Critical analysis of the effects of e-commerce on taxation

A research report submitted by:

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"When we are no longer able to change a situation, we are challenged to change ourselves"

Victor Frankl

To my wonderful family, Steven, Joshua and Ashira, thank you for your continued support and encouragement

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ABSTRACT

E-commerce has become a significant part of the global economy and will continue to grow. However, e-commerce doesn't only provide exceptional growth opportunities, but also creates considerable challenges in terms of taxation. Due to the nature of e-commerce, various commercial activities are carried out in cyberspace where trade is not confined by geographical boundaries. This study is motivated by the key importance of understanding the taxation landscape in a rapidly growing digital economy.

In this study the impact of e-commerce on taxation is explored by means of a systematic literature review. The primary research question was: what is the impact of e-commerce on taxation? In order to address the research question, secondary questions were formulated to firstly attend to the broader tax challenges in a digital economy and to determine how these challenges lead to tax avoidance practices. Secondly, the impact of e-commerce on taxation was explored specifically in terms of the artificial avoidance of the permanent residence status. Thirdly, the prevention of artificial avoidance of the permanent residence status was reviewed as well as investigating what practices have been put in place by some countries to protect their tax bases.

Based on the research question, the objective of this study was to explore and provide an overview of the existing literature to determine what the impact of e-commerce has been in terms of the challenges it poses to taxation. Due to the exploratory nature of the research, it was a qualitative study within the interpretivist paradigm. In this study, the aim was not to identify a specific theory, but rather to explore the existing literature and provide an overview of how e-commerce affects taxation within the framework of the primary and secondary research questions by means of systematic literature review.

In terms of the findings, the broader tax challenges were identified as: nexus, data and value-creation, the characterisation of payments and the impact of highly digitised business models. It was further established that these challenges created an environment where significant tax avoidance practices are employed by highly digitised organisations. The key tax avoidance practices were identified as: avoiding withholding tax, the use of preferential tax regimes, artificial internal trading of intangibles, internal debt shifting, transfer pricing and avoiding taxable presence.

This study has certain limitations, since the full domain of e-commerce and taxation is vast and complex and beyond the scope of a research report. Therefore, the key challenge that was explored is the artificial avoidance of the permanent residence status which is an issue that lies at the heart of the nexus issue since a PE normally requires some sort of physical presence which is not necessarily the case in the digital economy.

This study contributes to the existing body of knowledge as a useful assessment of the impact of e-commerce on the digital economy as well as the associated tax avoidance practices. Furthermore, in conducting the research, it became apparent to the researcher that South Africa has very limited exposure in the field of the tax challenges relating to e-commerce. This research could therefore provide some insight into some of the key tax challenges identified in the international arena and this study could provide a starting point from a South African perspective.

KEYWORDS: E-commerce, cyberspace, artificial avoidance, permanent establishment, broader tax challenges, highly digitalised business models, tax avoidance practices, nexus, physical presence

DECLARATION

I hereby declare that this research report submitted by me in partial fulfilment of the requirements for the degree of Master of Commerce in the Faculty of Commerce, Law and Management at the University of the Witwatersrand, Johannesburg, is my independent work and has not been submitted by me for a degree at another university.

Debrah Ann Hirschowitz
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ABBREVIATIONS

AICPA	**Association of International Certified Professional Accountants**
ATO	Australian Tax Authority
BEAT	Base Erosion and Anti-abuse Tax
BEPS	Base Erosion and Profit Shifting
DPT	Diverted Profit Tax
DST	Digital Services Tax
DZIT	Department of Zakat and Income Tax
EC	European Commission
ECIPE	European Centre for International Political Economy
ICT	Information and Communication Technology
IF	Inclusive Framework
IMF	International Monetary Fund
IP	Intellectual Property
ITA	Israeli Tax Authority
IT	Information Technology
MAAL	Multinational Anti-Avoidance Law
MNE	Multinational Enterprise
OECD	Organisation for Economic Cooperation and Development
OECD MTC	Organisation for Economic Cooperation and Development Model Tax Convention
PE	Permanent Establishment
POEM	Place of Effective Management
SEP	Significant Economic Presence
TCJA	Tax Cuts and Job Act
TFDE	Task Force on the Digital Economy
UN	United Nations
UNCTAD	United Nations Trade Conference on Trade and Development
UN DTC	United Nations Double Tax Convention
VAN	Value Added Network
WWW	World Wide Web

CHAPTER 1: INTRODUCTION

1.1 Background

E-commerce is fast becoming an essential part of our everyday lives allowing businesses to sell goods and services globally and providing customers to access these goods and services with ease (Yapar, Bayrakdar & Yapar 2015 p. 642). E-commerce allows for a speedier method of buying and selling, availability of shopping 24/7, relative ease with which to locate products, access to global markets, buying without physical movements as well as trading without a physical presence (Niranjanamurthy, Kavyashree, Jagannath & Chahar 2013, p. 2362).

> During this relatively short time, e-commerce has itself been transformed from its origin as a mechanism for online retail sales into something much broader. Today, e-commerce has become the platform for media and new, unique services and capabilities that aren't found in the physical world. There is no physical world counterpart to Facebook, Twitter, Google search, or a host of other recent online innovations from Pinterest and iTunes to Tumblr. The Internet is about to replace television as the largest entertainment platform. Welcome to the new e-commerce! (Laudon & Traver 2016, p. 7).

In the online environment, products and services are uploaded/downloaded and used in the "absence of any product or person physically crossing international borders" (Association of International Certified Professional Accountants 2018, p. 2) which is a key characteristic of e-commerce taking place in cyberspace – a nonphysical environment without boundaries. This creates complex tax challenges as significant profits may be generated from a source within a country in the absence of a physical presence in that country (Association of International Certified Professional Accountants, 2018) and is related to the concept of nexus. This will be discussed in further detail in Chapter 2, but suffice to state for now that nexus, in the context of taxation, refers to the connection between a country and an item of income. The main connecting factors entitling a country to tax income is the connection of that country and the income (source) or the connection of that country to the person who receives the income or to whom the income accrues (residence). Companies traditionally have a physical presence or nexus in a jurisdiction where they are subject to taxation, but in a digital economy, e-commerce permits access to final consumers without necessarily having such a presence (De Wilde 2015, p. 1).

The focus of this study is to explore the existing literature to determine what the impact of e-commerce has been in terms of the challenges it poses to taxation. Since the domain of e-commerce and taxation is vast and complex and beyond the scope of a research report, the key challenge that will be explored is the artificial avoidance of the permanent residence status since this issue lies at the heart of the above-mentioned nexus issue because a permanent establishment (PE) normally requires some sort of physical presence which is not necessarily the case in the digital economy.

In order to contextualise this study, e-commerce is firstly defined (Section 1.2). To further clarify the nature of e-commerce, a comparison is drawn to highlight the key differences between e-commerce organisations and brick-and-mortar organisations (Section 1.2.1). Attention is also given to related concepts, namely, digital enterprises (Section 1.2.2), cyberspace (Section 1.2.3) and the digital economy (Section 1.2.4). This is followed by a discussion of the growth of e-commerce (Section 1.3) which provides the basis of the problem statement which is summarised in Section 1.4. Based on the problem statement, the research objective (Section 1.5) and the primary research question (Section 1.6) were formulated. In order to find answers to the research questions, a systematic literature review was undertaken which is discussed in Section 1.7 which deals with the research methodology. The chapter concludes with stating the significance of the study (Section 1.8) as well as the limitations and delimitations (Section 1.9). In Section 1.10 an overview of the structure of this report is provided followed by a brief summary of Chapter 1 (Section 1.11).

1.2 Defining e-commerce and related concepts

There are various definitions of e-commerce. Electronic commerce, or e-commerce, simply refers to economic activity that occurs online and is rapidly changing the way of doing business in the 21th century (Niranjanamurthy et al. 2013, p. 2360-2361). According to InvestorWords (2018), the definition of e-commerce is “the buying and selling of products and services by businesses and consumers through an electronic medium, without using any paper documents”. In general, e-commerce refers to buying and selling of products over the Internet, but in the broadest sense it indicates transactions that are completed by only making use of electronic measures (InvestorWords, 2018). Another definition of e-commerce refers to “using the Internet and other networks (such as intranets) to purchase, sell, transport, or trade data, goods and services” (Turban, Outland, King, Lee, Liang & Turban 2018, p. 7).

A further definition by the Organisation for Economic Cooperation and Development (2011, p. 72) is that e-commerce refers to:

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

The United Nations Trade Conference on Trade and Development also accepts this definition (UNCTAD 2015, p. 3). According to the World Trade Organisation’s (World Trade Organisation) website, e-commerce is defined as the "production, distribution, marketing, sale or delivery of goods and services by electronic means".

E-commerce refers to a variety of businesses, but can be subdivided into three categories: business-to-business (Cisco), business-to-consumer (Amazon), and consumer-to-consumer (eBay) (OECD 2015a, pp. 55-56). Business-to-business refers to transactions between and among organisations. According to Turban et al. (2015, p. 10) approximately 85% of e-commerce volume is generated through business-to-business transactions. Business-to-consumer refers to retail transactions of products or services from a business to an individual consumer. This type of e-commerce is also referred to as “e-tailing” (Turban et al. 2015, p. 10-11) which indicates electronic retailing. Consumer-to-consumer refers to instances where a consumer sells to, or buys from another consumer (Turban et al. 2015, p. 11).

1.2.1 E-commerce organisations and brick-and-mortar organisations

Organisations that are purely physical are referred to as brick-and-mortar (or old economy) organisations, whereas companies that are engaged in e-commerce are considered virtual (pure-play) organisations (or digital economy organisations). Click-and-mortar organisations "are those that conduct some e-commerce activities, usually as an additional marketing channel" (Turban et al. 2015, p. 7-8). Table 1 (Turban et al. 2015, p. 23) below indicates the core differences between digital organisations and brick-and-mortar organisations.

Table 1

Digital organisations compared to brick-and-mortar organisations

Comparison between brick-and-mortar enterprises and digital enterprises	
Brick-and-mortar enterprises	**Digital enterprises**
Selling in physical stores	Selling online
Selling tangible goods	Selling tangible and digital goods
Internal inventory	Online collaborative inventory and production planning
Paper catalogues	Smart electronic catalogues
Physical marketplace	Electronic marketplace
Use of telephone/fax	Use of computers, smartphones, the Internet
Physical auctions, infrequently	Online auctions, everywhere, anytime
Broker-based services, transactions	Electronic infomediaries, value-added services
Paper-based billing and payments	Electronic billing and payments
Paper-based tendering	Electronic tendering
Push production, starting with demand forecasting	Pull production, starting with an order
Mass production	Mass customisation, built to order
Physical based commission and marketing	Affiliated, virtual marketing
Word-of-mouth, slow and limited advertisements	Explosive viral marketing, in particular social networks
Linear supply chains	Hub-based supply chains
Large amount of capital needed for mass production	Less capital needed for built to order, payments can be collected before or after production starts
Large fixed cost required for plant operation	Small fixed cost required for smaller and less complex plant operation
Customers' value proposition is frequently a mismatch (cost>value)	Perfect match of customers' value proposition (cost<value)

Looking at the above comparison between digital organisations and brick-and-mortar organisations, it is clear that e-commerce brought fundamental changes to almost every aspect of conducting business. According to OECD (2015a, p. 53-54), many sectors of the economy have adopted information and communication technology (ICT) "to enhance productivity, enlarge market research, and reduce operational costs". A few of the examples the OECD (2015a, p. 53-54) mentions, are:

- Retail: the digital economy has enabled retailers to allow customers to place online orders and has made it easier for the retailers to gather and analyse data on customers, to provide personalised service and advertising, as well as manage logistics and increase productivity.
- Transport and logistics: This sector has been transformed by the digital economy, which enables the tracking of both vehicles and cargo across continents, the provision of information to customers and facilities, and the development of new operational processes such as "Just-In-Time" delivery in the manufacturing sector.
- Financial services: Bank, insurance providers and other companies, including non-traditional payment service providers, increasingly enable customers to manage finances, conduct transactions and access new products online. The digital economy has also made it easier to track indices and manage investment portfolios and has enable specialist businesses such as high frequency trading.

Given the far-reaching impact that the development of e-commerce has had on all aspects of conducting business, it can be expected that there will be a significant impact on the regulatory environment in which these organisations operate, including the domain of taxation. In order to truly understand the nature of e-commerce, it is necessary to explore the nature of digital enterprises (Section 1.2.2) in more depth as well as providing an overview of the nature of the environment in which e-commerce is conducted, namely, cyberspace (Section 1.2.3). As digital enterprises operating in cyberspace are key aspects of a digital economy, the concept of a digital economy will be discussed in Section 1.2.4.

1.2.2 Digital enterprises

One of the major impacts of e-commerce is the creation of the digital enterprise. The digital enterprise has several definitions. According to (Turban et al. 2015, p. 22) it is a fairly new business model "that uses IT[1] to gain competitive advance by increasing employee productivity, improving efficiency and effectiveness of business processes, and providing better interactivity between vendors and customers" and examples of these enterprises are Amazon.com, Google, Facebook, or Ticketmaster, whose business processes are largely automated through the use of computers and information systems. According to Medus (2017, p. 38), digital enterprises are based mainly on:

- Intangible assets rather than fixed assets
- Goods and services marketed through websites rather than traditional commercial workforces with a local and physical presence, with goods often stored and maintained close to final customers in specific countries and no substantial physical presence in the end users' countries.
- Distribution networks operated through independent distributors or agents receiving commissions and selling goods/services in their own names and on behalf of a third enterprise instead of classic standard integrated distribution networks.

In Section 1.4, attention is given to the impact of these characteristics on taxation.

1.2.3 Cyberspace

Cyberspace can be defined as "the nonphysical environment where e-commerce is conducted by using computers and networks" (Turban et al. 2018, p. 8). According to Turban et al. (2018, p. 8), the key mechanisms used in cyberspace are "the Web, electronic market places, social networks and communication tools".

1.2.4 The digital economy

According to Li (2014, p. 4-5), there is as yet no authoritative definition of a digital economy. Turban et al. (2018, p. 20; 2015, p. 21), describe the digital economy, or 'Internet economy', as "an economy based on online transactions,

[1] Information Technology

mostly e-commerce. It includes digital wireline or wireless communication networks, (e.g., the Internet, intranets, extranets and VAN[2]s), computers, software, and other related information technologies". The Australian government defined the digital economy as "the global network of economic and social activities that are enabled by information and communications technologies, such as the internet, mobile and sensor networks" (Australian Government 2009, p. 2).

Interestingly, the OECD Discussion Draft[3] (OECD 2014b) does not define 'digital economy' but according to Li (2014 p. 4-5) it seems like they accept the definition of the Australian government. The International Monetary Fund (IMF) (International Monetary Fund, 2018, p. 7) describes the digital economy in much broader terms, and states: "the 'digital economy' is sometimes defined narrowly as online platforms, and activities that owe their existence to such platforms, yet, in a broad sense, all activities that use digitized data are part of the digital economy: in modern economies, the entire economy".

As such, the growth of the digital economy is not simply due to platforms and activities, but it is also the very nature of e-commerce organisations that drives the digital economy. The various drivers of the digital economy are summarised in Table 2 (Money matters nd; Niranjanamurthy et al. 2013, p. 2363-2365, Australian Treasury 2018, p. 3).

[2] Value Added Network

[3] The OECD published a discussion draft on 24 March 2014 regarding the BEPS Action 1 ("Discussion Draft"). The Discussion Draft was prepared by the Task Force on the Digital Economy, a subsidiary body of the Committee on Fiscal Affairs (CFA). The Task Force issued a public request for input on 22 November 2013. The Draft reflects the input received and thinking of the Task Force on the evolution and pervasiveness of the digital economy, as well as the key features and tax challenges raised by the digital economy (OECD, 2014b, p. 7).

Table 2

Drivers of the digital economy

Drivers of the digital economy		
Economic drivers	**Technology drivers**	**Market drivers**
Interaction with suppliers and customers at a lower cost	Variety of devices to gain access to the internet	Ease of access and convenience of accessing products and services online
Significantly lower overheads: cost of establishing and maintaining a website is lower than building/buying/renting and maintaining a bricks-and-mortar business and often less staff is required	Ease of access to networks (cyber cafes, fixed lines, fibre, Wi-Fi)	High level of customisation is possible
Increased profitability as a result of reduced costs	Improved online security and technological advances mean that consumers are increasingly willing to settle financial commitments using electronic payment options	Wide variety of products and services available and consumers have the ability to compare products and prices in real time
Ability to reach a global market at a low cost	Communication is quicker, easier and more cost-effective	Consumers have the convenience to compare products, place orders, track delivery and make payment
		Consumers have access to global retailers and services providers and customers can be provided with support and service beyond regional markets

In addition to the above, Hadzhieva (2016, p. 13) states: “the rise of the digital economy is largely due to the fall in Information and Communication Technology (ICT) prices and a constant drive for innovation”. Furthermore, the availability and advances in terms of ICT tools (laptops, smart phones and tablets) and global interconnectivity through the World Wide Web (WWW) have created an environment ideal for the establishment and growth of e-commerce (Hadzhieva 2016, p. 13).

1.3 The growth of e-commerce

According to Turban et al. (2018, p. 21), despite the fact that e-commerce has only been in existence for approximately 24 years, it is expected that this retail segment will show “unstoppable growth”. Globally, e-commerce sales have increased significantly since 2014 and the projection is that e-retail revenues will amount to 4.88 trillion US dollars in 2021 as shown in Figure 1 (Statista 2019). This graph gives information on actual and forecasted retail e-commerce sales worldwide from 2014 to 2021. In 2017, retail e-commerce sales worldwide amounted to 2.3 trillion US dollars and e-retail revenues are projected to grow to 4.88 trillion US dollars in 2021.

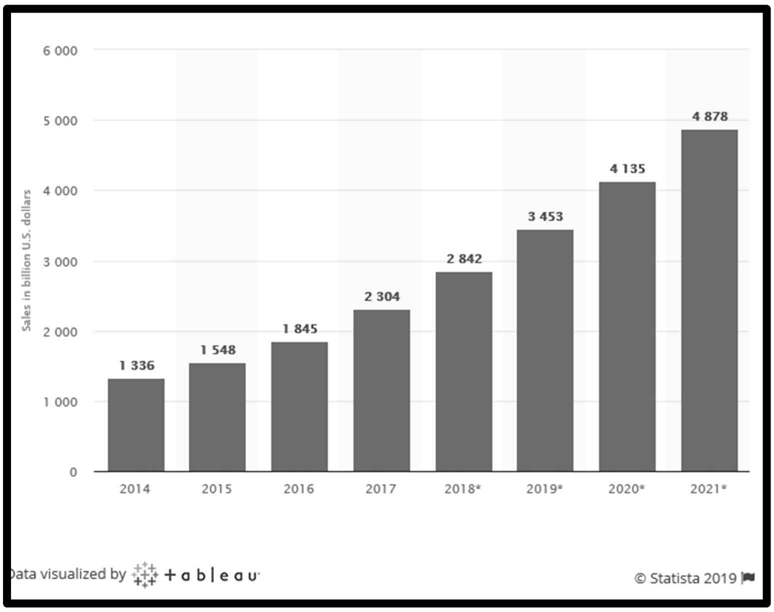

***Figure 1.* Actual and forecasted retail e-commerce sales worldwide from 2014 to 2021 (in billion U.S. dollars)**

Figure 2 (Statista 2019) shows e-commerce's actual and projected share of total global retail sales for the period 2015 until 2021. In 2017, e-retail sales accounted for 10.2% of all retail sales worldwide and the projected figure for 2021 is 17.5%.

