

Tax jurisdiction in a digitalizing economy; why ‘online profits’ are so hard to pin down

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Abstract

Although we live in an age in which everything and everyone is ‘online connected’, countries’ profit taxation systems are still based on an economic reality of around a century ago. And that creates tension. The problems this tension causes are 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. Although the time may not yet be ripe for fundamental reform, we perhaps ought in any event to start thinking about the direction in which our corporation tax systems should be moving. Suggestions in international tax literature, as well as from the OECD and EU, point in the direction of attributing the taxable base to the market jurisdiction; in other words, of imposing corporation tax on, or also on, the basis of the destination principle. There is certainly something to be said for these suggestions. The world is changing. And perhaps it is now time for our tax systems to change along with it.

1 Introduction

Globalization, worldwide competition, digitalization, ‘the internet of things’; the world around us is changing. But countries’ international profit taxation systems are not keeping up with the pace of this change. Indeed they have remained largely the same over the past century. These current systems for levying tax have become outdated, certainly with regard to how jurisdiction is determined; in other words, when states are authorised to impose tax. And the shortcomings in these systems are particularly evident in the case of profits generated by internet-related activities (‘online profits’). In today’s era of globalization and digitalization, the taxation model applied is unsuited for subjecting earnings from ‘virtual’ international business activities to adequate levels of tax.¹ The concept of the permanent establishment in profit taxes requires a permanent physical presence in a country, while this is obviously not relevant for a webstore. The ‘backstop’ of residency for tax purposes – i.e. the place of effective management – is as geographically mobile as the effective manager(s) of the company or group of affiliated companies operating the internet business. Against this background of a changing environment, the question arises as to whether we should perhaps now be changing, or at least considering the need to change, our profit taxation systems. This is the question at the heart of this article. Why is it so difficult for pin down the digital economy’s profits for tax purposes? And when can a state tax ‘online profits’ or, perhaps more importantly, when ought a tax jurisdiction to be able to do so?

2 Determining tax jurisdiction; ‘nexus’

2.1 Nexus; ‘residence’ and ‘source’ as points of reference ...

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¹ See also Eva Escribano López, ‘An Opportunistic, and yet Appropriate, Revision of the Source Threshold for the Twenty-First Century Tax Treaties’ 43 *Intertax* 6 (2015), p. 6-13.

The general idea when allocating the right to tax business profits in an international context is that tax should be imposed on such profits once, and then as closely as possible to the geographical source of the income.² According to the OECD, the source of income is “the jurisdiction in which value creation occurs”.³ The difficult question then is to determine where that place is. You could say that it is where the company carries out its business activities, i.e. where it has an economic presence, or ‘nexus’. As a point of reference, however, that is not exactly very specific.

Countries allocate the right to tax company profits on the basis of the well-known principles of ‘source’ and ‘residence’. The relevant points of reference for determining jurisdiction in this respect are the existence of a permanent establishment (‘source’) and the place of effective management (‘residence’). International tax law has applied these legal, physical and geographical references for the past one hundred years or more. It could also be queried what exactly the difference is between ‘residence’ and ‘source’. According to Vogel, ‘residence’ in the sense of ‘place of effective management’ could equally well be taken to mean ‘place of source’, disregarding for a moment the related issue of limited or unlimited liability for tax.⁴ Whatever the case, these points of reference for subjecting profits to tax are all based on the idea that an enterprise needs to be legally and physically present in a market in order to earn money there. And that certainly was the case in the past, when international trade was primarily reliant on bulk trade and capital-intensive ‘bricks-and-mortar’ industries. In those circumstances, there was nothing really wrong with using these points of reference, for pragmatic reasons, to determine how to apportion taxation rights.⁵

