tax proposal A in the United States should be as efficient as possible but not the introduction of tax proposal A at a global level.

[72] *See* e.g. J. Rawls, *supra n. 27*, 20.
[73] J. Rawls, *The Law of Peoples with "The Idea of Public Reason Revisited"* (Harvard University Press 1999)

This is not at all a contradiction but due to the different underlying basic structure.

A third justification refers to the equality principle.[74] But this claim is far less prominent than the welfare justification for an efficient international tax system. For instance, De Wilde argues in the following manner:

"As with equity, I believe that tax neutrality is founded on equality as well. This means that, again, the ability to pay principle and the benefit principle result from that. Each business activity should be taxed in the same manner. As I see it, unequal corporate tax treatment in equal circumstances – inequality – distorts business decisions and, with that, the allocation of production factors."[75]

However, as we have seen above the equality principle does not have a normative validity as an international policy goal.[76] An efficient international tax system can also not be justified by referring to such goal.

5.4.3. Intermediate conclusions

These remarks have shown that the efficiency principle has a weak normative content as a guiding principle for the design of the international tax regime including the design of a new taxing right for the market states in the digital economy. This is in particular true if it disables the application of the benefit and the source principle as rough reference points. Therefore, a distortive solution in line with the benefit and the source principle might lead to a fairer system than a non-distortive solution disallowing the market states to tax parts of the income. We are not arguing that efficiency concerns should be irrelevant at all[77], however, they should not be as relevant as they are in domestic tax policy, and they should definitely not be valued higher than the source and the benefit principle understood as rough reference points.

[74] M.F. De Wilde, Some *Thoughts on a Fair Allocation of Corporate Tax in a Globalizing Economy, Intertax (2010)* 288 et seq.
[75] De Wilde, supra n. 76, p. 288.
[76] The main line of argument was outlined with reference to the ability to pay principle (see section 5.1.3).
[77] And we are definitely not against free trade.

5.5. What needs to be done?

These remarks might have been rather abstract, but we firmly believe that the value of such principle-based analysis cannot be overstated. We are step-by-step moving to a global tax system, however, without having a proper institutional set-up insight which would ensure that the outcome is just, we need to focus on a principle-based solution. Therefore, while focusing on the right policy proposals (i.e., considering normatively valid principles), the rules to be developed will be much more legitimate. To be more concrete this means:

- The source and the benefit principle are valid from a normative perspective as both limitation-to but also justification-to-tax principles. Therefore, they should serve as rough reference points in the sense that if the international tax regime disables states to tax income that was created within a territory by using governmental benefits, such regime is considered to be unjust.

- However, both the source and benefit principle should not serve as principle to allocate income in a globalized economy in perfect pieces. We have shown that an allocation based on these principles can lead to counterintuitive results.

- The ability-to-pay principle is not a persuasive normative goal to refer to. We should be very careful to launch a debate about the fair share of the tax burden without having a detailed discussion about which basic structures we are talking about and who belongs to such basic structure.

- We should stop focusing on efficiencies as the claim for efficiency does not have a normative content as a policy goal at an international level. This is a key difference between domestic and international policy decisions. As academics we should also be open to develop new frameworks for an optimal international tax regime.

6. Blueprints for a New PE threshold

6.1. The three policy questions

These remarks have shown that it is very challenging to develop a clear understanding of how the international tax regime shall be designed. Nevertheless,

we will in the following outline some ideas on how the digital economy could be assessed by using a new permanent establishment threshold. The goal is to review whether our own 2015 proposal, i.e., the Blueprints for a new PE proposal, needs to be amended or not.[78] As it is well-known, taxing parts of the corporate income in the market requires several issues are tackled ("the policy questions").

1. Define a new nexus deviating from Art. 5 OECD MC and Art. 5 UN MC. I.e., what is the threshold to trigger taxation in the market state. ("The nexus question")

2. Define a new allocation key to allocate income to such new nexus. I.e., deviating from the transfer pricing practice outlined in the transfer pricing guidelines published by the OECD. ("The allocation question")

3. Define the scope of the new provision. I.e., outline which enterprises or at least which services shall fall under such new provision. ("The scope question")

Policy makers need to solve these questions if they intend to introduce a new rule into the OECD MC or the UN MC and in case, they do not want to develop a more fundamental tax reform such as the introduction of a formulary system. The broader options beyond a new permanent establishment definition are, however, manifold and several authors have already discussed the advantages and disadvantages of the following options:[79]

- Withholding taxes on gross-payments

- A destination-based corporate income system

- Formulary apportionment

- DSTs

[78] P. Hongler & P. Pistone, supra 1 at 1 et seq.
[79] *See* for a comprehensive analysis of various options Devereux et al, *supra* 66.