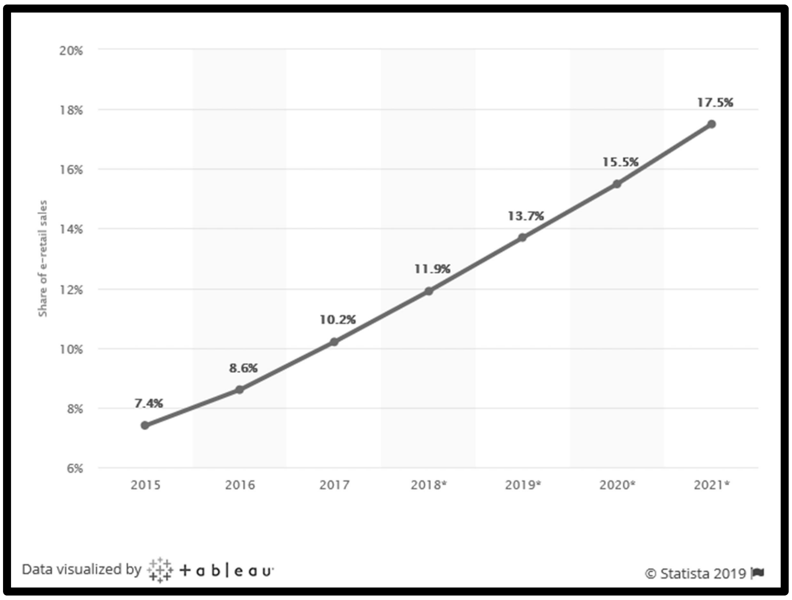

***Figure 2.* Actual and forecasted e-commerce share of total global retail sales from 2015 to 2021**

Figure 3 (Statista 2019) displays the actual and forecasted number of digital buyers worldwide from 2014 to 2021. In 2021, over 2.14 billion people worldwide are expected to buy goods and services online, up from 1.66 billion global digital buyers in 2017.

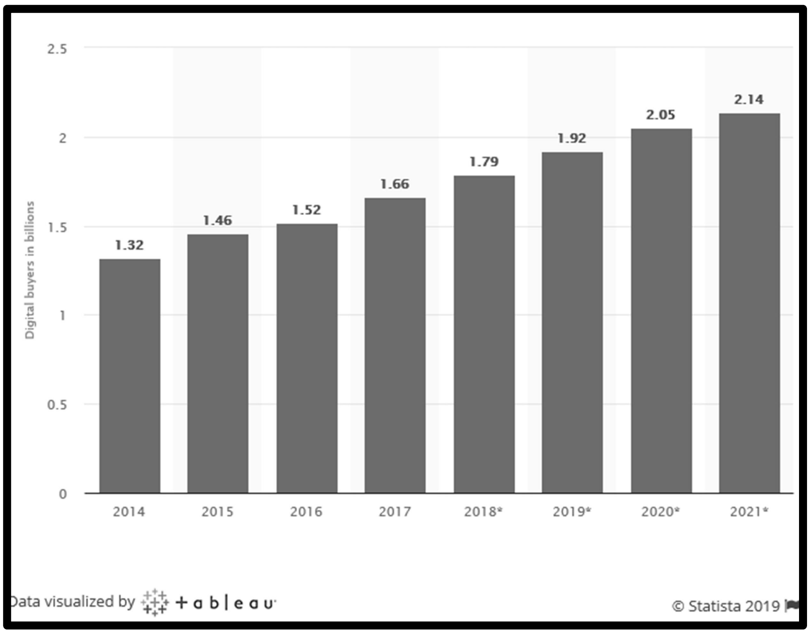

***Figure 3.* Actual and forecasted number of digital buyers worldwide from 2014 to 2021 (in billions)**

1.4 Problem statement

From the preceding discussion, it is clear that e-commerce has become a significant part of the global economy and will continue to grow in terms of the percentage of retail revenue that is generated through e-commerce. However, e-commerce doesn't only provide exceptional growth opportunities, but also creates considerable challenges in terms of taxation.

Due to the nature of e-commerce, which has been described as "the wide array of commercial activities carried out by electronic means that enable trade without the confines of geographical boundaries" (Davis Tax Committee 2016, p. 18) there are various challenges in terms of tax jurisdiction which leads to "the erosion of countries' tax bases".

At their meeting in St. Petersburg on 5-6 September 2013, the G20 Leaders fully endorsed the OECD's *Action Plan on Base Erosion and Profit Shifting (BEPS) 2013*, and issued a declaration that included the following paragraph related to BEPS (G20 Leaders 2013, p. 12):

> In a context of severe fiscal consolidation and social hardship, in many countries ensuring that all taxpayers pay their fair share of taxes is more than ever a priority. Tax avoidance, harmful prices and aggressive tax planning have to be tackled. The growth of the digital economy also poses challenges for international taxation. We fully endorse the ambitious and comprehensive Action Plan – originated in the OECD – aimed at addressing base erosion and profit sharing with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. Profits should be taxed where economic activities deriving the profits are performed and where value is created.

The above principle namely, that "profits should be taxed where economic activities deriving the profits are performed and where value is created" (G20 Leaders 2013, p. 12) is however a matter of great complexity in the digital economy. De Wilde (2015, p. 1) states:

> Although we live in an age in which everything and everyone seems to have become connected online, countries' taxation systems are still based on an economic reality of around a century ago. This creates a problem. This problem is

> particularly evident in the case of profits generated by internet-related activities. The fact that these online profits are difficult to tax is becoming increasingly critical, given the rising share of the economy now accounted for by digital activities.

In the past the right to tax has been based on the principles of source and residence[4]. However, these principles can no longer be applied with absolute clarity due to the borderless nature of e-commerce transactions. Furthermore, according to De Wilde (2015, p. 1) the relevance of a concept such as "permanent establishment" should also be questioned as it refers to "a permanent physical presence in a country" which doesn't apply to an online store in cyberspace.

The nature of the digital economy has allowed companies to pay minimal taxes (Hadzhieva 2016, p. 15). According to the OECD, there are various strategies employed by companies with a digital footprint that erodes the taxable base of the country where the sales took place.

Furthermore, it has become increasingly difficult to segment the digital economy as a separate segment of the global economy. According to the OECD (2015a, p. 11), "the digital economy is increasingly becoming the economy itself and it is increasingly impossible to ring-fence the digital economy from the rest of the economy for tax purposes". In this regard the OECD (2015a, p. 54) makes the important point that any attempt to "isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not".

It is partly due to the uniqueness of digital business models that place companies in a position to avoid paying taxes (Hadzhieva 2016, p. 15). The digital economy has given rise to a number of different types of businesses (OEDC 2015a): Modern advances in ICT have made it possible to conduct many types of business at substantially greater scale and over longer distances than was previously possible. Below are a few prominent examples of new

[4] The concepts of 'source' and 'residence' will be further elaborated on in Chapter 2.

business models mentioned by the OECD (2015a p. 56-62), but this list is by no means exhaustive:

- Electronic commerce: This has been defined previously and includes business-to-business, business-to-consumer and consumer-to-consumer.
- Payment services: A variety of secure online payment options are offered by online payment service providers.
- Application stores: Digital distribution platforms are created for selling software.
- Online advertising: The Internet is used as a medium to target and deliver marketing messages to customers with detailed options for segmentation.
- Cloud computing: Provision of standardised, configurable, on-demand, online computer services, which can include computing, storage, software and data management, users share physical and virtual resources (including networks, servers and applications)
- High frequency trading: Trading securities at high speed through the use of sophisticated technology and complex computer algorithms.
- Participative networked platforms: a participative network platform is an intermediary that enables users to collaborate and contribute to developing, extending, rating, commenting on and distributing user-created content which comprises various forms of media and creative works (written, audio, visual, and combined) created by users. Social networking applications are possibly the best known participative network platform.

Based on the preceding discussion, it is clear that e-commerce and the wide variety of business models that have been created is a matter of significant complexity giving rise to numerous challenges. Furthermore, due to the growth and expected growth of e-commerce, its affects are of relevance to governments, businesses and consumers alike. In terms of taxation, because transactions are taking place in cyberspace (in the absence of geographic boundaries) there are significant issues to be addressed. These issues include determining whose country has the taxing authority and the absence of physical presence may lead to either transactions going untaxed anywhere or double taxation taking place (Yapar et.al 2015, p. 647).

One of the fundamental problems is that current international tax rules are based on a set of standards developed in the 1920's (OECD 2018, p. 167) which are firmly rooted in the physical (OECD 2018, p. 168). This poses a problem in the sense that the digitisation of the economy allows for access to a global market via technological means without having a physical presence (OECD 2018, p 170). The current international tax framework may be outdated as "value creation is becoming less dependent on physical presence" (OECD 2018, p. 169).

Income tax base in the digital economy is also increasingly eroded by multinational enterprises (MNEs) through various means. Firstly, they provide goods and services in countries without a physical or legal presence. Secondly, MNEs can market directly to customers as customers provide their personal data free of charge, and MNEs can generate visibility in the market country without a value being attributed to it in that specific country. Thirdly, artificial contracts are created in order to shift profits and the circumvention of withholding tax through transfer pricing practices takes place. An example of this would be converting royalties into services (Li 2014, p. 3).

As a result of weaknesses in the current tax rules, MNEs have been able to shift profits away from where the underlying economic activities and value creation took place. As a result of the above and at the request of the G20, the *OECD 2013 Action Plan on Base Erosion and Profit Shifting (BEPS)* was launched with 15 action steps in order to prevent BEPS and restore confidence into the tax system (OECD 2015a, p. 11). After 2 years of work, in October 2015, Actions 1-15 (Addendum A) were completed and released as part of the BEPS package, and the full package was endorsed by the G20 Leaders in November 2015. At the time, more than 110 countries and jurisdictions were committed to the successful implementation of the project. One of the fundamental outcomes of the BEPS project was, as stated, that it was not possible to "ring fence the digital economy" as it "is increasing becoming the economy itself" (OECD 2015, p. 11; OECD 2018, p. 18). This research study focuses on Actions 1 and 7:

- Action 1 – addressing the tax challenges of the digital and economy
- Action 7 – preventing artificial avoidance of the PE status

as both of these action points are at the heart of the nexus issue as will be discussed in detail in Chapter 2.

1.5 Research objective

The objective of this research study is to provide an overview of the existing literature to determine what the impact of e-commerce has been in terms of the challenges it poses to taxation. As stated previously, the domain of e-commerce and taxation is vast and complex and as such it is beyond the scope of a research report. The key challenge that will be explored is the artificial avoidance of the permanent residence status which is an issue that lies at the heart of the nexus issue since a PE normally requires some sort of physical presence which is not necessarily the case in the digital economy.

This will provide insight into the current set of rules in terms of whose right is it to tax (source vs residence) with a particular focus on the prevention of artificial avoidance of PE status. This research will also highlight the recommendations made by the OECD and European Commission to tax the digital economy as well as the unilateral measures adopted by some countries to protect their tax bases.

1.6 Research question

The primary research question was formulated as follows:

What is the impact of e-commerce on taxation?

The secondary research questions were formulated as follows:

- *What are the broader tax challenges in a digital economy and how have these challenges led to tax avoidance practices?*
- *What is the impact of e-commerce on taxation specifically in terms of the artificial avoidance of the permanent residence status?*
- *How is the artificial avoidance of the permanent residence status prevented with specific reference to the OECD's modifications to the*

OECD Model Tax Conventions 2014 on Income and Capital Article 5 to prevent artificial avoidance of PE status?

- *What practices have been put in place by some countries to protect their tax bases?*

1.7 Research methodology

As stated previously, the objective of this study is to explore the existing literature to uncover what are the challenges within a digital economy in terms of taxation with specific reference to the artificial avoidance of the permanent residence status, and how the artificial avoidance of the permanent residence status is prevented. Due to the exploratory nature of the research, it is a qualitative study within the interpretivist paradigm. Within a positivist paradigm, the objective of a literature review is to study the existing body of knowledge to "identify an appropriate theory and then construct a hypothesis" (Collis & Hussey 2009, p. 63). In this study, the aim was not to identify a specific theory, but rather to explore the existing literature and provide an overview of how e-commerce affects taxation within the framework of the primary and secondary research questions by doing a systematic literature review. The appropriateness of systematic literature review has recently been established in the broad field of accountancy research (Engelbrecht, Yasseen & Omarjee 2018, p. 657-674; Mohamed, Yasseen & Omarjee 2019, p. 1; Dumay, Bernardi, Guthrie & Demartini 2016, p. 166-185). The systematic literature review was conducted following the steps provided in Table 3.

Table 3

Steps of the systematic literature review

Steps of the systematic literature review
1. Thorough review of literature around taxation in the digital economy to determine key issues.
2. Formulating primary research question based on the key issues identified in the literature.
3. Narrowing literature search to focus on relevant literature related to formulated research question.
4. Formulating secondary research question based on key issues identified in the literature.
5. Expanding literature search to also include literature specific to secondary research questions.
6. Structuring information according to primary and secondary research question.
7. Writing the research report.

The literature review has been based on peer reviewed articles in the majority of cases and literature prepared by authoritative sources, such as the OECD, European Commission and treasury departments of various countries to name a few. Books, articles and journal articles were also used to obtain further information and to provide clarity on various matters regarding the research topic. Due to the nature of the research topic, various reports were consulted as well as commentaries on these reports. Lastly, media releases issued after significant events related to the topic of this paper were also incorporated.

1.8 Significance of study

While this is a literature review, creators of tax policy may find this research useful as it provides an assessment of the impact of e-commerce on the digital economy as well as highlights tax avoidance practices used by companies used in the digital economy.

In preparing the research it became apparent to the researcher that South Africa has very limited exposure in the field of the tax challenges relating to e-commerce. Major legal firms were consulted to provide their input, however the feedback received was that they are inadequately equipped to assist due to the lack of skills in this field. This research could therefore provide some insight into the tax challenges identified in the international arena as this could provide a starting point from a South African perspective.

1.9 Limitations and delimitations

This study is restricted to direct income taxes. Furthermore, this study is limited to legal persons or persons other than natural persons as referred to in the Income Tax Act 58 of 1962. The implications of indirect taxes, including VAT, and Actions 2, 3, 4, 5, 6, 8, 9, 10, 11, 12, 13,14 and 15 of the *OECD/G20 Base Erosion and Profit Sharing Project, 2015* have not been addressed as such an extensive study is beyond the scope of this research report.

Aspects that are related to the existence or lack of an existing permanent residence, such as, splitting up of contracts, strategies for selling insurance in a state without having a PE and profit attribution to PEs and interaction with action points on transfer pricing, all dealt with in Action 7 of the *OECD/G20 Base Erosion and Profit Sharing Project: Preventing the Artificial Avoidance of PE Status 2015 Final Report*, have not been addressed in this research.

1.10 Structure of research report

In order to answer the main research question as well as the sub-questions, the following will be discussed. In Chapter 2, the key concepts relating to nexus are discussed because, before any item of income may be taxed, there has to be a connection or nexus between that country and item of income. This connection may be in terms of source or residence and the concepts of 'source' and 'residence' will also be elaborated on. Chapter 2 also deals with the concept of a PE (which by definition requires some sort of physical presence) which is absent in many digital business models. This highlights the issue as to whether the current international tax system is suitably equipped to cater for the digital economy, as it has historically been based on the traditional bricks-and-mortar business.

Based on this discussion, Chapter 3 will focus on the broader tax challenges brought about by the digital economy, as well as identify the common characteristics of highly digitised businesses. The chapter will explore the impact of the current international tax system's two fundamental concepts, namely nexus and profit distribution, and the ways in which organisations are able to engage in tax avoidance practices due to the very nature of the digital economy.

Based on this discussion, Chapter 4 is dedicated to a detailed discussion of how organisations artificially avoided PE status, and the steps taken by the OECD to address these issues in an attempt to ensure that profits are taxed in the jurisdiction were the economic activity is taking palace.

Following on this, Chapter 5 deals with the reports issued by both the OECD and the European Commission on their recommendations on how to tax the digital economy, despite the fact that a global solution has not yet been reached. As a result of this, certain countries have taken unilateral measures in an effort to protect their tax base. The research report concludes with a summary of the study highlighting key findings, limitations of the study and the significance of the study.

1.11 Summary of chapter

This chapter provides a brief summary of the online environment and highlights one of the major tax challenges relating to e-commerce, namely that substantial profits are being generated in cyberspace with an almost complete absence of corresponding taxing rights. Key concepts such as e-commerce and other related concepts have been defined and explained as well as the impact of information and communication technology on the various business sectors of the digital economy. In addition, the expected growth of e-commerce has been illustrated to make the point that e-ecommerce is one of the highest growth areas of economies worldwide, and this growth is expected to continue exponentially in the future.

CHAPTER 2: TAXING RIGHTS AND JURISDICTION IN THE E-COMMERCE ENVIRONMENT

2.1 Introduction

For any country to levy tax on any item of income, a connection or nexus should be established between that country and that item of income. Nexus refers to an "important connection between the parts of a system or a group of things" (Cambridge Online Dictionary). In terms of taxation, as stated in Chapter 1, nexus refers to the connection between a country and an item of income. The main connecting factors entitling a country to tax income is the connection of that country and the income (source) or the connection of that country to the person who receives the income or to whom the income accrues (residence). Companies traditionally have a physical presence or nexus in a jurisdiction where they are subject to taxation, but in a digital economy, e-commerce permits access to final consumers without necessarily having such a presence (De Wilde 2015, p. 1).

In this chapter the key concepts relating to taxing rights and jurisdiction will be discussed (Section 2.1). The two central points of reference are, as stated, source jurisdiction (Section 2.2.1) and residence jurisdiction (Section 2.2.2). In terms of each of these concepts the related terms of reference will also be discussed, namely the existence of a permanent establishment (Section 2.2.1.1) as it relates to source jurisdiction and the place of effective management (Section 2.2.2.1) as it relates to residence jurisdiction. These are fundamental to the issue of jurisdiction and according to De Wilde (2015, p. 2) "international tax law has applied these legal, physical and geographical references for the past 100 years or more". This chapter includes a conclusion (Section 2.3) with a summary of the chapter (Section 2.4).

2.2 The concepts of taxing rights and jurisdiction

There is a direct link between taxing rights and jurisdiction. As stated by Olivier and Honiball (2011, p. 9-10):

> One of the fundamental questions to ask in deciding whether income is taxable in a particular country is whether a connection, or *nexus*, exists between the income and the country.

> The required connecting factor, which is laid down under domestic law of the different countries, is either that the person who received the income is connected to the particular country or the activities that gave rise to the income are connected to the particular country. These connecting factors are referred to as a ‘residence jurisdiction’ and ‘source’ jurisdiction’.