These days, however, we live in a world of multinationals, open markets, ‘intangibles’ and the internet. And it is the internet, more than anything else, that has made it possible for businesses to supply markets without any need for a local presence, either physically or legally. Internet companies generate virtual profits from gaming, streaming, data storage or other forms of internet servicing activities such as social media platforms or online search engines. And our outdated points of reference make it difficult to subject these virtual profits to effective taxation. A webstore does not have physical business premises, while the company carrying out the store’s activities can be located in any jurisdiction whatsoever. That is why it is so hard to pin down the digital economy’s profits for tax purposes. The tools available in international tax law have simply become outdated and are no longer ‘fit for purpose’.⁶ It is as if we were trying to play an MP4 file on a gramophone player and then wondering why it didn’t work. And the increasing spread of the digital economy means the problem is becoming increasingly pressing. Where are the ‘internet of things’, the markets for mobile devices and maybe soon 3D printing and robotics leading us?

It should be pointed out that this issue also arose before the internet era, specifically in the case of the traditional mail order companies, most of which have now been replaced by online distance sellers (‘e-tailers’). These businesses, too, were notoriously difficult for tax authorities to pin down to specific jurisdictions. The reason for this was essentially the same as with today’s ‘e-tailers’: the geographical distance between business inputs on the supply side and business outputs on the demand side or, to put it simply, products are produced in one country and sold in another. The mail order company’s lack of a physical presence in the selling country, other than perhaps the glossy catalogue in the letter box, made it impossible for this country to subject the mail order company’s profits to effective taxation, even though the company was certainly economically active in that local market. And that was a thorn in the side of many tax authorities. The problem in those days was admittedly less widespread than that created by internet companies, at least in macro-economic terms. This was because mail order companies accounted for far less of a country’s gross domestic product than internet companies do today, while mail order companies also in any event still sold physical products. The software products of today’s internet companies, however, are just as virtual as the online platforms from which they can be downloaded.

² For in-depth assessments and literature references supporting the analysis in this section, see M.F. de Wilde, ‘*Sharing the Pie*’; *taxing multinationals in a global market*, diss. Erasmus University Rotterdam (2015), Ch. 6, available on ssrn.com.

³ See OECD (2013), ‘Action Plan on Base Erosion and Profit Shifting’, OECD Publishing, p. 10.

⁴ See Klaus Vogel, “‘State of Residence’ may as well be ‘State of Source’ – There is No Contradiction”, 59 *Bulletin for International Taxation* 420 (2005).

⁵ For a comparison, see López, *supra* note 1, Sec. 3.

⁶ See Tatiana Falcão, Bob Michel, ‘Assessing the Tax Challenges of the Digital Economy: An Eye-Opening Case Study’, 42 *Intertax* 317 (2014), p. 317-324.

2.2 ... or maybe 'origin' and 'destination'?

The question facing us today is whether we should simply do nothing and stick to the old, traditional model – like the proverbial ostrich with its head in the sand – or whether we should now start looking for possible solutions to a problem that is becoming more and more serious by the day.

If we do decide to go down the latter route, it may well be a good idea immediately to start thinking along totally different lines. By that I mean not continuing along the well-trodden route of 'residence' and 'source', but instead switching to 'origin' and 'destination'.⁷ 'Origin' represents the *supply* side of income production, where the production factors of capital and labour ('business inputs') converge, as in the durable organization of capital and labour used in income tax and corporation tax systems to determine whether a business is being operated. 'Destination', on the other hand, represents the *demand* side of income production and is where the goods and services produced are brought to market ('business outputs'), and where the existence of a source of income is conditional upon participation in economic or social exchanges. Perhaps we ought to take account of *both* sides of income production when seeking a point of reference for determining tax jurisdiction. That would mean taking account, for example, not only of the location at which capital and labour converge ('the origin country'), as is currently the case for business profits in tax law, but also of the place in which goods and services are effectively sold or supplied ('the destination country'), as is currently the case in VAT. As explained in more detail in section 3 of this article, ideas on allocating the base for the taxation of 'online profits' to the destination jurisdiction are actually already relatively well developed.