The present article cannot elaborate on the advantages and disadvantages of all these broader options. We will limit ourselves to solving the above mentioned three questions of nexus, allocation, and scope in case there is a political agreement to change the permanent establishment definition.

Looking back at the blueprints published in 2015 one theoretical weakness was that the principles used for income allocation (i.e., mainly the benefit and the source principle) were too much in the focus for defining the nexus threshold as well. The nexus definition should be as simple as possible to apply, since complexity is already triggered by the fact that we need to define what kind of services fall under the new provision and by the question of how to attribute profits.[80] So, we should not add more (and unnecessary) complexity by defining a complicated nexus. Therefore, looking back at the blueprints in which the amount of users was a key part of the nexus definition, the definition of a new nexus is the far less important part of a new tax policy proposal compared to the definition of the allocation key and the requirement to be within the scope of the new allocation rule.

6.2. The nexus question

So how can nexus be defined to achieve a just and fair solution?

If you are faced with such a policy question in a domestic setting you would as mentioned find some guidance in its legal and constitutional framework. However, at an international level such framework does not exist.[81] Therefore, you are faced with the problem of not having legal guidance to solve the policy problem but the only way of having a substantiate approach would be to rely on policy principles. However, these policy or design principles require thinking without a banister[82] which is a challenging task.

Moreover, if we consider again the nexus question and the allocation question together it is not necessary that all the principles that have normative validity

[80] See for a broad discussion on how to define a nexus and what are the current approaches: J. Hatting & P. Hongler, Finding the meaning of nexus for taxes – past, present and future, General Report, in: cahier de droit fiscal international, IFA Congress 2024, Cape Town, 15 et seq.

[81] Of course, this is an interesting academic question of whether there is such an international constutitional framework.

[82] H. Arendt, *Denken ohne Geländer*, Texte und Briefe (H. Bohnet & K. Stadler eds, Piper), (2006).

have the same value. For instance, and here I might as already mentioned depart from the first version of the blueprints published in 2015, if the allocation key leads to an allocation in line with the source and the benefit principle as understood above,[83] the nexus does not need to be defined by focusing on the source and the benefit principle but maybe by focusing on the certainty and simplicity. And this is exactly what I would propose here. I.e., the nexus could be defined by referring to certain revenue within a jurisdiction (e.g., USD 200'000). This is a simple approach and at least at first glance leading to legal certainty. It is not necessary that the nexus is defined in line with the source and benefit principle as justification-to-tax principles but is sufficient if these principles are addressed through the allocation question. This brings us to the question of how we should allocate income to such nexus.

6.3. The allocation questions

6.3.1. In general

During the discussions on Action 1 within the BEPS project and on Pillar 1, policy makers were not only faced with the question of how a nexus could be designed but also how much income should be attributed to such nexus. It is well-known that if the nexus is defined in a form which does not require that specific supply functions are in the market state, there would be situations in which there is no allocation although the source and the benefit principle would require so. The current transfer pricing rules based on functions, assets and risks will not work. This was essentially the most disputed issue. However, the final solution in Pillar 1 was a mix between sticking to existing transfer pricing rules for Amount B by at the same time following new concepts under Amount A. We will in the following discuss whether the allocation should consider distributive duties before outlining potential solutions.

6.3.2. Distributive duty

The question to be discussed in the present chapter is whether the international tax regime shall be designed in a form that would allocate more income to poorer countries, i.e., it would have a distributive impact.[84] We have argued

[83] See section 5.2.2 and 5.3.2.

[84] See on this topic e.g. P. Mahu Martínez, *Distributive Profit Allocation Rules: A New Approach for an Old Problem*, 49(2) Intertax 2021.

in detail in a different publication that internationally there is at least a humanitarian duty which would require that we help people in the most inhuman circumstance, however, there is no obligation to per se lower inequalities. This is different to a cosmopolitan understanding of global distributive duties.[85]

But as the poorest people live in countries which are to a large extent excluded from global trade, it is, therefore, very difficult to define an allocation key that would (only) follow humanitarian duties by not at the same enhancing a relative distribution. It would therefore not make sense to draft an omnipotent allocation key in the interest of these countries that only affects a very small part of all crossborder trade in goods and services. Therefore, it is our understanding, that distributive concerns shall not be the major rationale of a potential allocation key.[86] But of course we need international policy projects to enhance the living standards of the poorest in the world.[87]

6.3.3. Potential solution

Following the above logic, the goal of the allocation key is to reflect both the benefit and the source principle as justification-to-tax and limitation-to-tax principles. However, only as rough reference points. This makes it easier as we do not need to perfectly slice the pie into ideal pieces following value creation or benefits obtained.