Residence jurisdiction refers to “a sufficient connection between the tax payer and the country” and source jurisdiction refers to “a sufficient connection between the source of income and the country” (Olivier & Honiball 2011, p. 10). However, the principles are not always strictly applied in terms of residence jurisdiction or source jurisdiction and according to Olivier and Honiball (2011, p. 10) these principles are adapted “to establish common ground”.

The concepts of source jurisdiction versus residence jurisdiction are of particular importance in the e-commerce environment as these fundamental concepts allocate a country’s right to tax income. In the following sections (Section 2.2.1 and Section 2.2.2) these concepts are discussed in further depth in order to highlight the problem that e-commerce creates with reference to these 2 fundamental principles.

2.2.1 Source jurisdiction

In terms of source or territoriality jurisdiction, a country’s right to tax depends on whether the activities that generated the income took place within its borders (Olivier & Honiball 2011, p. 11; Australian Treasury 2018, p. 5; Katz Commission n.d, para. 1.2) and when source jurisdiction applies, an individual’s place of residence is of no consequence. In other words, the income had to have originated within the geographical boarders of the country to be based on the source-based principal. In Section 2.2.1.1 it is explained how business profits will be taxed in a country of which the business is a non-resident (connection of that country and the income as a result of source).

2.2.1.1 Permanent establishment (PE)

It is important to define the concept of a permanent establishment as it plays a central role in terms of source jurisdiction. A PE can be defined as “a fixed place of business through which the business is carried on" (OECD 2014a, p.M-16; United Nations 2017, p 15-16).

Under Article 7 of the OECD Model Tax Convention, a company is subject to tax on its business profits in a country of which it is a non-resident only if it has a PE in that country (OECD 2014, p. M-22). The implication of this is, that companies who haven't been incorporated, formed or established in a particular country, will still be subject to tax on the basis of having a PE in a particular country.

According to Basu, (2008, p. 2) due to the borderless nature of the Internet and e-commerce, "concepts of PE (to determine the location of manufacture), point of sale (for the application of relevant tax rates), income classification (based on source of income) and product classification (for preferred tax rates)" have become increasingly difficult to apply. As a result of new business models, "including digital marketplaces, online catalogues, virtual communities, subscription based information services, online auctions and portals" allow taxpayers to "conduct business and generate income in a country with little or no physical presence in that country" (Basu 2008, p. 4).

The concept of a PE has become significantly more complex as the retail environment has evolved. A defining characteristic of a permanent establishment is that it "requires a permanent physical presence in a country" (De Wilde 2015, p. 1) and this is, for example, not applicable to an online retailer. However, this is not the first time that this has been a stumbling block as the same problem presented itself with mail order companies according to De Wilde (2015, p. 2):

> These businesses, too, were notoriously difficult for tax authorities for pin down to specific jurisdictions. The reason for this was essentially the same as with today's 'e-tailers'…..The mail order company's lack of physical presence in the selling country, other than perhaps the glossy catalogue in the letter box, made it impossible for the country to subject the mail order company's profits to effective taxation, even though the company was certainly economically active in that local market.

What makes the current problem far more significant is the percentage of a country's gross domestic production that is generated through online retailers compared to the relatively small segment of the market that was/is occupied by mail order companies. (De Wilde 2015, p. 2).

2.2.2 Residence jurisdiction

According to Rohatgi, (2005) there are a variety of tests that are applied internationally to determine the tax residence of corporations. Some of these tests pertain to "place of incorporation, registered office, place of residence of shareholders, directors or managers or the place of management or administration" (Rohatgi 2005, p. 209-210)

Residence jurisdiction refers to a taxation basis where "the person who receives the income or to whom it has accrued" is the connecting factor between the country and the income (Katz Commission n.d., para. 1.1) and is also referred to as a "worldwide system of taxation" (Olivier & Honiball 2011, p. 19; Katz Commission n.d, para 1.3). This system is used by Belgium, Canada, Germany, Italy, South Africa and United Kingdom (Olivier & Honiball 2011).

2.2.2.1 Place of effective management (POEM)

In terms of the *OECD, 2014a, Model Tax Convention on Income and Capital*, paragraph 24, commentary on article 4 (OECD 2014a, p. C(4)-20), the place of effective management is defined as:

> (T)he place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily take place where the most senior person or group of persons (for example a board of directors) makes decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definite rule can be given and all relevant factors and circumstances must be examined to determine the place of effective management. An entity can have more than one place of management, but it can have only one place of effective management at any one time.

Article 4(3) of the *OECD, 2014a, Model Tax Convention on Income and Capital* (2014, p. M-13) deals with place of effective management (POEM) as follows:

> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

Similarly, according to article 4(3) of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (United Nations 2017, p. 10-11) deals with POEM:

> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors.

It can be concluded from the above, it is where decisions are executed and implemented rather than the place where they are taken.

2.3 Conclusion

As discussed in this chapter, source jurisdiction is governed by the principle that income was originated within the geographical borders of a country. However, Oguttu and Van der Merwe (2005, p. 313-314) rightfully state, "e-commerce transactions can generate income without substantially using infrastructure in any given physical location". This creates a problem in creating a connection or nexus between the income and the country.

As a result of technological devices and digital networks, companies are able to conduct business without having a physical presence which is a change from the traditional sense where companies had a physical presence or nexus in a jurisdiction where they were subject to taxation. E-commerce now permits access to final consumers (for example, through a web store) without necessarily having such a presence (De Wilde 2015, p. 1).

Most of the digital products such as intellectual properties or patents are of an intangible nature, hence it is difficult to calculate their value in comparison with physical goods. Moreover, unlike physical goods, they can travel easily across borders (OECD 2018, p. 110). This makes it easy for companies to set up a business far away from their consumers, where the actual economic activity takes place (OECD 2013, p. 19; OECD 2018, p. 111 and 170).

Traditionally, companies have a physical presence or a nexus in a given jurisdiction, where they are obliged to pay their taxes. E-commerce eliminates the need for a physical presence or nexus of a company in order to have access to its customers there (Hadzhieva 2016, p. 17). Although the ability to conduct business with customers with little or no physical presence in that country is not unique to the digital economy, the ability to do so is so much more. Where tax planning structures are put in place that avoid physical presence and are coupled with tax strategies that eliminate taxation in the state of residence, this has the result of the revenue in question not being taxed anywhere, which is a real concern for BEPS (OECD 2015a, p. 79).

A further risk in terms of eroding the tax basis is linked to the advancement in telecommunications. According to Oguttu and Van der Merwe (2005, p. 311), companies can avoid conducting day-to-day business from a specific location by using modern technology. This shifts the focus to where business operations take place which can be relatively easily determined by where the manufacturing or selling of tangible goods take place but in the instance of a company dealing with intangible goods and services, "it will be easier to manipulate the place of effective management by conducting business operations and activities from various locations" (Oguttu & Van der Merwe 2005, p. 311). This is specifically applicable to the digital economy.

As stated previously, the current international tax framework was developed almost a century ago and was primarily based on a bricks-and-mortar business. The digital economy poses a variety of challenges in terms of taxation, enabling organisations to engage in a variety of tax avoidance practices. These issues will be addressed in the following chapter (Chapter 3).

2.4 Summary of chapter

In Chapter 2 .it was explained how a country's right to tax is based on well-known concepts, namely source and residence. In terms of the aforementioned source, a non-resident is taxed in a source country if its business is carried on through a PE. A primary characteristic of a PE is that it requires a physical presence which is clearly not relevant for a webstore. In terms of residence, an enterprise is taxed in a jurisdiction where it has its place of effective management (POEM). With the use of modern technology, MNEs can manipulate their POEM by conducting multiple business operations from various locations. When structures are put in place requiring no physical presence in conjunction with strategies that avoid taxation in the resident country, substantial BEPS issues are created, resulting in revenue not being taxed at all.

CHAPTER 3: TAX CHALLENGES AND COMMON TAX AVOIDANCE PRACTICES IN THE DIGITAL ECONOMY

3.1 Introduction

According to the OECD (2018, p. 167) the current international tax framework was conceptualised in the 1920's and created on a foundation firmly based on aspects such as capital, labour and physical assets in order to determine taxing rights. The Australian Treasury (2018, p. 7) rightfully highlights that, at the time of developing the framework, the policy makers had no idea how and to what extent digitisation would have on the economy. Goolsbee (2001, p. 20), for example, was of the opinion that e-commerce was only a small percentage of the total economy and expected that it would remain so for many years to come. Clearly this argument is no longer valid. Non-residents are able to interact with customers in virtually "any jurisdiction in a fundamentally different way that was never envisaged at the time the international tax rules were designed. Traditionally, there was always some sort of physical presence" (OECD 2015a, p. 98).

It is clear that the digital economy poses a variety of challenges in terms of taxation. In this chapter, these challenges will be explored in further depth in order to identify the broader tax challenges brought about by the digital economy as well as identify the common characteristics of highly digitised business models and how these impact the two fundamental concepts of taxation, namely nexus and profit attribution. Because of the very nature of the digital economy these challenges provide opportunities for organisations to avoid paying taxes.

3.2 Tax challenges in a digital economy

Firstly, it is necessary to provide a brief summary of two fundamental concepts of the current international tax framework, namely:

1. Using the nexus rule to determine jurisdiction to tax a non-resident (OECD 2018a, p. 168)
2. Allocating profit, based on the arms-length principle (OECD 2018a, p. 168).

Under most tax treaties the right to tax business profits is imposed by the resident state unless the enterprise carries on a business in the other state (source state) through a PE in terms of Article 7 of the OECD MTC 2014 (OECD 2014, p. M-22) and the UN MTC (UN 2017, p. 15-16). The concept of PE has been dealt with in previous chapters, but, to reiterate, an enterprise requires some sort of physical presence in terms of Article 5 of the OECD MTC and UN MTC. As can be seen, this rule is aimed at the traditional bricks-and-mortar business with the aim of taxation in the jurisdiction were the income producing activity is taking place (OECD 2018a, p. 168). Put very briefly, once it has been decided which jurisdiction to tax, one has to determine how much share of the profit to tax. This is where profit allocation rules fit in. The internationally accepted principle for allocating profits is known as the arms-length principle as it is based on the analysis of the function performed, assets used and risks assumed by each associated party. Both sets of rules are strongly rooted in the physical.

The OECD in the 2015 BEPS Report identified three broad tax challenges that are specific to the digital economy, namely, nexus, data and value creation and the characterisation of payments and posed the question whether the current international framework is equipped to deal with the changes as a result of the digital economy (OECD 2015a, p. 99; OECD, 2018, p. 169) and recognised that these challenges relate to the allocation of taxing rights between source and residence jurisdiction (OECD 2015a, p. 99; OECD 2018, p. 167).

In the following sections (Section 3.2.1, 3.2.2 and 3.2.3) the nature of each of these challenges will be described. In terms of this discussion, it is important to bear in mind that nexus, data and value creation, and the characterisation of payments cannot be viewed in isolation. These challenges overlap with each other and are intrinsic to the 2 fundamental concepts which underpin the international tax framework, namely rules attributable to nexus and allocation of profit (OECD 2018). The impact of highly digitised business models on taxation is described (Section 3.2.4) and the views presented by the OECD's 3 schools of thought as to how and to what extent highly digitised businesses are affected by the 2 fundamental international tax concepts of nexus and allocation of profit. Finally, as a result of the tax challenges indicated above, businesses have the ability to engage in tax avoidance practices. This chapter concludes with a discussion of these practices (Section 3.3).

3.2.1 Nexus

In terms of taxation, as stated in Chapter 2, nexus refers to the connection between a country and an item of income. In a digital economy it is possible to be heavily involved in a country in the absence of a fixed place of business or a dependent agent (rules contained in Article 5(5) and 5(6) of the *OECD Model Tax Convention on Income and Capital 2014*) and therefore escape the PE threshold. With the use of modern technology via remote access, it is no longer necessary to include the involvement of a dependent agent to conclude contracts (this may be done by automated equipment), which questions whether existing rules relating to the conclusion of contracts by persons other than independent agents is still relevant (Article 5(5) and 5(6) which deals with dependent and independent agents are discussed in detail in Chapter 4). (OECD 2015a, pp.100-101).

In addition, activities that would be considered preparatory or auxiliary in nature previously enjoyed exemption under Article 5(4) of the *OECD Model Tax Convention on Income and Capital 2014*, but when it comes to the digital economy, these activities are actually core activities (OECD 2015a, p. 102). Examples of such an activity is data that is collected, analysed and sold to advertisers which overlaps with data and value creation as will be discussed in Section 3.2.2.

Many digital products (i.e. intellectual properties or patents) are of an intangible character. Because of this, it is difficult to determine the value of intangibles compared to physical goods, and unlike physical goods, cross-border distribution poses no difficulty (OECD 2018, p110). Therefore, there is very little hindrance in setting up a business remotely from either consumers or the place of actual economic activity or both (OECD 2013, p. 19; OECD 2018, pp. 111 and 170). Effectively, “e-commerce eliminates the need for a physical presence or nexus of a company in order to have access to its customers” (Hadzhieva 2016, p. 17).

3.2.2 Data and value creation

There is no denying the value of customer data regardless of whether marketing takes place in a traditional or digital environment. As Medus (2017, p. 39) states “customer data has always been a source of value”. The digital economy has however changed the landscape of marketing forever and “offers the marketer the opportunity to collect marketing information at a relatively low cost" (Cant & Van Heerden 2013, p. 412).

According to Medus (2017 p. 39), data and value creation in a digital economy refers "to the difficulty of attributing value to data generated by using and analysing collected data of end users" (OECD 2015a, p. 103). Medus (2017 p. 39) further states, that the data that is collected, analysed and sold to advertisers and commercial companies is often not "a mere auxiliary activity" but "the core business and most valuable asset of some digital companies".

In terms of taxation, the core issue is to determine "how collected data is monetised, given that most of the time data collected in the consumer market are sent through the Internet to a foreign-based company to be analysed" (Medus 2017, p. 39). In order to determine what the value chain of business collection/data analysis is, requires extensive investigation as stated by Medus (2017, p. 39): "tax authorities must first make a thorough examination of functions performed, assets involved, and risks assumed". In addition, what makes this an even more complex challenge, is the fact that the value created through data analysis probably far exceeds the value that is created by simply collecting data (Medus 2017, p. 39).

Other issues which could arise are whether taxing rights should be allocated to the jurisdiction where the data was gathered and whether it is correctly characterised and valued for tax purposes? Another compounding factor could be where data is collected in one country but using technology developed in another country, where the second country refines the data to be targeted at advertisements in the first country. This adds to the complexity of taxation rights and can be further compounded if data is stored and processed using the cloud. Where and how to allocate profits would not be a trivial task (OECD 2015a, p. 103). Another problem with data and value-creation, is how to characterise an activity for tax purposes (e.g. free supply of goods or barter transactions) (OECD 2018, p. 169).

3.2.3 Characterisation of payments

As a result of digital technology delivering products and services in new ways, has led to the creation of uncertainty relating to the characterisation of income. The type of income is important for tax treaty purposes as to whether it should be treated as royalties, fees for technical services or business profits as different types of income are subject to different provisions for tax treaty purposes. Clarity may be required in order to characterise certain types of income as a result of new business models. This would be true of cloud computing, which provides different kinds of services (OECD 2015a, pp. 104-106). Source taxation could be restored if a new category of income is introduced which is subject to a withholding tax. Therefore, the issue of characterisation of payments would have significant implications for nexus. This could be relevant for new business models (OECD 2015a. p. 106).

As a result of the above challenges, one has to consider whether the existing international tax framework is appropriate to deal with the challenges posed by the digital economy and whether the end result will be achieved, namely, taxation is paid in the jurisdiction where the economic activity occurs and value is created (OECD 2015a, p. 99).

As stated in Section 3.2 it is clear from the above discussion that the complexities around nexus, data and value-creation, and characterisation of payments cannot be viewed in isolation. In addition, these challenges cannot be separated from the two fundamental concepts which underpin the international tax framework (rules attributable to nexus and allocation of profit) (OECD 2018, p. 169). An example of this would be, because of the characterisation of the nature of a payment, that taxation is triggered in a jurisdiction where the individual or entity that makes a payment, is a resident/established. This then overlaps with the nexus issue. Another example would be the collection of data from users located in a certain jurisdiction. Should this not give rise to a nexus in that jurisdiction? And if so, how would one allocate value to that nexus/jurisdiction (OECD 2015a, p. 99).

3.2.4 The impact of highly digitised business models

In order to keep up with the exponential growth of digitisation, many businesses have changed the way in which they operate, which has led to the development of new business models as stated previously. These new business models challenge the current international tax framework which was created a century ago (OECD 2018, p. 167).

Extending on the work performed and reflected in the OECD 2015 BEPS Report on the tax challenges of the digital economy, the OECD 2018[5] (2018, p. 24) report analysed highly digitised business models and found 3 common characteristics (see Figure 4), which may be found in varying degrees in traditional businesses, being:

- Cross jurisdictional scale without mass;
- Heavy reliance on intangibles; and
- Data, user participation and their synergies with a brand.

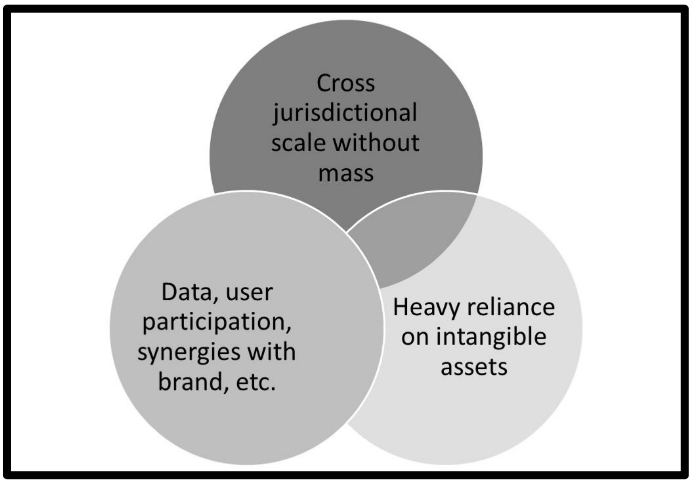

***Figure 4.* Common characteristics of highly digitised business models**

These three characteristics will be discussed in the following sections (Section 3.2.4.1, Section 3.2.4.2 and Section 3.4.2.3).

3.2.4.1 Cross jurisdictional scale without mass

Digitisation has allowed businesses to split the stages of their production processes across various countries and have access to customers around the world. In addition, digitisation allows highly digitised businesses to be significantly involved in the economic life of a country, with no or little physical presence.

The impact of this is that MNEs can access a market via technology and share in profits of cross border activities and not being taxed in the market jurisdiction. This highlights the problem with current tax rules which are firmly rooted in physical factors (OECD 2018, p. 170).

[5] OECD /G20 Base Erosion and Profit Sharing Project: Tax challenges arising from the digitalisation – interim report 2018, builds on the work of BEPS Action 1: Addressing the tax challenges of the digital economy issued in 2015

3.2.4.2 Heavy reliance on intangibles

Highly digitised businesses rely heavily on intangibles (specifically intellectual property) as well as on the investment in intangible assets (such as patents, trademarks and brand names). In addition to being intangible, these assets are also highly mobile. Since these assets can be located anywhere in the world it would not be difficult for highly digitised businesses to have a significant economic presence in a country, whilst the majority of profit producing assets and labour are located in another country (OECD 2018, p.170). This would result in a loss of taxation revenue in the market jurisdiction.