As outlined above, the underlying idea in corporation tax is essentially to impose tax as close to the geographical source of the income as possible. The geographical source is the location at which the value is created. But where is that location? Where does a multinational create its profit? Where does it add value? None of these questions has a simple answer. Profit is an *amount*, expressed in a monetary unit. With some effort we can determine *who* has earned that profit. But the more difficult – or perhaps even impossible – question to answer is *where* that profit is earned. This is because profit does not have any geographical characteristics.⁸

Profit is the resultant of the interplay of supply and demand. There is no profit without supply. But equally well there is no profit without demand. This may mean it is worth considering looking at both the supply and the demand sides when seeking to determine income's location. Rather than just looking at business inputs on the supply side, as we do now. But what should the split be? 30% demand, 70% supply? Or maybe the other way round? 50/50? Or maybe a customized apportionment ratio for each individual multinational? Multinationals perform functionally integrated business activities ('functions performed') using the assets available to them ('assets used') on a risk-bearing basis ('risks assumed') around the globe. The production factors of capital and labour are distributed across the world, while the goods and services the multinationals produce are traded on an equally worldwide basis. It can indeed truthfully be said that "[c]orporate profits are equally multinational as the multinational firm generating them."⁹ This in turn makes it extremely difficult to devise a suitable profit division mechanism.

Can the value drivers on the supply and demand sides actually be disentangled in any meaningful way? Or does its lack of geographical characteristics mean that profit does not ultimately have a location and that any attempt to allocate profits

⁷ See Peggy B. Musgrave, 'Principles for Dividing the State Corporate Tax Base', in Charles E. McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination*, (1984), p. 228 *et seq.* For a comparison, see Eric C.C.M. Kemmeren, 'Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach', 60 *Bulletin for International Taxation* 430 (2006).

⁸ See Michael J. McIntyre, 'The Use of Combined Reporting by Nation-States', in Brian J. Arnold *et al* (eds.), *The Taxation of Business Profits under Tax Treaties* (2003) 245, p. 253.

⁹ See Maarten de Wilde, 'Sharing the Pie': Taxing Multinationals in a Global Market', 43 *Intertax* 438 (2015), p. 444.

geographically should therefore be seen as inherently arbitrary? It would certainly seem so.¹⁰ The transfer pricing model, for example, attributes profit purely on the supply side and totally disregards the demand side. In contrast to what may sometimes be believed, transfer pricing does not in any way identify the *actual* location of profit. In the past it has been decided to attribute taxable profit to the places where the multinational's production factors converge. This says very little, however, about the actual location of that profit. This is because the production of goods and services does not in itself generate any profit; these goods and services first need to be sold. There need not necessarily be any causal relationship between business inputs on the supply side and profit, and there is not necessarily any positive correlation between one unit of labour and capital and one unit of profit.¹¹ The same also applies to a unit of business outputs.¹²

The idea that any apportionment mechanism is inherently arbitrary, given that profit has no location, can perhaps be regarded as worrying. But perhaps also as reassuring in that if profit does not have a geographical location, there is no need for the purpose of the apportionment mechanism to be to attribute profit to its actual location. The apportionment of a multinational's profit will then ultimately be little more than just a question of apportionment, albeit ideally in a manner with some degree of economic rationality. And, perhaps more importantly, in a manner that can broadly be regarded as fair. In my view, such an apportionment should not distort the use of production factors, or should at least cause as little distortion as possible.