Therefore, a persuasive option would be to focus on what Schön calls *"digital investments"*.[88] The allocation key should reflect how committed an enterprise is in the market states through digital investments. As we have seen, however, both the source and the benefit principle will not help to find a clear allocation key and it is also impossible to assess the exact digital investment.

Thus, if we understand the benefit and the source principles as rough reference points it becomes clearer that a certain lump-sum allocation is the most feasible option. For instance, 20%, 30% or 33% of the corporate income of an enterprise like Amount A within the Pillar 1 project should be split among all market

[85] P. Hongler, *supra* 12 at 346 et seq.
[86] For more details see P. Hongler, *supra* 12 at 463 et seq.
[87] See eg www.tax4sdgs.com. We cannot explore in the present article the particular need fo developing states (see eg A. W. Oguttu, Preventing International Tax Competition and the Race to the Bottom: A Critique of the OECD Pillar Two Model Rules for Taxing the Digital Economy – A Developing Country Perspective, Bulletin for International Taxation (2022) 547 et seq.
[88] W. Schön, supra 38 at 19 et seq.

states.[89] Again this would mean an up-front allocation to the market states as was already proposed in 2015.[90] We are, however, unable to solve all technical details of such an allocation key within the present contribution.

6.4. The scope question

Finally, we need to define which companies fall under the new permanent establishment threshold. Again, a link to the above-mentioned principle-based approach is key. This means that enterprises should be covered by the new nexus for which the current international tax regime does not guarantee that the market states have a taxing right following the benefit and the source principle.

This is true for pure and automated digital services. There are already several potential definitions of these pure and automated digital services be it for the purpose of defining covered services of the digital services tax (DST) or automated digitals services under Pillar 1. These can serve as inspiration.

We do, however, not see persuasive reasons that only highly profitable companies are covered by the new rules as intended by Pillar 1. We need to be careful that we are not misusing international tax policy decisions to challenge monopolies. This is the task of antitrust law. Therefore, the scope of the new provision shall not be limited to large and profitable MNEs only. The outlined nexus will already lead to a situation in which not all companies are covered by the new rules and, therefore, will exclude SMEs in many situations.

7. Conclusion

If we indeed aim at a just international tax regime, I firmly believe that we need to follow a principle-based approach as the institutional procedural setting is still weak. The negotiations on the UN Framework Convention are promising but we are still far away from a new governance structure that is considered to be inclusive and transparent.

[89] See also the anectodal evidance from the experiment above .
[90] P. Hongler & P. Pistone, *supra* 1 at 37 et seq.

We have demonstrated that very few principles are sufficient to improve fairness within the international tax regime.

As it was outlined in detail, an international tax regime to be considered just and fair should ensure that both the benefit and source principle are applied both as justification- and limitation-to-tax principles. But these principles should only be understood as rough reference points, and they should not serve as tools to achieve a perfect allocation of income. Therefore, we should ensure that the situations in which there is significant value creation in the market states and such value creation is partly caused by benefits obtained from the market state (e.g., through IT infrastructure), the market states shall have a taxing right although there might be no physical presence.

It is not detrimental (from a normative perspective) if such new solution has distortive impacts and if it is not in line with the ability-to-pay principle. These principles do not have a normative validity according to our understanding.[91] Based on such considerations we have argued that we are still supporting a new permanent establishment definition to tax digital services in the market states. Such approach should be based on a (i) very simple nexus definition (i.e., significant economic presence), (ii) an allocation key following a lump-sum allocation of a certain percentage of income to the market states and (iii) a scope definition covering a well-defined catalogue of digital services. Therefore, the major deviation from the original blueprints published in 2015 is that the nexus definition should be as simple as possible and not necessarily be in line with the source and the benefit principle. The latter is ensured by the allocation key and the scope definition.

We indeed need to consider how the future will look like. However, we should also aim at achieving small steps now towards more fairness in the international tax regime. Reducing situations in which there is no taxation at all in an country although both the benefit and the source principle would require so, should be a or the central goal of the current international tax policy.

[91] Although we should not fully ignore efficiency concerns but we need to develop a clearer understanding of what kind of inefficiencies indeed lead to unjust solutions.