3.2.4.3 Data, user participation and their synergies with intellectual property

A common feature of highly digitised companies is the interaction of data and user participation with intellectual property. This interaction creates platforms for user generated content and, in addition, creates network effects where data can be collected across platforms. An example of this would be where “search engines and social media business rely heavily on gathering data about users’ preferences in order to sell highly targeted advertising services to businesses. Network effects occur when the usefulness of a service grow exponentially with the number of users” (Australian Treasury 2018, p. 2).

Business can generate significant profits as a result of user-created value where the business has no or limited physical presence in the country where the users are located. Highly digitised businesses can benefit from user data and user generated content with little or no physical presence in the country where the user is located. The issue is that the current tax system does not cater for the concept of user created value (OECD 2018, p. 171). Some countries, have requested that user created value should be used as a basis for the allocation of taxing rights to a country where these activities occur (Australian Treasury 2018, p. 15).

User created value can be made in the following ways (Australian Treasury 2018, p. 15):

- User data – data collected from consumers which allows advertisers to target a specific customer base who may be interested in their products which increases the value of these advertising services to businesses
- User generated content - this includes providing reviews, ratings and pictures which attracts additional users by creating credibility and trust

- Network effects – as more users participate in a particular online platform this encourage other business to participate

In summary, the OECD 2015a BEPS report highlighted the broader tax challenges relating to the digital economy, i.e. nexus, data and value creation and characterisation of payments and further noted that these tax challenges relate to the allocation of taxing rights. The OECD 2018 Report, which builds on the OECD 2015 report, identified the 3 common characteristics of highly digitised businesses, namely:

- scale without mass;
- heavy reliance on intangibles; and
- data, user participation, and their synergies with intellectual property.

Furthermore, the findings of the OECD 2018 Report highlighted a particularly important question – the implications of, and the extent to which these characteristics challenge the current international tax system, specifically in terms of the 2 most fundamental concepts of international tax being, nexus (which country has the taxing rights) and profit allocation (the quantum of profits to be taxed in that country).

As one can expect, the members of the Inclusive Framework[6] could not agree on whether and to what extent highly digitised businesses impacts on the current international tax rules (OECD 2018, p. 171). There are 3 schools of thought on this issue which is explained in more detail in Chapter 5.

3.3 Tax avoidance practices

The challenges described in Section 3.2 create an environment in which various tax avoidance practices are employed by many organisations. In this section the most commonly used tax avoidance practices are discussed.

3.3.1 Avoiding withholding tax

Avoiding withholding tax refers to an instance where a non-resident who receives certain types of income (i.e. interest and royalties) may be required to pay tax on that income in that country, known as a withholding tax. Tax treaties may be abused by

[6] The IF agreed to review the 2 current existing rules namely nexus and profit allocation and report back in 2020 (OECD, 2018, p. 173).

treaty shopping to avoid the payment of withholding tax in a high tax rate jurisdiction by the formation of a shell company in a low tax jurisdiction (OECD 2015a, p. 81).

MNEs often make use of tax havens or special regulations for this purpose. It has been revealed by the Consortium of Investigative Journalists that Luxembourg, for instance, has approved complexed tax saving models, developed by PriceWaterHouseCoopers, with MNEs such as Amazon, allowing the companies to pay close to zero tax on profits. Such cases, which are referred to as double non-taxation, involve a complex mechanism, which allows for the non-payment of withholding taxes in the source country and in the intermediary countries. As the ultimate tax collection occurs in the tax haven, it amounts almost to zero (Hadzhieva 2016, p. 24).

3.3.2 Use of preferential tax regimes

A preferential tax regime is a tax incentive offering favourable tax rates. This motivates MNEs to locate their intellectual property (IP) in these low tax rate jurisdictions to benefit from the favourable tax rates (OECD 2018, p. 110) which could then lead to the erosion of another country's tax base. A patent box, which is a preferential tax regime, (or an Intellectual Property Box) is a tax advantage offered to companies for income earned form intellectual property (Hadzhieva 2016, p. 26). MNEs use subsidiaries to pay royalty payments (which are tax deductible) to the holding company (where the IP is located) thereby shifting profits from where the substantial business activity is carried out to a low tax rate jurisdiction (OECD 2018, p. 110). In addition, IP such as patents, trademarks, and copyrights constitute a challenge as they lack a fixed location (absence of nexus) and therefore can be easily relocated (Hadzhieva 2016, p. 26).

In a statistical analysis of the effects of patent boxes in the EU published in 2015 (European Commission 2015), the Commission found that patent boxes do not spur innovation but serve as a means for MNEs to shift their patents without necessarily increasing their research activities or the number of personnel involved in inventions. This leads to the obvious conclusion that their effects are mainly of a 'tax nature' (Alstadsæter et al. 2015, p. 18).

In the UK, a tax incentive is given for returns on earnings from patents and other innovations, which reduces the tax rate to 10% (The Editorial Board 2014). The UK announced intentions that it was going to introduce alternative limitations (Otto et al. 2015, p. 23). A range of IP boxes is available in Europe with tax rates including 0% in Malta, 2.5% in Cyprus, just over 5.6% in Luxembourg compared with just over 15% in France (Eurodad 2015, p. 21).

3.3.3 Artificial internal trading of intangibles – IP Licencing

An example of this would be a holding company registering intellectual property in a low tax rate jurisdiction and charging the subsidiary in another jurisdiction a licencing fee to use the IP. This creates an erosion of the country's tax base as profits are removed from the jurisdiction where the economic activity takes place (OECD 2014, p. 7).

3.3.4 Internal debt shifting

MNEs can manipulate the location of their debts to take advantage of favourable tax rates in a low tax rate jurisdiction. For example, in cases where a subsidiary is heavily indebted to another one, the high interest rates decrease the tax base of one subsidiary while increasing the profits of the other thereby shifting profits and engaging in BEPS (Hadzhieva 2016, p. 25).

3.3.5 Transfer pricing

The transfer price is "the price that is set for the exchange of goods and services between various subsidiaries of a corporate group" (Otto et al. 2015, p. 25) and here the arms-length principle plays a significant role (Otto et al. 2015, p. 25). In accordance with the OECD's "arms-length principle[7]", subsidiaries of a group are treated as if they were legally independent companies and their transactions are organised following standard transaction related methods and profit methods. The original aim of this principle was ensuring profit-sharing is possible amongst all countries (Otto et al, 2015). It also means that subsidiaries' income can't be artificially increased or decreased through internal transactions between

[7] Arms-length principle is defined in Article 9 of the OECD MTC which is as follows: where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly" (OECD MTC, 2014a, p. M-26)

subsidiaries. This can relate to either goods and/or merchandise or services such as management or consultancy services to subsidiaries, “which may be even imaginary services” (Hadzhieva 2016, p. 25).

Through applying the principles of transfer pricing, MNEs can attribute income to tax havens by arbitrarily inflating prices for goods and services between different subsidiaries in either low-tax jurisdictions or high-tax jurisdictions. According to Hadzhieva (2016, p. 28):

> (T)his is a widespread practice in the digital sector where intangible assets such as patent rights, royalty rights or marketing rights can be established in low-tax jurisdictions or tax havens. Other subsidiaries based in high-tax jurisdictions then have to pay royalties for these intangible assets (company names, software licences, etc), which can be deducted from their tax as operating expenses.

3.3.6 Avoiding taxable presence

Taxable presence refers to a PE which gives rise to a tax liability in a particular jurisdiction. Organisations are able to avoid their taxable presence in the market country because it is difficult to determine nexus and characterise a PE (OECD, 2015) as discussed in Chapter 2.

Under the current system, many companies are artificially avoiding the PE status while maintaining some form of physical presence in the market country by use of commissionnaire arrangements, artificial fragmentation of activities to avoid requirements of a PE or to qualify for the exceptions to their PE status for preparatory and ancillary activities under Article 5(4) of the OECD MTC (OECD, 2015b, p 9-10). All of the above anti-avoidance measure will be dealt with in detail in Chapter 4, where measures to prevent artificial avoidance of PE status are discussed.

As stated in Chapter 1, the key challenge that is the focus of this research report is the artificial avoidance of the permanent residence status since this issue lies at the heart of the nexus issue because a permanent establishment normally requires some sort of physical presence which is not necessarily the case in the digital economy). In Chapter 4, the challenge regarding enterprises artificially avoiding the

PE status, is explored in further depth with specific reference to changes in the way in which PE status is defined by the OECD.

3.4 Summary of chapter

The current set of international tax rules were developed in the 1920's and is firmly based on the physical. Given the broader tax challenges that exist in the digital economy (nexus, data and value-creation and the characterisation of payments) one needs to consider the efficacy of the current system in a modern, digital age.

The 2018 OECD Report identified 3 common characteristics of highly digitised businesses; scale without mass, heavy reliance on intangibles and data, user participation and their synergies with IP. The OECD posed the question of how and to what extent these 3 common characteristics affect the current international tax system. Countries included in the IF could not reach consensus on the above question raised, which resulted in the formation of 3 schools of thought (discussed in Chapter 5.)

Due to the unique nature of the digital economy, enterprises have been able to engage in tax avoidance practices utilising a number of different strategies, a number of which have been included in this chapter. One of the central themes of digitisation is the ability to access global markets remotely, without having a physical presence, which is a key requirement for a permanent establishment. The following chapter (Chapter 4) contains a detailed discussion on the prevention of artificial avoidance of PE status.

CHAPTER 4: PREVENTING ARTIFICIAL AVOIDANCE OF PERMANENT ESTABLISHMENT (PE) STATUS

4.1 Introduction

As stated in Chapter 2 and 3, taxable presence refers to a permanent establishment which gives rise to a tax liability in a particular jurisdiction. In a digital economy, organisations are able to avoid their taxable presence in the market country because it is difficult to determine nexus and characterise a PE (OECD 2015, pp. 100-102). As mentioned previously in Chapter 1, the overall aim of the BEPS project is to restore source taxation in anticipation that profits are appropriately taxed in the jurisdiction where the economic activity is taking place (OECD 2015, p. 3). That said, sales made through a website should be taxed in the source country. However, in terms of Article 7 of the OECD Model Tax Convention on Income and on Capital (condensed version as on 21 November 2017) (OECD MTC 2017)[8] and United Nations Double Tax Convention (UN DTC) 2017 Update[9] profits of a non-resident enterprise are only taxable in that state if the enterprise carries on the business through a permanent establishment (OECD MTC 2017, p. 33; UN DTC 2017, p. 15 and 16).

In Chapter 3, avoidance of taxable presence was briefly discussed. In this Chapter, the ways in which organisations avoid PE status are highlighted (Section 4.2) followed by an overview of the proposed changes to Articles 5(5) and 5(6) of the OECD Model Tax Convention on Income and Capital 2014 to prevent the artificial avoidance of PE status (Section 4.3) as well as the amendments made to Article 5(4) (Section 4.4) which includes the OECD's anti-fragmentation rule introduced in paragraph 4.1 to Article 5 which is discussed in Section 4.5. The chapter concludes with a chapter summary (Section 4.6).

4.2 Actions taken by enterprises to avoid PE status

In the digital economy, enterprises were able to artificially prevent permanent establishment status. In summary, these strategies are: replacing local distributors with commissionnaire agreements; further contracting strategies; classification as

[8] Provided in Addendum B
[9] Provided in Addendum C

preparatory or auxiliary activities; and fragmentation of activities between closely related parties as discussed in Sections 4.2.1, 4.2.2, 4.2.3 and 4.2.4.

4.2.1 Replacing local distributors with *commissionnaire* agreements

Many digital companies were replacing their local distributors with *commissionnaire* arrangements[10]. By definition, a *commissionnaire* arrangement is an agreement whereby an enterprise sells goods in country B in its own name but on behalf of a foreign enterprise located in country A who is the owner of the goods. Due to the absence of *de facto* ownership of the goods, the *commissionnaire* cannot be taxed on the profits generated from the sale. Since the *commissionnaire* is the middleperson, it will be taxed on the commission earned on the sale. The enterprise that uses these *commissionnaire* arrangements does not have a PE and is able to avoid the application of Article 5(5) of OECD MTC 2017 - the dependent agent provision - as the contracts concluded by the person acting as *commissionnaire* are not binding on the enterprise in country B (OECD 2015b, pp. 9-10). See Figure 5.

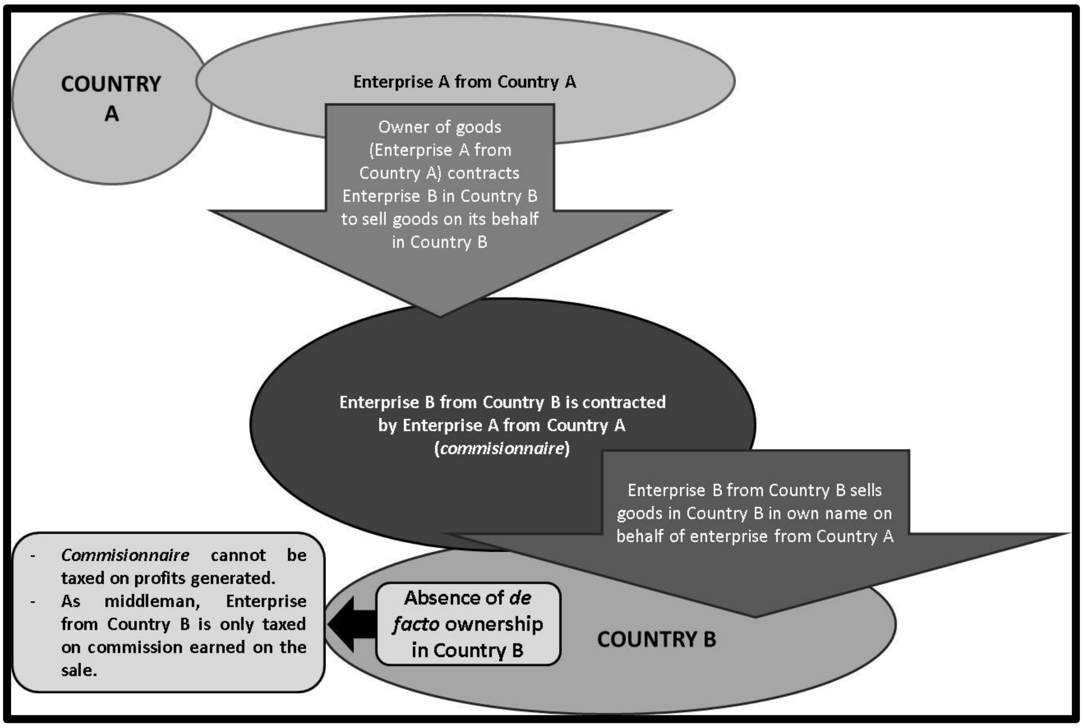

***Figure 5*: Replacing local distributors with commissionnaire agreements**

[10] Definition provided in Addendum D. Artificial Avoidance of PE status through *commissionnaire* arrangements and similar strategies (OECD 2015b, p. Section A-15)

For example, some enterprises were replacing their local subsidiaries selling goods and services with *commissionnaire* arrangements, resulting in profits being diverted from the country where sales took place without a fundamental change in the functions performed in that country. The resultant effect is that these enterprises were able to artificially avoid PE status whilst simultaneously retaining a limited physical presence in that country (OECD 2015b, p. 9 and 10; OECD 2018, p. 94).

4.2.2 Further contracting strategies

Similar strategies to avoid Article 5(5) are:

- Contracts which are substantially negotiated in one country but finalised abroad; or
- Where the person that habitually exercises authority to conclude the contracts does so as an independent agent, under the exception of Article 5(6), even though he is closely related to the foreign enterprise on behalf of which he is acting (OECD 2015b, p. 10 and Section A-15).

In terms of the current Article 5(5), the foreign company in country A will be deemed to have a PE in country B when the person selling the goods and services also has the authority to conclude contracts on behalf of the foreign company. However, when the agent selling the goods abroad also has the authority to negotiate the main provisions of the contract, without concluding the contract (which are finalised or authorised abroad), the agent would not be considered a PE of the foreign enterprise. By simply concluding the contract outside the source state, an enterprise would escape the PE status thereby circumventing the provisions of article 5(5) (OECD 2015b, p. 10 and A-15).

More specifically, relating to highly digitised businesses such as the online provision of advertising services, where these contracts substantially are negotiated in a market jurisdiction through a local subsidiary, but not concluded in that jurisdiction (same as above), and an “automated system managed overseas by the parent company could be responsible for the finalisation of these contracts” (OECD 2018, p. 94), enables a company to avoid the dependent agent provision included in Article 5(5).

The above exploitation extends to Article 5(6), whereby the agent would be classified as an independent agent which is specifically excluded from PE status, despite being closely related to the enterprise on behalf of which he is acting (OECD 2015b, p. 10). This brings into question whether the independent agent is really “independent”. Once again, the source country could not tax the profits from the sale of goods and services as there was no PE due to the exception under Article 5(6), independent agent provision.

4.2.3 Classification as preparatory or auxiliary activities

Article 5(4) lists certain activity exceptions to the PE status, which correspond to activities which are preparatory or auxiliary in nature. The key issue is that activities which are considered to be of a preparatory or auxiliary nature, may constitute core parts of digital business models, which could trigger PE status (OECD 2015b, p. 10).

4.2.4 Fragmentation of activities between closely related parties

Finally, enterprises are also using fragmentation to circumvent PE status. This entails an enterprise fragmenting what was a cohesive and global operating business into several separate operations, thus arguing that each is engaged in preparatory or auxiliary activities and thereby attempting to be exempt from PE status (OECD 2015b, p. 10; OECD 2015b, p. Section B – 39). Digital businesses have used this scheme, splitting their overall business into various fragmented functions through either subsidiaries or closely related parties (Medus 2017, p. 62).

In order to counteract these circumventions the OECD decided to modify Articles 5(4), 5(5) and 5(6) as will be discussed in Section.4.3, 4.4 and 4.5. Table 4 provides an overview of the changes which will be discussed in Section 4.3, Section 4.4 and Section 4.5.

Table 4: Overview of changes to Article 5(5), 5(4) and 5(6)

Overview of changes to Action 7 **In terms of commissionaire (and similar arrangements), specific activity exemptions, and fragmentation of activities**	
Focus Area	**Significant Change**
Section 4.3 Commissionaire and similar arrangements	The changes to Article 5(5) will lower the threshold for creating a PE by expanding the scope and tightening independence criteria in Article 5(6)
Section 4.4 Specific activity exemptions	Limiting the scope of PE exemptions in Article 5(4)
Section 4.5 Fragmentation of activities	Inclusion of anti-fragmentation rule whereby preparatory or auxiliary exemptions would not apply to a place of business maintained by the enterprise of a closely related enterprise under certain circumstances

4.3 Changes to Articles 5(5) and 5(6) of OECD Model Tax Convention on Income and Capital 2014[11]

The changes to Article 5(5) will lower the threshold for creating a PE by expanding the scope. When a person acting on behalf of an enterprise "habitually concludes contracts", or "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without modification" that are (OECD 2015b, Section A 16-17)[12]:

- In the name of the enterprise, or
- For the transfer of ownership of, or for the granting of right to use, property owned by that enterprise, or that the enterprise has the right to use; or
- For the provision of services by that enterprise the enterprise will now be deemed to have a PE.