If the demand side is relevant for creating income, why then does international tax law currently take no account of this when apportioning companies' international profits? The answer would seem to be that this is simply how things have evolved. The practice of allocating profit to the supply side is just how things have worked out and merely is a 'product of history'. There is not much more that can be said on that from a substantive perspective. It is a fact, however, that there have been increasing claims in society that failing to apportion any profit to the demand side is simply not 'fair' 'If a business sells its products here, why shouldn't it pay tax on the profits it earns?' Although these claims may be incorrect from an international tax law perspective – given that activities relevant to the sale may, for transfer pricing purposes, be performed elsewhere – is it actually so wrong for society to want to remunerate the market jurisdiction in this way? There have been calls in France, for example, specifically with reference to digital businesses active on the social media, to attribute profits to the jurisdiction in which those using the social media services are located.¹³ The idea in this respect is that the value added in that jurisdiction by those using these services justifies subjecting the social media company's virtual profits to tax; in other words, allocating the taxable base for profits tax to the market jurisdiction. On 1 April 2015 the United Kingdom introduced the 'diverted profits tax' ('DPT'), also commonly referred to as the 'Google tax' (*Finance (No. 2) Bill 2015*). This tax, which is imposed at a rate of 25% on what are referred to as 'diverted profits', has been introduced as an anti-abuse measure designed to counter artificial erosion of the UK tax base. It aims *inter alia* to establish jurisdiction to subject profits to tax if a multinational economically active in the United Kingdom has substantial sales of goods and services there and, by circumventing classification as a permanent establishment, has (previously) avoided liability to UK corporation tax. In other words, therefore, the DPT establishes a 'nexus' in the market jurisdiction. These developments in France and the United Kingdom are both in the direction of taxation in the destination country; in France this is as a generic rule, while the anti-abuse measure in the United Kingdom is of a less far-reaching nature. This is certainly different from the usual approach in tax law, but does that *consequently* mean it is wrong? If demand does not constitute a source of income, why then do people rush to join the queue even before that latest tablet of that particular brand has been released?

¹⁰ See Richard M. Bird and J. Scott Wilkie, 'Source vs. residence-based taxation in the European Union: the wrong question?', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union; Issues and Options for Reform* (2000) 78, p. 91.

¹¹ See James R. Hines Jr., 'Income misattribution under formula apportionment', 54 *European Economic Review* 108 (2010, No. 1), p. 108-120.

¹² *Ibidem*.

¹³ See Pierre Collin and Nicolas Colin, 'Task Force on Taxation of the Digital Economy, Report to the Minister for the Economy and Finance, the Minister for Industrial Recovery, the Minister Delegate for the Budget and the Minister Delegate for Small and Medium-Sized Enterprises, Innovation and the Digital Economy', January 2013.

International tax law does not currently allocate profit in a multijurisdictional environment to the market jurisdiction, at least not explicitly (see section 2.3), but this does not mean that such a system is inconceivable. Indeed, there are already profit tax systems that allocate the tax base to the destination jurisdiction. The ‘formulary apportionment systems’ used by individual US states, for example, increasingly attribute the tax base to the market jurisdiction, being the state in which the business sells its products. The same applies in the case of the Canadian ‘formulary allocation system’, in which the tax base is apportioned to the provinces for 50% by reference to a ‘sales factor’ based on market location and for 50% on the basis of a ‘payroll factor’.

Those who devised these apportionment mechanisms would seem to see the demand side as a source – or, indeed, other source – of income that justifies allocating the tax base to the market jurisdiction. There is certainly something to be said for that view, given that profit is the resultant of supply *and* demand. Of particular interest in this respect is the 1993 judgment by the Supreme Court of South Carolina in the case of *Geoffrey Inc. v. South Carolina Tax Commission*.¹⁴ This involved an out-of-state trademark owner, Geoffrey Inc., that was established in the US state of Delaware and licensed its ‘Toys “R” Us’ trademark to its affiliates in South Carolina in return for royalty payments. South Carolina subjected Geoffrey to South Carolina state tax on the grounds of its ‘intangible presence’ in this state. The Supreme Court observed that with regard to nexus for South Carolina state tax purposes, “... the real source of Geoffrey’s income is (...) South Carolina’s (...) customers...”.¹⁵ In other words, the Court saw a source of income on the demand side. It should be noted that the European Commission, too, continues to believe that member states should move towards ‘formulary apportionment’ in order to achieve a “holistic solution” to profit shifting.¹⁶ According to the 2011 proposal for a directive on a common consolidated corporate tax base, one third of the EU’s taxable base for profits tax would be attributed to the market jurisdiction if the sales factor were to be applied.