Prior to this amendment, the actual conclusion of the contract was required to create a PE. This amendment is directed at situations where the contract is concluded due to the person's actions, regardless of the geographical location of where the contract is concluded (OECD, 2015b, p. Section A-19). Figure 6 provides a diagrammatic presentation of the changes and the impact of the changes will be discussed in Section 4.3.1.

[11] Provided in Addendum E
[12] See Annexure of full description of changes

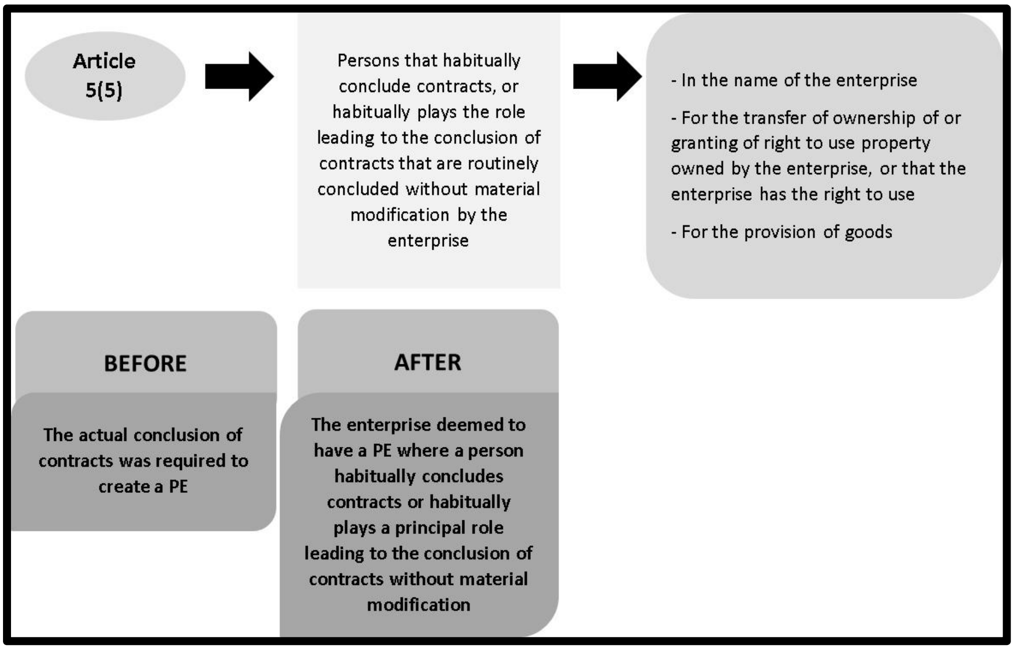

***Figure 6*: Changes to Article 5(5) of the OECD Model Tax Convention on Income and Capital 2014**

4.3.1 Practical application in a digital economy

The following example highlighted by the OECD 2015b, depicts how this new definition would apply in a digital economy in a situation where a company distributes products and services through websites (OECD 2015b, p. Section A -19 to 20).

A wholly owned subsidiary A, located in state A, through its employees, electronically solicits local customers to buy company B's products and also provide all the necessary information relating to the sale, and indicates that a standard contract (which cannot be modified by employee A) must first be completed online with B before B can provide products and services. This is the perfect example of how A's employees play the principal role leading to the conclusion of contracts between local customers in State A and B, and the contracts are concluded routinely without material modifications by B. Based on the amended article 5(5), B would now have a deemed PE in a state where A operates.

With regard to the above, there are two important factors to take into consideration:

- As the amended definition will now result in a deemed PE, profits will have to be allocated appropriately between entities per Article 7 (OECD 2015b, p. Section A – 23).

- A person's mere attendance/participation in negotiations in a state between a customer and an enterprise, is not sufficient to fulfil the requirement of "*habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise"* (OECD 2015b, p. Section A 21 to 22).

Regarding the amendment to article 5(6) relating to an independent agent (to which the exception of PE applies), the central issues to address are meanings of independence and person closely related to the enterprise. The OECD notes when considering independence, the following factors may be of relevance[13] (OECD 2015b, Section A – 24):

- Are the agent's activities for the enterprise subject to detailed instructions by the enterprise?
- Are the agent's activities for the enterprise subject to the control of the enterprise?
- Who bears the entrepreneurial risk? If it isn't the agent then the agent can't be independent.
- How many principals does the agent represent? The more principals that are represented, the more likely it is that it is an independent agent.
- Are there limitations on the scope of the business that the agent may conduct?
- What freedom exists regarding how the agent conducts the work?

It is important to note that this amended provision will <u>not</u> apply if the activities are made by a real independent agent to which the exemption under article 5(6) applies or are limited to the exemption activities covered under article 5(4) (OECD 2015b, p. Section A – 18). In addition, the OECD recognises that schemes based on "low risk distributors"[14] are still valid and will not create a PE for the foreign enterprise (OECD 2015b, Section A – 21).

[13] This list is not exhaustive, but only provides a few key indicators.

[14] In contrast to the commissionnaire type arrangement, para 32.12 of the OECD commentary (OECD, 2015b, Section A – 21) clarifies that Article 5(5) is not intended to apply when a person concludes contracts on its own behalf and, in order to perform the obligations deriving from these contracts, obtains goods and services from other enterprises. The transfer of title to property that the low-risk distributor sold passed from the enterprise to the distributor, and this operation will generate a profit from the final sale to local customers as opposed to remuneration in the form of commission.

The concept of "person closely related to the enterprise" seems similar to the concept of "associated companies" in term of Article 9 of the OECD MTC, but it is different (OECD 2015b, Section A – 26) in the following way: A person will not be considered an independent agent if he/she works exclusively or almost exclusively for one or more enterprises to which he/she is closely related (OECD 2015b, Section A – 16). Similarly, a person is deemed to be closely related to an enterprise if "one has control of the other or both are under the control of the same persons or enterprises" (OECD 2015, p. Section A – 26). This rule also covers situations in which the control derived from a special agreement granting rights similar to those that a party would hold if it held, whether directly or indirectly, 50% of the beneficial interest in the enterprise (OECD 2015b, Section A – 26). The definition will automatically be satisfied if (OECD 2015b, Section A – 26):

- one person holds, directly or indirectly, more than 50% of the beneficial interests in the other (or in the case of company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company); or
- a third party holds, directly or indirectly, more than 50% of the beneficial interests (or in the case of company, more than 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in both the person and the enterprise.

Figure 7 provides a diagrammatic presentation of the changes.

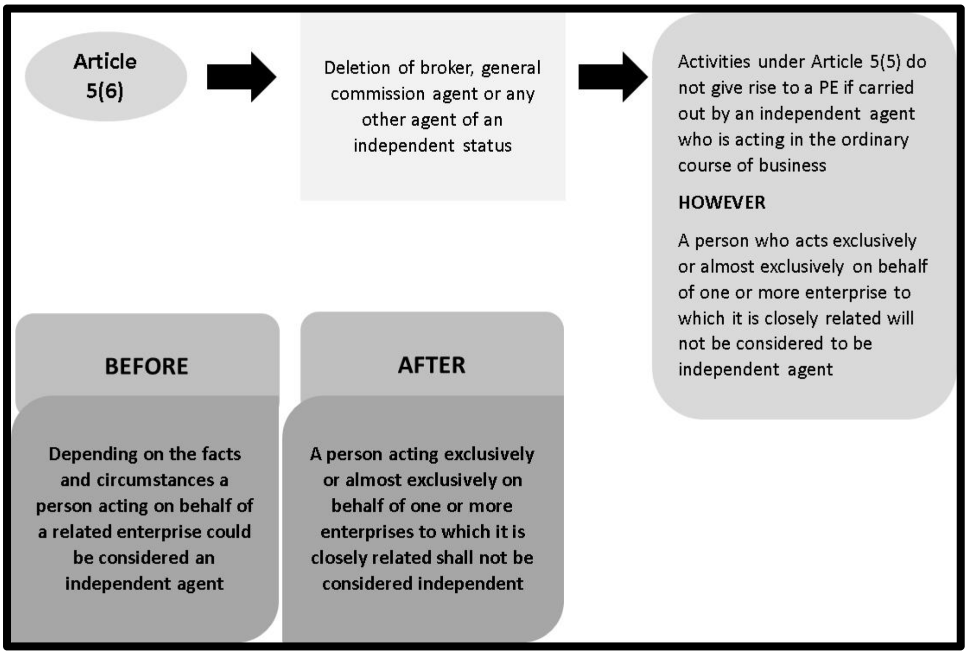

Figure 7**: Changes to Article 5(6) of the OECD Model Tax Convention on Income and Capital 2014**

4.4 Amendment to article 5(4)[15]

As mentioned previously, the use of specific activity exemptions available under Article 5(4) were being used in order to avoid PE status. As a result, the OECD proposed a new Article 5(4) in terms of which all the exceptions included therein are restricted to activities that are of a “preparatory or auxiliary character” (OECD 2015b, Section B-28 - 29). The amendment to Article 5(4) will serve as a “catch all” requirement in terms of which each specific activity or combination thereof must be of an “preparatory or auxiliary character” (OECD 2015b, Section B28 - 29). In its 2015 final Report on Action 7, the OECD notes that depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities (OECD 2015b, 10-executive summary). The OECD recommended that, in order to ensure that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) was modified to ensure that each of the exceptions included therein are restricted to activities that are otherwise of a “preparatory or auxiliary” character (OECD 2015b, 10-executive summary).

An activity has a “preparatory character” if the activity is done in contemplation of carrying on what constitutes the core business - the enterprise’s essential and significant activity. It generally precedes another activity and may be carried out during a relatively short period (although not necessarily). An activity having an “auxiliary character” generally involves support to the enterprise’s core business without being part of the essential and significant activity. It is unusual that an activity which requires a considerable portion of the assets or employees of the enterprise would be considered auxiliary in nature (OECD 2015b, Section B-30). Defining “core business” or “essential and significant activity” of the enterprise would be necessary to avoid the risk of subjective application. Figure 8 provides a diagrammatic presentation of the changes:

[15] Provided as Addendum F

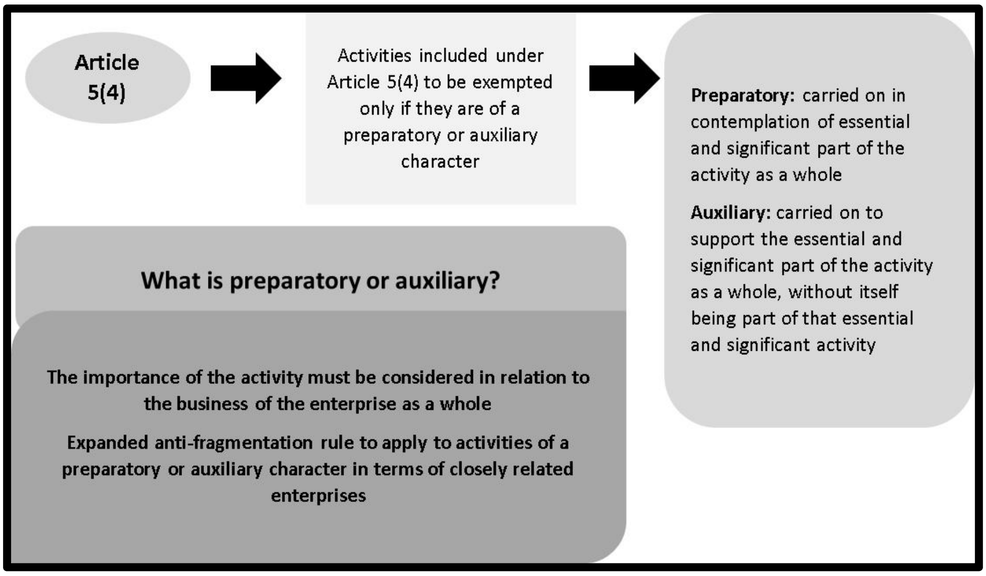

***Figure 8*: Changes to Article 5(4) of the OECD Model Tax Convention on Income and Capital 2014**

In Section 4.4.1 the impact of these changes is discussed.

4.4.1 Practical application in a digital economy

When Enterprise A maintains a large warehouse in foreign State B - utilising significant resources, including employees, storing, and delivering goods that A owns and sells to online customers in State B, storage and delivery activities will be deemed to be a central and vital aspect of A's business, and therefore, would no longer be considered auxiliary in character (OECD 2015b, Section B-31).

4.5 Anti-fragmentation rule

The new anti-fragmentation rule was introduced in Paragraph 4.1 of Article 5[16]. This rule prevents Paragraph 5(4) from providing an exemption from PE status for enterprises that fragment a cohesive operating business into smaller operations, in order to argue each is merely engaged in activities that are of a preparatory or auxiliary in nature (OECD 2015b, Section B – 40). The OECD is of the view that due to the ease of setting up subsidiaries, the anti-fragmentation rule should be extended to cases where these places of business belong to closely related enterprises (OECD 2015b, Section B – 39).

[16] Included as Annexure G

The anti-fragmentation rule would therefore prevent the exemptions under Article 5(4) from applying to a fixed place of business used/maintained by an enterprise, "if the same enterprise or closely related enterprise carries on business activities at the same place or another place" in the same country (OECD 2015b, Section B – 39). In addition, in order for paragraph 4.1 to apply (OECD 2015b, Section B – 39 to 40):

- At least one of the places where these activities are carried out must meet the definition of a PE; or
- The overall activity by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not preparatory or auxiliary.

The new Paragraph 4.1 will only apply if the business activities carried on by the two enterprises constitute "complementary functions that are part of a cohesive business operation" (OECD 2015b, Section B – 39 to 40). Depending on the circumstances, the anti-fragmentation provision applies when activities carried on by "two enterprises at the same place, or by the same enterprise or closely related enterprise at the two places, constitute complementary functions that are part of a cohesive business operation" (OECD 2015b, Section B – 39). Figure 9 provides a diagrammatic presentation of the changes. The impact of these changes will be discussed in Section 4.5.1.

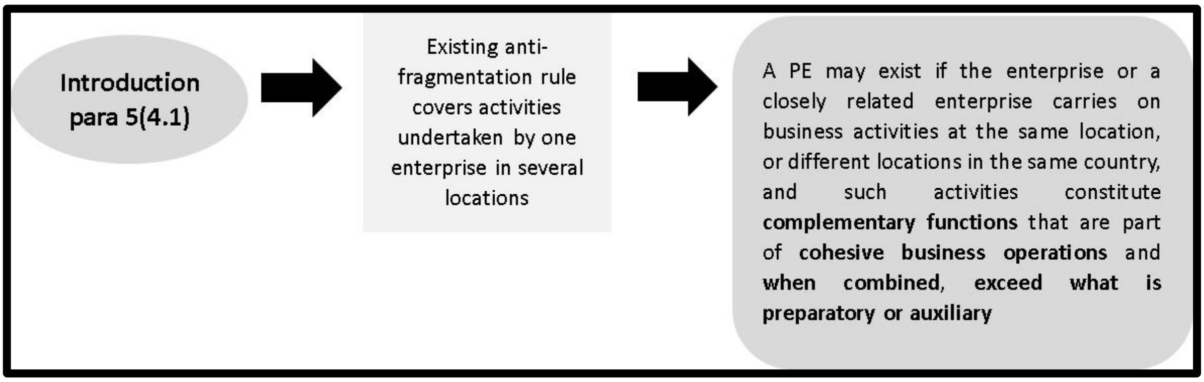

***Figure 9*: Changes to Article 5(4) of the OECD Model Tax Convention on Income and Capital 2014**

4.5.1 Practical application in a digital economy

The following example illustrates the application of Paragraph 4.1 (OECD 2015b, Section B – 41):

Enterprise A (in State A) manufactures and sells software. Enterprise A has:

- 100% subsidiary in State B that owns and operates stores where B sells (as a retailer) software acquired from Enterprise A; and
- Owns a small warehouse in State B where it displays a few items of software identical to those displayed in the stores belonging to subsidiary B.

When a customer buys an item from subsidiary B, B's employees are allowed to take possession of items in A's warehouse (which are located in State B) for customers and Subsidiary B acquires (from a legal point of view) these items when they leave A's warehouse. In this instance, the new anti-fragmentation rule will apply as:

(1) Enterprise A and B are closely related enterprises;

(2) Subsidiary B's store constitutes a PE; and

(3) The business activities carried on by Enterprise A at its warehouse and by Subsidiary B at its store constitute complementary functions that are part of a cohesive business enterprise (storing goods in one place for the purpose of delivering these goods through another place in the same country).

4.6 Summary

As mentioned previously, the existing definition of PE requires some sort of physical presence which is not relevant to a webstore. As a result of the absence of a "fixed place of business", the source state is unable to tax sales made through the website in that state, thus enabling enterprises to artificially avoid a PE status. This results in BEPS as the profits are not being taxed in the state where the sales are taking place. The OECD has realised that as a result of technology and the internet, non-residents are able to carry on business in a country without a taxable presence. This necessitated the updating of the definition of PE which aims to prevent the exploitation of this geographical anonymity (OECD 2018, p. 93; Medus 2017, p. 41).

Before the amendments to the PE definition, non-residents were able to enjoy substantial profits from transactions with customers located in another country. It is anticipated that these changes will restore source taxation where "cross-border income would otherwise go untaxed or would be taxed at very low rates" (OECD 2015b, p. 9). The next chapter will deal with tax policy developments and the measures adopted by different countries to protect their tax bases.

CHAPTER 5: INITIATIVES TO ADDRESS TAXATION IN THE DIGITAL ECONOMY: TAX POLICY DEVELOPMENTS

5.1 Introduction

This chapter deals with the initiatives to address taxation in the digital sector with specific reference to tax policy developments as well as measures adopted by various countries in an attempt to protect their tax bases. Some countries have imposed a tax on turnover for highly digitised businesses[17] and some have expanded the nexus rules in order to tax highly digitised non-resident businesses that have a significant economic presence in their country (Australian Treasury 2018, p. 13).

Section 5.2 deals with the details of the OECD and EC reports issued in March 2018 and January 2019 that provide an update on taxation in the digital economy in order to provide a background to the discussions in the rest of the chapter. Section 5.3 details what countries have done to protect their tax bases in the absence of a global solution and anti-avoidance measures addressed by countries to prevent MNEs profits from being taxed elsewhere. In Section 5.4 the view expressed by The Association of International Certified Professional Accounts in terms of taxation in a digitised economy is discussed. Section 5.5 deals with historical suggestions on how to approach taxation in a digital economy. The chapter concludes with a summary in Section 5.6.

5.2 Background

In the OECD 2015a Report, the OECD committed to continue monitoring the role of digitisation in the international arena and to report back in 2020. In this report, it was stated that, should countries decide to make unilateral changes to their tax framework, they would have to respect their treaty obligations (OECD 2015a, p. 13).

By 2017 a number of countries had introduced unilateral changes to their tax framework and the European Union (EU) was threatening to do the same. In

[17] Highly digitised businesses are identified by 3 key characteristics namely scale without mass, heavy reliance on intangibles and data and user participation (OECD 2018, p. 24).

response to this, the G20[18] requested the Task Force of the OECD to issue an interim report on their progress in April 2018 (Dateline: U.S. 2018, p. 56). As a result of this, the OECD and EC published their progress on 16 and 21 March 2018 respectively. Overviews of these reports are provided in Section 5.2.1 and 5.2.2.

5.2.1 The OECD report

The OECD interim report issued on 16 March 2018, *Tax Challenges Arising from Digitalisation-Interim Report 2018*, builds on the OECD 2015 report, *Addressing the Tax Challenge of the Digital Economy, Action 1 – 2015 Final Report*. It was stated that members of the Inclusive Framework[19] (IF) have not reached a consensus as to if and to what degree digitisation impacts international tax rules. Despite the different points of view of IF members, it was acknowledged that the members of the IF have a common interest in maintaining a "relevant and coherent set of international rules to address the cross-border taxation of business profits in a way that improves, inter alia, economic efficiency and global welfare" (OECD 2018, p. 173). As a result, the members agreed to review the two fundamental concepts of the existing tax framework, namely, profit allocation (how much profits to tax) and nexus (where to tax the profits) (OECD 2018, p. 166). The IF is divided into 3 schools of thought (OECD 2018, pp. 171-172):

- The first group of countries notes the lack of recognition of the user contribution to the value-creation as a shortcoming of the existing international framework. However, this may be addressed through targeted amendments to existing tax rules. These countries do not want to see any changes to the broad international taxation principles.
- The second group of countries is of the view that the current profit allocation and nexus rules are no longer appropriate for the changing global economy and these challenges are not exclusive to the digital economy. Some, but not all of the countries, reject the idea that user contribution should be considered as a driver of value-creation.
- The third group of countries is of the view that the BEPS Project has, to a large extent, dealt with the concerns of double non-taxation (however, they

[18] Membership of the G20 includes 19 individual countries plus the European Union.
[19] The **OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS)** brings together over 128 countries and jurisdictions to collaborate on the implementation of the BEPS Package.

are aware that it may still be too early to assess the impact) and don’t see the need for any significant changes to the international tax rules.

According to the *PwC Global Tax Policy: PwC EU Direct Tax Group*, since so many countries are involved, getting everyone to agree will be a rather challenging task (Dateline: U.S., p. 58). Implementing a global solution will take some time, and there is a chance that no consensus will be reached. Although the OECD is not in favour of any interim measures, they understand that some countries may take unilateral action (OEDC 2018, p. 178). Should this be the case, the OECD noted that this may result in adverse consequences on the impact on investment, innovation, growth, welfare, may result in double taxation, and may lead to compliance and administration costs (OECD 2018, p. 178-180). In addition, the OECD set out certain considerations that should be taken into account when considering the introduction of interim measures (OECD 2018, p. 180-189), namely:

- There should be compliance with international obligations and no conflict with tax treaties.
- It should be a temporary measure and cease to exist once a global solution is reached.
- Interim measures should be targeted at those businesses which are considered high risk. In addition, the interim measure should apply to e-services and not all services that take place over the internet.
- Over-taxation should be minimised.
- The impact on start-ups, business creation and small businesses should be minimised. This could be achieved through the introduction of a gross threshold.
- Cost and complexity should be kept to a minimum.

The IF will move towards providing a consensus-based solution by 2020 with an update provided in 2019 (OECD 2018, p. 173).

5.2.2 March 21, 2018 European Commission

In a media release issued on the same day as the EC publication on 21 March 2018, Valdis Dombrovskis, Vice-President for the Euro and Social Dialogue said (European Commission 2018, pp. 1-2):

> Digitalisation brings countless benefits and opportunities. But it also requires adjustments to our traditional rules and systems. We would prefer rules agreed at the global level, including at the OECD. But the amount of profits currently going untaxed is unacceptable. We need to urgently bring our tax rules into the 21st century by putting in place a new comprehensive and future-proof solution.

Pierre Moscovici, Commissioner for Economic and Financial Affairs, Taxation and Customs added (European Commission, 2018c, p. 2) stated in the media release:

> The digital economy is a major opportunity for Europe and Europe is a huge source of revenues for digital firms. But this win-win situation raises legal and fiscal concerns. Our pre-Internet rules do not allow our Member States to tax digital companies operating in Europe when they have little or no physical presence here. This represents an ever-bigger black hole for Member States, because the tax base is being eroded. That's why we're bringing forward a new legal standard as well as an interim tax for digital activities.

Digital business has contributed significantly to the economic growth in the EU, however, the current tax rules are not designed to cater for companies which have global, virtual or little or no physical presence. The world has undergone such dramatic change that nine of the world's top 20 companies by market capitalisation are now digital, in comparison to one in 20, ten years ago. Due to these staggering statistics, it is vital that the digital companies contribute to the tax base (European Commission 2018c, p. 1).

In order to ensure a "fair share of tax revenues from online activities" (European Commission, 2018c, p. 2) the EC introduced 2 distinct legislative proposals which they believe will "lead to a fairer taxation of digital services in the EU" (European Commission, 2018c, p. 1). In an attempt to stop countries form seeking unilateral solutions to tax digital activities, which creates a "legal minefield and tax uncertainty for business", a coordinated approach is necessary which would result in long term benefits (European Commission, 2018c, p. 1). As a result of the above, the EC introduced the following two proposals:

- Proposal for a **Council Directive** laying down rules relating to the corporate taxation of a significant digital presence (European Commission, 2018a); and

- Proposal for a **Council Directive** on the common system of a digital services tax on revenues resulting from the provision of certain digital services (European Commission, 2018b).

The above proposals were issued in March 2018 which included the following two initiatives:

- A change to the EU's corporate tax rules relating to digital activities; and
- Digital service tax

These two initiatives will be discussed in Section 5.2.2.1 and Section 5.2.2.2 respectively.

5.2.2.1 A change to EU's corporate tax rules relating to digital activities (digital PE)

This preferred long-term solution (OECD 2018a, p. 4) is aimed at creating a nexus in a territory where a company has a significant digital presence (i.e. profits will be taxed in a territory if there is a significant digital presence), despite there not being a physical presence (this is in addition to the PE concept). A significant economic presence exists in a member state if one or more of the following criteria are met (European Commission 2018a, pp. 7-8)

- Revenues from providing digital services[20] to users in a jurisdiction exceed EUR 7 000 000 in a tax year
- The number of users of the digital services is greater than 100 000 in a tax year
- The number of business contracts for digital services is greater than 3 000

In terms of determining the amount to be taxed, the proposal suggests that a functional analysis should be performed and the 'profit split method' is the preferred method for the allocation of profits, alternatively another more appropriate profit

[20] A digital service has been defined in Chapter 1 of Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence issued by the EC in March 2018 (European Commission, 2018a, p. 14-15).

allocation method may be used provided the appropriateness thereof can be proved by the taxpayer[21] (European Commission 2018a, p. 8, 9 and 18).

According to the *PwC Global Tax Policy: PwC EU Direct Tax Group*, the opinion is that these changes represent a significant departure from the current OECD definition of PE (as neither establishment, nor permanence is a requirement), and would only really impact countries where there are no double taxation agreements. PwC is of the opinion that if member states change the treaties between themselves, "this would be a significant change in the allocation of taxing rights internationally, and poses a very low threshold for a foreign taxpayer to come within the charge to tax" (Dateline: U.S. 2018, pp. 61 and 62). In short, this proposal creates a connection between where digital profits are made and where they are taxed.

5.2.2.2 Digital service tax – interim measure

The EC acknowledges in the 2018 media release (European Commission 2018c, p. 2) that the comprehensive long-term solution as indicated above would take some time and introduced this interim measure to ensure that "those activities which are currently not being effectively taxed would begin to generate immediate revenues for Member States". The interim measure would also assist in preventing member states from introducing their own unilateral solutions would could seriously damage the Single Market (European Commission 2018b, p. 5).

This indirect tax will be applied to revenues from certain digital services which remain untaxed in terms of the current taxation framework (European Commission 2018b, p. 4). This Digital Services Tax (DST) will be levied on gross revenues from the provision of certain digital services where users play a major role in the chain of

[21] The proposal suggests profit splitting factors may include the expenditure incurred on research and development or the number of users and data collected (Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence issued by the EC in March 2018 (European Commission, 2018a, p. 18)

value creation (European Commission 2018b, pp. 6 and 7). These taxable revenues are created from (European Commission 2018b, p. 7):

- Selling online advertising space
- Sale of data generated by users providing information
- Provision of intermediary services which allow users to interact with each other which may result in the sale of goods and services between them.

In terms of the proposal, an entity above the following two thresholds will be liable for DST (European Commission 2018b, pp. 10 and 11):

- Consolidated global revenues greater than EUR 750 000 000; and
- Taxable revenues exceeding EUR 50 000 000.

If the above two thresholds are met, a DST of 3% will be paid on gross revenue by member states where the users are located. The DST is applicable to businesses meeting the above thresholds irrespective of whether they are established in a member state or not and is due where the user is located. The location will be based on the Internet Protocol (IP) address of the user or any other method of geolocation in the member state (European Commission 2018b, pp. 11-12). The proposal recommends that, when dealing with consolidated groups, there is an option to nominate a single entity to deal with the compliance issues and to pay the tax due (European Commission 2018b, p. 12).

From the above it would appear that the thresholds are targeting large groups. According to the European Commission press release (2018, p. 2), it is estimated that the introduction of this tax may generate an estimated EUR 5,000,000 tax revenues based on a rate of 3%. PwC is of the opinion that a 3% levy could have the following impact (Dateline: U.S. 2018, pp. 62 and 64):

- Eroding many businesses' net margins which may result in the forced renegotiation of treaties to accept the PE concept, or seek some other form of reactive measure. Businesses would need to consider their future profitability to determine whether they now or in the future will fall into the thresholds.
- This high tax rate could be an initiator to encourage member states to renegotiate treaties in line with the more favourable long-term solution.

In summary, tax revenue will be collected based on certain thresholds where the user is located. It is envisaged that this tax will be implemented by 1 January 2020 and given that member states have differing views, this appears highly optimistic. In addition, since the OECD report is due in 2020, many states may wait for the outcome of the report before making any firm decisions (Dateline: U.S. 2018, p. 64). In terms of the EU, in order to introduce a new tax, all 28 member states have to agree unanimously unless a smaller group acts through the EU's enhanced cooperation instrument[22] which requires the support of only 9 member states.

5.2.3 OECD Policy Note issued in January 2019

5.2.3.1 Background

To provide a background to the *OECD Policy Note* issued in January 2019, a brief recap of events leading up to the issuing is provided. The timeline of these events is depicted in Figure 9 (OECD 2019c).

***Figure 9*: Timeline of events leading to the issuing of the OECD Policy Note of January 2019**

[22] According to the European Union website, the "enhanced cooperation is a procedure where a minimum of 9 EU countries are allowed to establish advanced integration or cooperation in an area within EU structures but without the other EU countries being involved. This allows them to move at different speeds and towards different goals than those outside the enhanced cooperation areas. The procedure is designed to overcome paralysis, where a proposal is blocked by an individual country or a small group of countries who do not wish to be part of the initiative. It does not, however, allow for an extension of powers outside those permitted by the EU Treaties".
https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1526387769790&uri=LEGISSUM:enhanced_cooperation

The issuing of the *BEPS Action 1 Report* in October 2015 was followed by the *OECD's Interim Report on Tax Challenges Arising from Digitisation* in March 2018. In this report, the IF committed to continue to work together to issue a final report in 2020, with an update in 2019. As a result, the IF and the Task Force on the Digital Economy (TFDE) met in July 2018 where members put forward proposals on how to achieve a global consensus-based solution. Some proposals addressed the allocation of taxing rights (broader tax challenges) while another proposal focused on more of the general unresolved BEPS issues (OECD 2019b, p. 7).

Based on the outcome of the July 2018 meeting, the IF agreed to continue working on the proposals on a "without prejudice" basis and also try and bridge the gaps between the different schools of thoughts identified in the March 2018 interim report (OECD 2019b, p. 7). In January 2019, the OECD released a policy note, *OECD/G20 Base Erosion and Profit-Sharing Project: Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, as approved by the Inclusive Framework on BEPS on 23 January 2019* (OECD 2019)*,* which included proposals brought forward by its members. These proposals are examined under two pillars (OECD 2019a, pp. 1 and 2):

- The first pillar will address the broader tax challenges of the digital economy with a focus the allocation of taxing rights (nexus and profit allocation)
- The second pillar will focus on the remaining BEPS issues.

According to OECD (OECD 2019a, p. 1) a two-pillar approach recognises that the digitisation of the economy is pervasive, and recognises that a global solution is required (OECD 2019a, p. 1). The two pillars will be explained in Section 5.2.3.1.1 (nexus and profit allocation) and Section 5.2.3.1.2 (BEPS).

5.2.3.1.1 Pillar 1: Nexus and allocation

The first pillar, relating to nexus and allocation, is summarised by the OECD (2019a, p. 2) as follows:

Pillar one: nexus and allocation

> "Under the first pillar, focused on the allocation of taxing rights including nexus issues, several proposals have been made that would allocate more taxing rights to market or user jurisdictions in situations where value is created by a business activity through participation in the user or market jurisdiction that is not recognised in the framework for allocating profits."
>
> OECD Policy Note

***Figure 10*: Pillar one: nexus and allocation**

This pillar will focus on the allocation of taxing rights between jurisdictions (including nexus issues). Under this pillar, proposals have been made to allocate taxing rights based on (OECD 2019c, Slides 10–12):

a. *User participation. This proposal involves the revision of the existing rules on profit allocation and nexus with reference to active user contribution. This proposal would apply to **highly digitised businesses** and recognises the **value created by users of digital services.***

Value generated by user participation is not captured under the current international tax system which focuses on the physical activities of a business in determining the allocation of taxing rights. Under the current international tax system, businesses are able to derive substantial profits from a jurisdiction which has a significant user base without the profits being subject to tax in that jurisdiction. The aim of this proposal is to better align the allocation of profit with value creation and allow for the revision of the nexus rules which would allow the right to tax profits in the user jurisdiction (OECD 2019b, p. 10).

b. *Marketing of intangibles. This proposal involves the revision of the existing rules on profit allocation and nexus with reference to marketing of intangibles.*

This proposal is applicable generally to most types of businesses and recognises the value created by the market jurisdiction.

The OECD 2019b recognises there is a "functional link between marketing intangibles and the market jurisdiction" (OECD 2019b, p. 12) which is evidenced in two different ways namely:

- brand and trade names which create a favourable attitude in the minds of customers and as a result, have created a market in the jurisdiction; and
- customer data, customer relationships and customer links are "derived from activities targeted at customers and users in the market jurisdiction, supporting the treatment of such intangibles as being created in the market jurisdiction" (OECD 2019b, p. 12).

A consequence of this proposal would be the ability of the market jurisdiction to tax highly digitised businesses, despite the absence of a taxable presence, as a result of the importance of marketing intangibles for such business models (OECD 2019b, p. 12). The digitisation of the economy has allowed businesses to interact with customers in a jurisdiction either remotely or through a limited physical presence which results in a loss in taxing rights in the market jurisdiction. For example, an online retailer may have limited physical presence in a jurisdiction despite having a large user and customer base in that jurisdiction and know more about the shopping habits of its users or customer base than a local shop in the same area (OECD 2019b, p. 13).

c. *Significant economic presence. This concept was first dealt with in the OECD 2015a Action 1 report and proposes that nexus should be based on significant economic presence and aims for simplified, easy to administer solutions.*

This proposal is based on the view that digitisation has enable businesses "to be heavily involved in the economic life of a jurisdiction without having a significant physical presence" (OECD 2019b, p. 16). According to the OECD, the existing nexus and profit allocation rules are no longer effective (OECD 2019b, p. 16). This proposal creates a taxable presence in a jurisdiction when a non-resident enterprise has a significant economic presence based on factors “that evidence a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means” (OECD 2019b, p. 16) and one can establish a link between the “revenue-generating activity of the non-resident enterprise and its significant economic presence” (OECD 2019b, p. 16).

The IF agreed to consider these proposals (a-c above) on a without prejudice basis (OECD 2019a, p. 2) and appreciate that these proposals may fundamentally challenge the current international tax system as they require changes to current nexus and profit allocation rules (OECD 2019b, p. 17). For example, some of the proposals require reconsidering the current transfer pricing rules and all proposals would lead to “solutions that go beyond the arms-length principle” (OECD 2019a, p. 2). These are all well-known taxation principles.

These proposals would also go beyond the limitations on taxing rights which is presently determined with reference to a physical presence which is a fundamental tax concept in terms of current international tax rules. The IF agreed that issues of profit attribution and nexus are required to be dealt with simultaneously with each playing a key role in any solution implemented, understanding that this may result in changes in tax treaties. Dealing with the nexus issue, the IF has agreed to explore new concepts which would include changes to the PE threshold, namely the concept of “significant economic presence” (discussed in the Action 1 Report 2015) or “significant digital presence” which is a departure from the way double tax treaties are designed (OECD 2019a, p. 2). Given all of the above, the IF will have to strike the right balance between accuracy and simplicity and ensure that the solution is administrable by tax authorities and taxpayers whilst taking into account the abilities of the different countries (OECD 2019a, p. 2).

5.2.3.1.2 Pillar 2: BEPS

The second pillar, relating to BEPS, is summarised by the OECD (2019a, p. 2) as follows:

Pillar two: BEPS 2.0

> "The proposal under this pillar would be designed to address the continued risk of profit shifting to entities subject to no or very low taxation through the development of two inter-related rules, i.e. an income inclusion rule and a tax on base eroding payments."
>
> OECD Policy Note

***Figure 11*: Pillar two: BEPS**

Under the second pillar, the IF agreed "without prejudice" to investigate a basis of taxing rights that would enhance the ability of a jurisdiction to tax profits where the other jurisdiction which has the taxing rights, applies a low tax rate to tax those profits. Under this pillar, proposals are aimed to address the challenge of profit shifting, where an entity is subject to no or low rates of taxation through the introduction of two inter-related rules being (1) an income inclusion rule; and (2) a tax on base eroding payments (OECD 2019a, p. 2).

In conclusion, taking into account the various proposals under pillar 1 and 2, the members of the IF will have to perform an in-depth analysis of each proposal and their impact before any final decision is made. The IF recognises that taking on these challenges together and in a co-ordinated fashion may go a long way in easing the tension that exists in the international tax architecture which is evidenced by a number of countries taking unilateral decisions to protect their tax bases (OECD 2019a, p. 3).

The IF agrees that any amendment to rules should not have a taxation impact where there is no economic profit or result in double taxation. In addition, tax should be certain, simple and not create a compliance burden. Given the complexity of issues to be discussed, the short time frame and the fundamental nature of the proposed changes, the IF have instituted a Steering Committee to develop an intensive programme with detailed instructions which the IF could possibly approve in its May 2019 meeting, in order to provide another update to the G20 Finance Ministers in June 2019 with the view to deliver the ultimate solution in 2020 (OECD 2019a, p. 3). Figure 12 indicates the timeline with the OECD's planned steps for 2019 (OECD 2019c).