2.3 Tax jurisdiction in international tax law: only ‘origin’ or also ‘destination’?

Returning to the apportionment of the tax base in international tax law, it is perhaps interesting to examine the tax treaties through the prism of ‘origin versus destination’. As mentioned earlier, the dominant focus of the systems currently applied is on business inputs on the supply side, with international tax law allocating the taxable base to the country of origin. Consideration is given to ‘significant people functions’ (labour), ‘assets used’ (capital) and ‘risks assumed’, with the risks following the assets, which in turn follow the functions. Profit is ultimately then allocated to the place in which the people relevant to the enterprise perform the activities relevant to the enterprise, and thus to the supply side (labour) and the country of origin. The same applies when establishing the tax jurisdiction, given that there, too, the primary focus is on business inputs: the place of effective management (labour), the physical permanent establishment (a physical presence: capital), the services permanent establishment (labour) and the dependent agency permanent establishment (performance of representative functions: labour). All these places relate to the supply side of income production and take no account whatsoever of the demand side. Under the international tax regime, remote sales by an ‘e-tailer’, for example, do not create a taxable presence.

It is perhaps strange that the presence of capital alone is sufficient to establish tax jurisdiction, while the only factor that ultimately counts when allocating the tax base is the presence of labour. The existence of a ‘stand-alone server’ as a physical business establishment, for example, even if no labour is performed at that location, can create a permanent establishment and, therefore, establish tax jurisdiction. For the purposes of allocating the tax base, however, the risks assumed are deemed to follow the assets used, while the assets used are deemed to follow the functions performed. Here, therefore, the functions are dominant. It is perhaps hardly surprising then that problems arise in situations in which assets are used in different geographical locations

¹⁴ See Supreme Court of South Carolina, *Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13 (1993).

¹⁵ *Ibidem*.

¹⁶ See Communication from the Commission to the European Parliament and the Council, ‘A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action’, Brussels, COM(2015) 302 final, 17 June 2015, p. 7.

from the locations in which the functions are performed. Such situations give rise to tax jurisdiction without profit allocation, and to profit allocation without tax jurisdiction, i.e. for instance to a permanent establishment without profit, and to profit without a permanent establishment. How this will work out in the future once everyone has a 3D printer both at home and at work is anyone's guess. It should be noted, incidentally, that the concept of a fixed establishment in VAT specifically requires a combination of capital *and* labour.¹⁷

Although the origin country is dominant, international tax law also contains some points of reference for assigning jurisdiction to the destination country, i.e. the demand side of income production, albeit not specifically in those words. These are the references to "income arising..." in Articles 10, 11 and 12 of the model conventions of the OECD and the UN and indeed in most tax treaties. This income comprises payments to creditors in return for the use of borrowed capital ('interest'), payments to portfolio shareholders in return for the use of equity ('dividends'), payments to licensors for the use of intellectual property ('royalties'), payments for "information (know-how) concerning industrial, commercial or scientific experience" and payments for the "provision of technical services" or for "use of or the right to use industrial, commercial or scientific equipment". These provisions apply insofar as the service provider and the recipient are third parties. The economic reality within a group of companies, however, is different.

The point of reference for determining the jurisdiction for such service providers' income is the location of the recipient of the service. Reference is made to that recipient's place of residence or to the place where the recipient's business activities are performed (through a permanent establishment). The party providing the services is taxed at the place in which the services are received. This means, for example, that the creditor is taxed in the debtor's state, while the licensor is taxed in the licensee's state, the provider of rights to use equipment or expertise is taxed in the user's state and the portfolio shareholder is taxed at the place at which the capital is incorporated into the production process (barring any cases of extraterritorial taxation in the latter situation).

The tax mechanism applied in such situations is a withholding tax. A withholding tax on outbound dividends, outbound interest, royalties, leasehold payments and service fees. The tax base is the gross payment, with no costs eligible for deduction. Although it may have a different name, such a withholding tax is essentially a "sales tax" charged on certain services in the destination jurisdiction: a sales tax on outbound payments for specific types of inbound services and which are able to be offset against income tax or corporation tax in the state in which the service provider is resident. In international tax law, therefore, 'source' is not only to be found at the origin, but also, it turns out, at the destination.

It should be noted that views differ internationally on how fees for software user licences should be classified for treaty purposes. In many countries, the fees for a software download under a user licence do not normally qualify as royalties for tax treaty application purposes.¹⁸ They are more likely to be seen as remuneration for use of a product or service (i.e. the software) than for use of underlying intellectual property rights such as copyright and the like. Some countries, however, particularly emerging markets and countries with transition economies, do regard outbound payments for software user licences as constituting royalties under the broadened royalty article and so subject them to withholding tax.¹⁹ Admittedly this may be less correct from a legal-technical perspective, but it is nevertheless a good example of an attempt to subject digital gross profits to a withholding tax – or perhaps a sales tax – in the market jurisdiction.

3 Nexus; suggested points of reference for tax jurisdiction of 'online profits'

¹⁷ See, for instance, the Court of Justice (ECJ) case 168/84 (*Berkholz*).

¹⁸ See Machiel Lambooi, 'Chapter 13: Netherlands: Nexus for Purposes of Imposing Corporate Income Tax', in IBLs/Oxford University Press, *Global E-Business Law & Taxation*, 2009, 205-226, p. 215.

¹⁹ *Ibidem*, p. 217.

3.1 When should a tax jurisdiction be able to impose tax?

Tax jurisdiction and internet profits: in what circumstances should a country be allowed to tax 'online profits'? As well as regularly being examined in tax literature,²⁰ this question has now – thanks to the G20/OECD's Base Erosion and Profit Shifting ('BEPS') project – become a topical and politically important issue. It is interesting to note that when the topic of imposing tax on 'online profits' arises in an international environment, it is very often accompanied by calls for taxation rights to be allocated in one way or the other to the market jurisdiction.

The OECD's BEPS project seemed initially to be moving towards a new point of reference for establishing the tax jurisdiction for digital businesses. Indeed its Discussion Draft of 24 March 2014 referred to the possibility of introducing a new standard for nexus, based on a "significant digital presence" and with three options for testing for the presence of a "virtual permanent establishment": the "virtual fixed place of business PE", the "virtual agency PE" and the "on-site business presence PE".²¹ However, the report does not actually say very much on the subject of profit allocation.

As in the past (the OECD paid some attention to the issue of e-commerce around the turn of the millennium),²² the OECD ultimately, however, opted to seek a solution "in the context of the existing international tax framework",²³ with the idea now being to take another critical look at exemptions for ancillary and sideline activities and the fact that the warehouse or storage facilities held by the e-tailer in the market state may not actually be used in support of the activities. The functions performed within the 'warehouse/storage facilities permanent establishment' will then need to be remunerated on an arm's length basis (cost-plus, for example). Another option being considered is the possibility of introducing measures to counter the fragmentation of functions by having activities qualify more quickly as a permanent establishment than is currently the case.²⁴ Although these relatively modest changes are perhaps understandable from a political perspective, they are at the same time somewhat disappointing in that they can hardly be regarded as fundamental, given that the problems that have arisen have come about specifically within the context of the existing framework. Whether a solution can actually be found within that same framework is consequently very much open to question.