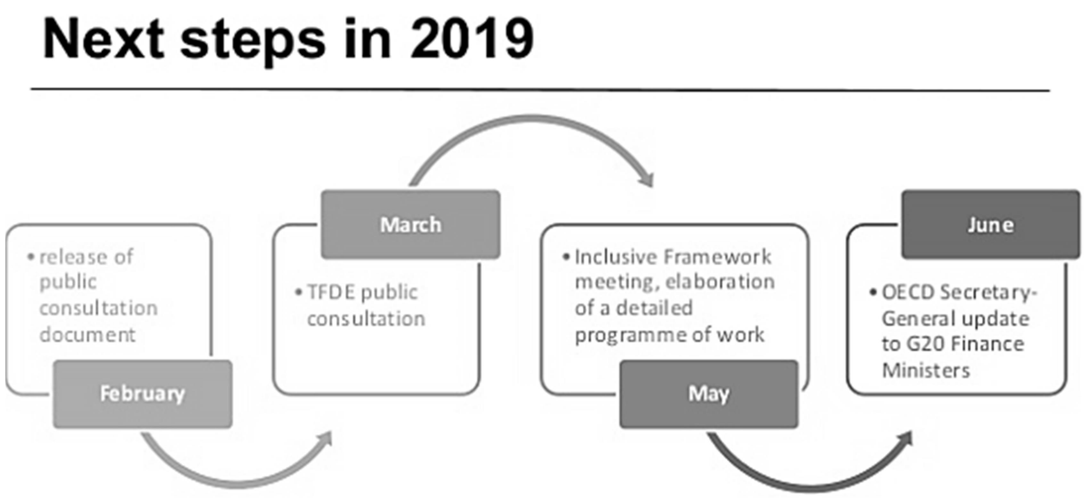

***Figure 12*: OECD's timeline of planned steps in 2019**

The OECD issued the *BEPS Project Public Discussion Document, Addressing the tax Challenges of the Digitalisation of the Economy 13 February – 6 March 2019* (OECD 2019b), which provides more detail on the proposals indicated above. This public discussion document (with the various proposals included therein) will hopefully contribute to a "long term solution to the broader tax challenges arising from digitalisation of the economy and the remaining BEPS issues" (OECD 2019b. p. 7). These proposals are discussed at a high level given that they are still at the design policy phase (OECD 2019b, p. 7).

Feedback relating to the OECD (2019b) Public Discussion document has been extended to 6 March 2019 in order to ensure all stakeholders are given an opportunity to provide feedback, with the public consultation meeting scheduled for 13-14 March 2019. The OECD's public invitation can be accessed at the following web address:
http://www.oecd.org/tax/oecd-invites-public-input-on-the-possible-solutions-to-the-tax-challenges-of-digitalisation.htm

5.3 Unilateral actions

As mentioned previously, in anticipation of a global solution and given the understanding that it will take time to implement, member states feel pressure to react in order to protect their countries' tax bases. As a result, many countries have taken a unilateral approach to ensure a fair allocation of taxing rights due to the globalisation and the digitisation of the economy (European Commission 2018b, p. 3). In the following sub-sections (Section 5.3.1 to Section 5.3.12) examples of what countries have done in this area are provided.

5.3.1 France (turnover tax)

France has implemented a 2% (maximum 10%) tax on the "online and physical distribution of audio-visual content (known as the YouTube tax). In the case of creating a nexus in France, the tax is based on the destination of the supply (OECD 2018, p. 146). In December 2018, the Minister of Economy and Finance, Bruno Le Maire, announced during a press conference that France would implement a 3% digital tax on advertising revenue, online marketplaces and resale of personal data as from 1 January 2019. He estimated that this tax based on revenue should generate roughly EUR 500 million in revenue in 2019 (French Government, 2018).

5.3.2 Italy (turnover tax)

Italy has published in its Official Gazette on 1 January 2019 that it proposes to introduce a digital service tax (Law no.145/2018). The Ministry of Finance is required to issue an implementing decree by 30 April 2019 and the DST will apply as from the 60th day after its publication in the Official Gazette. The DST will be at a rate of 3%. The thresholds for the implementation of the DST are as presented in Table 5 (EY, 2019):

Table 5

Italy DST versus EU DST proposal

	Italian DST (2019)	EU DST Proposal
Taxable Persons	Entity (either resident or nonresident) carrying on business activities that meet the following thresholds in the calendar year: ▸ Total amount of revenues (wherever arose) not lower than €750,000,000 ▸ An amount of revenues derived in **Italy** from the carrying out of **digital services** not lower than €5,500,000	Entity (either resident or nonresident) carrying on business activities that meet the following thresholds in the calendar year: ▸ Total amount of revenues globally arisen in the previous financial period exceeding €750,000,000 ▸ An amount of revenues arisen **in the EU** during the same financial period exceeding €50,000,000

5.3.3 Hungary (turnover tax)

Hungary's advertisement tax applies to net sales (excluding VAT) of both resident and non-resident enterprises on the sale of advertising time or space in Hungary. The list of advertising services is broad and covers TV and radio, newspapers, billboards, vehicles, real estate and internet websites. In the case of online advertising, a nexus is created when the advertisement is displayed mainly in the Hungarian language (OECD 2018, p. 145).

5.3.4 India (form of turnover tax)

India announced a specific measure called the equalisation levy, aiming to level the playing field. Instead of imposing a straight tax on digital advertising platforms, India will charge 6% on the fees paid by advertisers. The core of the issue is that multi-national digital platforms don't have permanent establishments in the country, which would make them liable to pay tax in India (Chanchani, Alawadhi & Dave 2016; Indian Government 2016, p. 53).

The 6% tax in the form of an equalisation levy was introduced on 1 June 2016 and must be deducted from amounts paid to non-residents who don't have a PE in India for "specified services" being "online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement (Indian Government 2016, p. 53). This levy is to be withheld by residents who conduct business in India or non-residents who have a PE in India (Indian Government 2016, p. 53). The levy came to be known as the Google tax because the bulk of online advertising expenditure went to the search engine giant (Chaturvedi & Bureau 2018).

The Indian Government has reported that for the period June 2016 (implementation date) to March 2017, the revenue generated from the equalisation revenue has amounted to 3.4 billion Indian Rupees (approx. EUR 52million) (OECD 2018, p. 142).

5.3.5 India: New nexus based on significant economic presence

With effect from 1 April 2019, India amended its domestic nexus rules relating to business income and introduced the concept of significant economic presence

(SEP). The legislation defines that SEP of a non-resident can be defined by two thresholds (Indian Government 2018, Section - 9; OECD 2018, p. 138):

- Threshold based on local revenue: “any transaction in respect of any goods, services or property carried out by a non-resident in India including provision of downloading of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or
- Threshold based on number of local users: “systematic and continuous soliciting of business activities or engaging in interaction with such number of users as may be prescribed, in India through digital means”

This amendment would result in the taxation of profits of a non-resident business on a source basis irrespective of the level of physical presence in that tax jurisdiction. It is also important to note that the amendment will only apply to countries with no double tax treaty until changes are made to Indian double tax treaties (OECD 2018, p. 138).

5.3.6 Israel (significant economic presence)

The Israeli Tax Authority (ITA) issued Administrative Circular No. 04/2016 (only available in Hebrew) and used the concept “significant economic presence” to address the challenges faced by the digital economy (OECD 2018, p. 137). The circular makes a distinction between treaty and non-treaty countries. In terms of a treaty country, the ITA states that due to the nature of the digital economy, a company which has a significant digital presence in Israel may be deemed to be a PE, even if the activity meets the exclusion of being preparatory or auxiliary in nature (thus excluded from PE definition). In terms of a treaty country, the “activity of a foreign company may generally give rise to a taxable presence in Israel under the domestic law if the income generating business activity is concluded in Israel. The circular provides guidance for implementing this rule in the context of the digital economy” (EY Global Tax Alert 2016, p. 2). A significant digital presence includes, but is not limited to (EY Global Tax Alert 2016, p. 2):

- A significant number of contracts are concluded online between foreign entity and Israeli customers
- A large number of Israeli customers utilising the digital service

- The online service is adjusted for Israeli users (e.g., use of Hebrew language, style, use of Israeli currency, etc.)
- High web traffic by Israeli users

Consultation with the ITO is vital in order to determine the existence of a PE or significant digital presence as mentioned above (EY Global Tax Alert 2016, p. 2)

5.3.7 Saudi Arabia (other measures, service PE)

Saudi Arabia’s Department of Zakat and Income Tax (DZIT) recently changed its approach to the interpretation of the PE concept with respect to services rendered by non-residents in the Kingdom of Saudi Arabia (the Kingdom). DZIT introduced the concept of a “Virtual Service PE” (Association of International Certified Professional Accountants 2018, p. 2) which may result in the denial of withholding tax relief claimed by non-residents under the applicable double tax treaties of the Kingdom. DZIT introduced a “Virtual Service PE” concept, according to which a non-resident is deemed to have a PE in the Kingdom if the following conditions are met (EY 2015):

- A non-resident furnishes services to a person in connection with the latter’s activity in the Kingdom
- The period during which such services are rendered according to the contract, exceeds the threshold period under the applicable tax treaty (most often the 183-day period threshold is used following the UN Model Convention).

Therefore, Saudi Arabia is establishing the concept of virtual PE based on the UN Tax Model.

5.3.8 Diverted profits tax in the UK (Google tax) (anti abuse tax target MNE’s)

The UK established the diverted profits tax (DPT) or the so-called Google tax at a rate of 25% on 1 April 2015 to counter the artificial erosion of the UK tax base. It avoids the PE principle and allows the UK to tax large groups, typically MNEs, having a significant economic activity in the UK, by establishing a nexus in the market jurisdiction. The aim is to ensure that “profits taxed in the UK fully reflect the economic activity here” (HM Treasury, 2018a, pp. 3 and 4). This tool is used to decrease the possibility of profit shifting by avoiding the use of contractual arrangement aimed at avoiding taxable presence. According to Medus (2017, p. 64) Google merely determined that they were not subject to the tax.

5.3.9 Austria (turnover tax)

Chancellor Sebastian Kurz intends to introduce a digital tax in Austria in 2020 (Dubush 2019).

5.3.10 Slovak Republic (significant economic presence)

Effective from 1 January 2018, the Slovak Republic extended the definition of fixed place of business for a PE to include non-resident operators of digital platforms who frequently conclude contracts providing transportation and accommodation services within the Slovak Republic (EY Global Tax Alert 2018, p. 3).

5.3.11 Spain

In January 2018, Spain introduced a 3% digital tax which is estimated to collect EUR 1.2 billion. This tax is aimed at large companies with revenues of EUR 700 million globally and at least EUR 3 million in Spain (Rodriguez, 2019).

5.3.12 United Kingdom

HM Treasury (2018b) issued a report, *Corporate tax and the digital economy: position paper*, in November 2017 and updated the report in March 2018. The position paper essentially provides insight into the government's thinking and suggests that users are important aspects of value-creation and the most "preferred and most sustainable solution" would be to "reform the international corporate tax framework to reflect the value of user participation" (HM Treasury 2018b, p. 3). The UK Government understands the complexity of the OECD reaching an agreement amongst all parties and is therefore receptive to working with other countries to achieve an interim solution based on a turnover solution (HM Treasury, 2018b, p. 24).

The UK is of the opinion that current international tax rules do not recognise the value created by user participation (OECD 2018b, p. 14) and that "the government's position is that active user participation creates value for certain digital businesses, and that jurisdictions in which users are located should be entitled to tax a proportion of those business profits" (OECD 2018b, p. 15). The position paper asks the questions (HM Treasury, 2018b, p. 15)

- Where are the profits from user participation currently being realised?
- How do you measure the user created value?

There is an attempt to answer these questions with the follow solutions as proposed in the paper.

- In highly digitised businesses, the value from user participation most likely resides with companies in the group which received residual profits (profits after an arms-length rate of return). The UK government is of the opinion “that some relocation of the profits currently recorded by these companies to user jurisdictions is justified” which would in some way reflect the value created (HM Treasury 2018b, p. 15).
- The UK government is of the opinion that, “a percentage share of residual profit realised by principal companies in the group” would be a mechanism to reward user created value (HM Treasury 2018, p. 16).
- The government suggests:
  - An arms-length return to companies for which comparable information is available; and
  - Allocating a share of residual profits to user jurisdictions to reflect the value created by user participation (HM Treasury 2018b, p. 20).

The UK government understands that if user participation were to be used in the allocation of taxing rights and profits of countries, this would require amending the international tax framework to ensure:

A. user participation is recognised as an important value driver for certain businesses;
B. set out a method for determining value is set out;
C. identification of the companies within a business group that users should be linked to, and that should therefore be taxed on profits attributable to user created value as determined in the preceding step;

D. jurisdictions in which users are located are given the right to tax those companies, even if they are non-resident companies that do not have a permanent establishment under traditional definitions;
E. a method for determining the proportion of those companies' user-created profits is set out, as determined by Step B, that should be allocated to each user jurisdiction that has been awarded a taxing right under Step D (HM Treasury 2018b, p. 19 and 20).

In order to give effect to the changes above, the UK government believes that Articles 5, 7 and 9 of the *OECD Model Tax Convention 2014 on Income and Capital* will have to be modified as well as transfer pricing and profit attribution guidelines that relate to those articles (HM Treasury 2018b, p. 20).

Effective April 2020 the UK will introduce a UK Digital Service Tax (DST) which is expected to raise revenues of GBP 500 million a year. According to HM Treasury and Hammond (2018):

> Digital platforms delivering search engines, social media and online marketplaces have changed our lives, our society and our economy, mostly for the better [but] they also pose a real challenge for the sustainability and fairness for our tax system… the rules have not kept pace with changing business models….The UK has been leading attempts to deliver international corporate tax reform for the digital age,…. but progress is painfully slow. We cannot talk forever so we will now introduce a UK digital services tax….It will be carefully designed to ensure its established tech giants – rather than our tech start-ups - that shoulder the burden of this new tax.

The DST will be levied at 2% on the "revenues of certain digital businesses to ensure the amount of tax paid in the UK is reflective of the value they derive from their UK users" (HM Treasury, 2018c, p. 44). In terms of his 2018 budget speech, Hammond also stated that the UK is currently working with the G20 and OECD to agree upon a global solution and should this be achieved he may abandon the DST and adopt the global solution (HM Treasury & Hammond 2018).

5.3.13 Australia's MAAL and DPT (anti abuse tax targeting MNEs)

The Multinational Anti-Avoidance Law (MAAL) came into effect on 11 December 2015 and is part of the Australian government's effort to combat tax avoidance by MNEs operating in Australia. The MAAL seeks to ensure that profits made by MNEs in Australia, are taxed in Australia where MNEs have a global revenue of above $1 billion (Australian Government 2017). According to the *Treasury Discussion Paper* issued in October 2018, *The digital economy and Australia's corporate tax system*, as of 30 October 2018, 44 MNEs had already changed or were in the process of changing their tax affairs to comply with the MAAL. According to their statistics, "more than $7 billion in sales annually is expected to be returned to the Australian tax base as a result of the MAAL (Australian Treasury 2018, p. 12).

The DPT was introduced as a second package to the MAAL and came into effect on 1 July 2017. The aim of the DPT is to prevent MNEs who shift profits made in Australia offshore in order to avoid paying tax. The DPT will apply to MNEs with a global income greater than $1 billion levied at a rate of 40%. DPT is aimed at MNEs who enter into arrangements with the principal aim of avoiding to pay tax in Australia by diverting profits to offshore related parties (Morrision press release 2017). The DPT aims to ensure that the "tax paid by multinational enterprises reflects the economic substance of their activities in Australia" (Australian Treasury 2018, p. 12).

The Australian Tax Authority (ATO) together with the Tax Avoidance Taskforce (formed in July 2016) have raised over $10.5 million in taxes due (approximately $7 billion relating to large public groups and MNEs) and collected over $6 billion in cash (approximately $4.1 billion relating to large public groups and MNEs) (Australian Treasury 2018, p. 12).

The Government has also implemented the following (Australian Treasury 2018, p. 12; Morrision press release 2017):

- Effective 1 July 2015, the maximum administration penalty for MNEs entering into schemes which result in tax avoidance and profit shifting has doubled.
- Effective 1 July 2015, MNEs which fail to comply with their reporting obligations will be fined with a maximum penalty of $525,000.

- Penalties will be double where MNEs make a false or misleading statement to the ATO.

5.3.14 USA

Introduced as part of the Tax Cuts and Job Act (TCJA), the new “base erosion and anti-abuse tax” (BEAT) is applicable to certain corporations that make “base erosion payments” paid or accrued by US corporations or branches subject to US income tax to foreign related parties (Villano & Leeds 2018, p. 1). This tax is not only specific to the digital economy but rather targets large MNEs in the US. The aim is to achieve a minimum corporate income tax based on a specific calculation which limits deductions in respect of a range of payments (examples are interest and royalties). The projected revenue to be raised from the implementation of BEAT is estimated at USD 149.6 billion (OECD 2018, p. 148).

5.4 Views of the Association of International Certified Professional Accountants

There is a general consensus (but not all agree) that it is best to achieve a global co-ordinated approach regarding the taxation of the digital economy rather than a unilateral approach. The Association of International Certified Professional Accountants[23] (AICPA, 2018, p. 2) is in favour of a solution that would:

- allow for the resolution of disputes,
- avoid double taxation; and
- adhere to global standards and tax treaties as much as possible.

However, some countries would prefer to act immediately on a unilateral basis to impose digital taxes. Such countries include the countries discussed in the previous sections (Association of International Certified Professional Accountants 2018, p. 2 and 3). In the modern world, most companies (irrespective of their size) are involved in some way or another in the digital economy, through the use of a website, social media, online advertising or the sale of goods and services online, therefore the same “basic international tax rules should apply to all companies in relation to sourcing of profits and the right to tax (Association of International Certified Professional Accountants 2018, p. 3).

[23] The Association of International Certified Professional Accountants is the most influential body of professional accountants in the world

The AICPA is not in favour of digital taxes and prefer for the OECD and UN to “adopt a more sustainable modification of the PE concept…. and should work to develop an administrable, predictable, and enforceable PE standard with which all business of all sizes can easily comply” (Association of International Certified Professional Accountants 2018, p. 7).

Although the debate on revenue vs. source taxation is ongoing, it appears that a number of jurisdictions favour source taxation rather than residence taxation. An example of the source-based taxation would be the proposed digital service tax DST by the EC based on the user’s location. One of the major issues using the user’s location is that fact that the provider of the service will only know their tax liability after the service has been consumed, which is not practical. The AICPA is not in favour of this source taxation and would prefer a digital tax based on residence of the provider of the digital service as this is more predictable allowing providers of the goods/service to manage their affairs with some level of certainty (Association of International Certified Professional Accountants 2018, p. 9).

5.5 History of previous recommendations

5.5.1 OECD

In the OECD’s, 2015a, *Base Erosion and Profit Shifting Project Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report (BEPS Action 1)* some options are proposed to address the tax challenges of the digital economy, namely (OECD 2018, p. 134):

- Taxable nexus based on significant economic presence;
- Withholding tax on digital transactions; and
- An equalisation levy.

Since not all countries could agree on the way forward, none of the above options were adopted as international standards. However, there is an understanding that countries could introduce any of the above options in their domestic laws, provided they “respect their existing treaty obligations and other international obligations” (OECD 2018, p. 134)

The OECD BEPS Discussion Draft dated March 2014 (OECD 2014b, p. 65) mentioned several options for amending the definition of a PE, particularly a very creative option of a new nexus standard called "significant digital presence" based on a test for the presence of a virtual PE, resulting in a greater allocation of taxable revenue to the country of sales. When a digital business does not necessarily require a taxable presence according to existing tax principles, the OECD suggested that "fully dematerialized digital activities" could constitute a PE if a significant digital presence is maintained in a country's economy (OECD 2014b, p. 65).

5.5.2 Virtual PE

Pursuant to this approach, a virtual permanent establishment was also proposed split into 3 broad categories (OECD 2014b, p. 66):

- A "virtual fixed place of business PE", which would create a permanent establishment when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website;
- A "virtual agency PE", which would seek to extend the existing dependent agent PE concept to circumstances in which contracts are habitually concluded on behalf of an enterprise with persons located in the jurisdiction through technological means, rather than through a person; and
- An "on-site business presence PE", which would look at the economic presence of an enterprise within a jurisdiction in circumstances in which the foreign enterprise provides on-site services or other business interface at the customer's location.

This concept raised various criticisms. According to the European Centre for International Political Economy (ECIPE) (Lee-Makiyama & Verschelde 2014, p. 2), a digital presence and virtual PE would in essence create a separate tax regime applicable to the digital economy. It would not only contradict the OECD's neutrality principle but also the free movement of services in the European single market. Moreover, requiring online services to register locally would not be in accordance with multi-lateral free trade agreements on cross border services trade. It could also curb productivity as ICT is the main driver of economic growth.

It was decided that the BEPS project would discard the concept of virtual PE and the discussion moved towards the establishment of a “deemed PE” and the amendment of Article 5(5), which includes the dependent agent provision. As such, taxpayers whose current sales entity structures may create deemed PE’s under the new standards need to start considering what alternatives they may have.

5.6 Concluding remarks

Change has already started with countries making unilateral changes as they grow frustrated waiting for a global solution. Unless an agreement is reached soon, more countries will seek to introduce their own solutions. Many argue that if special taxes for the digital economy were introduced, it would be ‘discriminatory taxation on productivity-improving activities’ (Lee-Makiyama & Verschelde 2014, p. 10). The 1998 Ottawa Principles regarding taxation are based on the principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility (OECD, 1998, p. 4). There is a certain level of consensus to keep the Ottawa principles as a basis for tax reform underscoring that ring-fencing the digital economy would violate the tax neutrality principle (Hadzhieva 2016, p. 33). These views are also shared by the AICPA (Association of International Certified Professional Accountants, 2017, p. 3).

Double-taxation and compliance of a range of options could have a negative impact on cross border trade, investment, and growth in the digital economy. PwC makes some interesting comments regarding the digital economy namely (Dateline: U.S. 2018, p. 64):

- The digital economy should not be separated and taxed separately
- There needs to be an understanding as to how value is created in the digitalised business models and determine if this is really different from traditional businesses
- Unilateral actions/potential solutions will have a negative impact
- The tax effects of the digital economy should be the same as traditional business

CHAPTER 6: CONCLUSION

6.1 Overview of chapter

In this chapter the research study is summarised to indicate how the research question was answered. The limitations of the study are discussed and the significance of this study is highlighted.

6.2 Overview of the research questions and objective

Firstly, to recap, the primary research question was formulated as follows:

What is the impact of e-commerce on taxation?

In order to address the research question, secondary questions were formulated:

- *What are the broader tax challenges in a digital economy and how have these challenges led to tax avoidance practices?*
- *What is the impact of e-commerce on taxation specifically in terms of the artificial avoidance of the permanent residence status?*
- *How is the artificial avoidance of the permanent residence status prevented with specific reference to the OECD's modifications to the OECD Model Tax Conventions 2014 on Income and Capital Article 5 to prevent artificial avoidance of PE status?*
- *What practices have been put in place by some countries to protect their tax bases?*

Based on the research question, the objective of this research was to explore and provide an overview of the existing literature to determine what the impact of e-commerce has been in terms of the challenges it poses to taxation. Due to the exploratory nature of the research, it was a qualitative study within the interpretivist paradigm. In this study, the aim was not to identify a specific theory, but rather to explore the existing literature and provide an overview of how e-commerce affects taxation within the framework of the primary and secondary research questions by doing a systematic literature review.

The full domain of e-commerce and taxation is vast and complex and as such it is beyond the scope of a research report, therefore, the key challenge that was explored is the artificial avoidance of the permanent residence status which is an issue that lies at the heart of the nexus issue since a PE normally requires some sort of physical presence which is not necessarily the case in the digital economy. This focus provided insight into the current set of rules in terms of whose right it is to tax (source vs residence) with a particular focus on the prevention of artificial avoidance of PE status. To explore these issues in depth, the recommendations made by the OECD and European Commission regarding taxation in the digital economy and well as the unilateral measures adopted by some countries to protect their tax base were also attended to.

6.3 Summary of the research study

In Chapter 1, the study was firstly contextualised by defining key concepts such as e-commerce versus brick-and-mortar organisations, digital enterprises, cyberspace and the digital economy.

Thereafter, an argument was built to indicate the importance of understanding taxation in the digital economy. It was highlighted that e-commerce has become a significant part of the global economy and it is expected to grow in the foreseeable future. As stated by the OECD (2015a, p. 11) “the digital economy is increasingly becoming the economy itself and it is increasingly impossible to ring-fence the digital economy from the rest of the economy for tax purposes”. Following from this, the nature of e-commerce was described to indicate the various challenges in terms of tax jurisdiction which leads to the erosion of countries’ tax bases.

The problem statement was formulated and it was highlighted how, in the online environment, products and services are uploaded, downloaded, purchased and used without products or people necessarily physically crossing international borders which is a key characteristic of e-commerce taking place in cyberspace – a nonphysical environment without boundaries. It was indicated how this creates complex tax challenges as significant profits may be generated from a source within a country in the absence of a physical presence in that country and the relation to the concept of nexus was briefly discussed, and it was indicated that, in the past, the right to tax has been based on the principles of source and residence (concepts elaborated on in Chapter 2). It was argued that these principles can no longer be applied with absolute clarity due to the borderless nature of e-commerce transactions (De Wilde 2015, p. 1). Furthermore, it was argued that the relevance of a concept such as “permanent establishment” should also be questioned as it refers to “a permanent physical presence in a country” which doesn’t apply to an online store in cyberspace (De Wilde 2015, p. 1).

Based on this discussion, and pertaining to the problem statement, it was also indicated how the nature of the digital economy has allowed companies to pay minimal taxes (Hadzhieva 2016, p. 15) and how various strategies are employed by companies with a digital footprint that erodes the taxable base of the country where the sales took place. The OECD and the G20’s commitment to the principle that “profits should be taxed where economic activities deriving the profits are performed and where value is created” was also highlighted (G20 Leaders 2013, p. 12).

Since the central points of reference relating to taxing rights and jurisdiction are source jurisdiction and residence jurisdiction, these key concepts were discussed in detail in Chapter 2. The related terms of reference were also elaborated upon, namely, the existence of a permanent establishment as it relates to source jurisdiction and the place of effective management as it relates to residence jurisdiction. These are fundamental to the issue of jurisdiction and according to De Wilde (2015, p. 2) “international tax law has applied these legal, physical and geographical references for the past 100 years or more”. It was indicated that a non-resident is taxed in a source country if its business is carried on through a PE and the primary characteristic of a PE was questioned as a PE requires a physical presence which is clearly not relevant for a webstore. In terms of residence, it was indicated that an enterprise is taxed in a jurisdiction where it has its place of effective management (POEM). It was argued that, with the use of modern technology, MNEs can manipulate their POEM by conducting multiple business operations from various locations. It was highlighted how, when structures are put in place requiring no physical presence in conjunction with strategies that avoid taxation in the resident country, substantial BEPS issues are created, resulting in revenue not being taxed at all.

Chapter 3 was dedicated to a deeper exploration of the tax challenges in a digital economy with specific reference to tax avoidance practices. It was argued that the current international tax rules were developed in the 1920's and is firmly based on the physical and, given the broader tax challenges that exist in the digital economy (nexus, data and value-creation and the characterisation of payments) it was stated that one needs to consider the efficacy of the current system in a modern, digital age. The key tax challenges were identified as nexus, data and value-creation and characterisation of payments and the impact of highly digitised business models.

To link the impact of highly digitised business models with the nature of these models, three common characteristics of highly digitised businesses were identified, namely, scale without mass, heavy reliance on intangibles and data, as well as user participation and their synergies with IP. It was indicated how and to what extent these characteristics affect the current international tax system.

It was further argued that these challenges created an environment where significant tax avoidance practices are employed by highly digitised organisations. The key tax avoidance practices were identified as: avoiding withholding tax, the use of preferential tax regimes, artificial internal trading of intangibles, internal debt shifting, transfer pricing and avoiding taxable presence.

Since one of the central themes of digitisation is the ability to access global markets remotely, without having a physical presence, which is a key requirement for a permanent establishment, Chapter 4 was dedicated to a detailed discussion on the prevention of artificial avoidance of PE status. Firstly, actions taken by enterprises to artificially avoid PE status were discussed in further detail to provide a background to the prevention of this practice. This discussion focused on four strategies employed by organisations to artificially avoid the PE status, namely: replacing local distributors with commissionnaire agreements, other contracting strategies, classifying activities as preparatory or auxiliary, and fragmenting activities between closely related parties.

Based on this discussion, it was highlighted what has been done to prevent the artificial avoidance of PE status. This topic was addressed in terms of: the amendments to Articles 5(5), 5(6) and 5(4) of the *OECD Model Tax Convention on Income and Capital 2014*. In each instance, it was also indicated what the practical application of each of these is in the digital economy.

In Chapter 5 the initiatives to address taxation issues in the digital economy were discussed in terms of the OECD report of 2018, the European Commission directives of 2018 in terms of a change to the EU's corporate tax rules relating to digital activities (digital PE) and digital service tax as an interim measure, as well as the OECD Policy Note issued in January 2019. The two pillars of the 2019 OECD Policy Note were discussed, namely nexus and allocation as well as BEPS.

It was indicated that the first pillar "without prejudice" will focus on the allocation of taxing rights between jurisdictions (including nexus issues) and under the second pillar, the IF agreed "without prejudice" to investigate a basis of taxing rights that would enhance the ability of a jurisdiction to tax profits where the other jurisdiction which has the taxing rights, applies a low tax rate to tax those profits. It was stated that, under this pillar, proposals are aimed to address the challenge of profit shifting, where an entity is subject to no or low rates of taxation through the introduction of two inter-related rules being (1) an income inclusion rule and (2) a tax on base eroding payments (OECD 2019a, p. 2).

Taking into account the various proposals under pillar 1 and 2, it was argued that the members of the IF will have to perform an in-depth analysis of each proposal and their impact before any final decision is made. Furthermore, it was stated that the IF recognises that taking on these challenges together and in a co-ordinated fashion may go a long way in easing the tension that exists in the international tax architecture which is evidenced by a number of countries taking unilateral decisions to protect their tax bases (OECD 2019a, p. 3).

It was stated that, in anticipation of a global solution and given the understanding that it will take time to implement, member states felt pressure to react in order to protect their countries' tax bases. As a result, many countries have taken a unilateral approach to ensure a fair allocation of taxing rights due to the globalisation and the digitisation of the economy (European Commission 2018b, p. 3). To clarify this, examples of what countries have done in this area were provided.

The chapter concluded with highlighting the views of the Association of International Certified Professional Accountants as well as an overview of previous recommendations to address the tax challenges in the digital economy. This was discussed with reference to measures of the OECD, virtual PE and bandwidth tax.

It was argued that, since change has already started with countries making unilateral changes as they grow frustrated waiting for a global solution, more countries will seek to introduce their own solutions in the absence of a global solution. It was further highlighted that many argue that if special taxes for the digital economy were introduced, it would be 'discriminatory taxation on productivity-improving activities' (Lee-Makiyama & Verschelde 2014, p. 10).

The importance of the 1998 Ottawa Principles regarding taxation, namely, neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility (OECD, 1998, p. 4) were highlighted as there is a certain level of consensus to keep the Ottawa principles as a basis for tax reform underscoring that ring-fencing the digital economy would violate the tax neutrality principle (Hadzhieva 2016, p. 33). These views are also shared by the AICPA (Association of International Certified Professional Accountants, 2017, p. 3). The perspectives of PwC (Dateline: U.S. 2018, p. 64) were also incorporated as summarised below:

- The digital economy should not be separated and taxed separately
- There needs to be an understanding as to how value is created in the digitalised business models and determine if this is really different from traditional businesses
- Unilateral actions/potential solutions will have a negative impact
- The tax effects of the digital economy should be the same as traditional business

6.4 Concluding remarks

It is clear that some form of tax reform is necessary given the impact of digitisation on the economy. As mentioned many times in the research, the current international tax architecture is based on rules which are primarily aimed at a bricks-and-mortar business firmly rooted in the physical. However, in the digital economy, MNEs conduct significant business in a jurisdiction with no or limited physical presence. As a result of this, the current international tax framework has become outdated as "value creation is becoming less dependent on physical presence" (OECD 2018, p. 169).

The G20/OECD are firmly committed to the principle that "profits should be taxed where economic activities deriving the profits are performed and where value is created" (G20 Leaders 2013, p. 12). This is being actively pursued with the release of the OECD 2015 Report, the later OECD March 2018 updated report on the digital economy, and more recently the January 2019 OECD Policy note. All 3 proposals require a re-thinking of the traditional nexus concept and need to go "far beyond the limitations on taxing rights determined by reference to physical presence" (OECD 2019b, p. 17). This is a fundamental shift from the current international tax system.

In addition, to obtain a consensus by all the members of the IF is no easy task, and considering we are already in 2019, "reaching international consensus on nexus and profit allocation rules by 2020 seems to be ambitious, albeit still the objective" (Hadzhieva 2019, p. 12). Should the OECD fail to achieve a global solution by 2020, not only would this seriously taint their reputation as a standard setting body but also pave the way for "further fragmentation of international rules through uncoordinated and complex unilateral rules" (Hadzhieva 2019, p. 12).

The EC is also committed to obtaining a consensus based global solution as evidenced by their March 2018 report where the EC introduced a short-term measure – Digital Service Tax, and a long-term measure – Digital PE.

Both the OECD and the EC will have to continue working tirelessly to achieve the required global consensus-based solution by 2020, failing which would lead to undesirable consequences and have a negative impact on international efforts.

6.5 Limitations of the research

This study is restricted to direct income taxes. Furthermore, this study is limited to legal persons or persons other than natural persons as referred to in the Income Tax Act 58 of 1962. The implications of indirect taxes, including VAT, and Actions 2, 3, 4, 5, 6, 8, 9, 10, 11, 12, 13,14 and 15 of the OECD/G20 Base Erosion and Profit Sharing Project, 2015 have not been addressed as such an extensive study is beyond the scope of this research report.

Aspects that are related to the existence of, or lack of existence of a permanent residence, such as, splitting up of contracts, strategies for selling insurance in a State without having PE and profit attribution to PE's and interaction with action points on transfer pricing, all dealt with in Action 7 of the OECD/G20 Base Erosion and Profit Sharing Project: Preventing the Artificial Avoidance of PE Status 2015 Final Report, have not been addressed in this research as such an extensive review is beyond the scope of this report.

6.6 Significance of the study

While this is a literature review, creators of tax policy may find this research useful as it provides an assessment of the impact of e-commerce on the digital economy as well as highlights tax avoidance practices used by companies used in the digital economy.

In conducting the research, it became apparent to the researcher that South Africa has very limited exposure in the field of the tax challenges relating to e-commerce. Major legal firms were consulted to provide their input, however the feedback received was that they are inadequately equipped to assist due to the lack of skills in this field. This research could therefore provide insight into some of the key tax challenges identified in the international arena and this could provide a starting point from a South African perspective. It is clear that e-commerce has become a significant part of the global economy and will continue to grow in terms of the percentage of revenue that is generated through e-commerce and South Africa needs to upskill itself in this area.

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ADDENDUMS

1.4 Addendum A

BEPS 2015 Final Reports

Actions 1 -15

Action 1: Addressing the Tax Challenges of the **Digital Economy**

Action 2: Neutralising the Effects of **Hybrid Mismatch Arrangements**

Action 3: Designing Effective **Controlled Foreign Company Rules**

Action 4: Limiting Base Erosion Involving **Interest Deductions** and Other Financial Payments

Action 5: Countering **Harmful Tax Practices** More Effectively, Taking into Account Transparency and Substance

Action 6: Preventing the Granting of **Treaty Benefits** in Inappropriate Circumstances

Action 7: Preventing the Artificial Avoidance of **Permanent Establishment** Status

Actions 8-10: Aligning **Transfer Pricing** Outcomes with Value Creation

Action 11: **Measuring** and Monitoring BEPS

Action 12: Mandatory **Disclosure Rules**

Action 13: Guidance on **Transfer Pricing Documentation** and Country-by-Country Reporting

Action 14: Making **Dispute Resolution** Mechanisms More Effective

Action 15: Developing a **Multilateral Instrument** to Modify Bilateral Tax Treaties

4.1 Addendum B

OECD, 2017, Model Tax Convention on Income and on Capital: Condensed version (OECD, MTC, 2017)

ARTICLE 7

BUSINESS PROFITS

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article (23 A] [23.B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.

4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

4.1 Addendum C

United Nations, 2017, Model Double Taxation Convention between Developed and Developing Countries (UN DTC, 2017)

Article 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (*a*) that permanent establishment; (*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.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or

for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

> (NOTE: The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)

4.2.1 Addendum D

Artificial avoidance of PE status through commissionnaire arrangements and similar strategies

A commissionnaire arrangement may be loosely defined as an arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without having a permanent establishment to which such sales may be attributed for tax purposes: since the person that concludes the sales does not own the products that it sells, it cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission).

4.3 Addendum E

CHANGES TO PARAGRAPHS 5 AND 6 OF ARTICLE 5

Replace paragraphs 5 and 6 of Article 5 by the following (changes to the existing text of Article 5 appear in ***bold italics*** *for additions and ~~strikethrough~~ for deletions):*

5. Notwithstanding the provisions of paragraphs 1 and 2 **but subject to the provisions of paragraph 6,** where a person — ~~other that an agent of an independent status to whom paragraph 6 applies~~ is acting **in a Contracting State** on behalf of an enterprise and ~~has, and habitually exercises, in a Contracting State, an authority to conclude contracts~~***, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are***

a) in the name of the enterprise, **or**

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

c) for the provision of services by that enterprise,

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. ~~An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.~~

> ***a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first- mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where,***

however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of

the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise.

4.4 Addendum F

Replace paragraph 4 of Article 5 by the following (changes to the existing text of the paragraph appear in ***bold italics*** of additions and ~~strikethrough~~ for deletions):

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity ~~of a preparatory or auxiliary character~~;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), ~~provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character;~~

provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

4.5 Addendum G

NEW ANTI-FRAGMENTATION RULE

Add the following new paragraph 4.1 to Article 5:

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

- **a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or**
- **b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,**

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