The EU's Commission Expert Group on Taxation of the Digital Economy relatively recently considered the issue of nexus in a digitalizing international environment.²⁵ With a view to finding a potential long-term solution, the Expert Group is discussing the possibility of applying a 'destination-based cash flow tax' as a means of allocating taxation rights to the demand side. This would, in essence, comprise a form of VAT on a cash flow basis, but without an exemption for financing transactions, while salaries would be deductible. In this way, therefore, it would be more like a profit tax. Under such a system, tax jurisdiction would need to be based on concepts broadly similar to the remote seller rules and place of supply of services provisions for digital services as applied in VAT. Those provisions, too, are based on the demand side, i.e. the place of residence of the (online) customer.

²⁰ See, for instance, Walter Hellerstein, 'State Taxation of Electronic Commerce,' 52 *Tax Law Review* 425 (1996-1997); Reuven S. Avi-Yonah, 'International Taxation of Electronic Commerce,' 52 *Tax Law Review* 507 (1996-1997); Charles E. McLure, 'Implementing State Corporate Income Taxes in the Digital Age,' 53 *National Tax Journal* 4 (2000); Dale Pinto, 'The Need to Reconceptualize the Permanent Establishment Threshold,' 60 *Bulletin for International Taxation* 266 (2006); Lambooj (2009), *supra* note 18, and López, *supra* note 1, Sec. 3. For a comparison, see Aleksandra Bal, 'Tax Implications of Cloud Computing – How Real Taxes Fit into Virtual Clouds', 66 *Bulletin for International Taxation* 335 (2012) and Manoj Kumar Singh, 'Taxing E-Commerce on the Basis of Permanent Establishment: Critical Evaluation', 42 *Intertax* 325 (2014), p. 325-333.

²¹ See OECD, Public Discussion Draft BEPS Action 1: Address the tax challenges of the digital economy, 24 March 2014 – 14 April 2014.

²² See OECD Committee on Fiscal Affairs, 'Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5', OECD, Paris, 22 December 2000.

²³ See OECD (2014), Addressing the Tax Challenges of the Digital Economy, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, p. 18.

²⁴ Including, if necessary, if these functions are performed by different affiliated entities; i.e. a sort of 'tax grouping for nexus purposes'. Profit allocation problems of this nature are expected to come up for discussion again in the future. See OECD, Public Discussion Draft BEPS Action 7: Preventing the artificial avoidance of PE status, 31 October 2014 – 9 January 2015 and OECD, Revised discussion draft BEPS Action 7: Preventing the artificial avoidance of PE status, 15 May 2015 – 12 June 2015.

²⁵ See Report of the Commission Expert Group on Taxation of the Digital Economy, 28 May 2014. The 'destination-based cash flow tax' has been proposed by Alan J. Auerbach, Michael P. Devereux and Helen Simpson, 'Taxing Corporate Income', Oxford University Centre for Business Taxation Working Paper 07/05, Paper Prepared for the Mirrlees Review, Reforming the Tax System for the 21st Century (2008).

The issue has also been examined in tax literature, with a range of potential solutions being proposed.²⁶ The suggestions have varied from virtual permanent establishments and quantitative turnover thresholds to withholding taxes on outbound payments for inbound digital services. Links have also regularly been sought with the ‘sales-only formulary systems’ operated in the United States. The profit tax systems of the US states are currently moving towards attributing the tax base for profits tax exclusively to the destination jurisdiction.²⁷ When establishing the jurisdiction, these systems tie in to varying degrees with the ‘sales factor presence tests’.²⁸ These are quantitative turnover thresholds comparable to the remote seller rules in VAT. The permanent establishment is not a concept used in US state taxation.

The common denominator in all the solutions proposed, both by the OECD and the EU, and also in tax literature, is that they all seem to be moving in the direction of establishing ‘nexus’ in the market jurisdiction and to focus on developing quantitative tax jurisdiction standards based on the location of the recipient of the digital product. It should be noted, however, that Kemmeren opts for a different approach in a solution that seeks reference to the supply side of income production (i.e. labour and, therefore, origin).²⁹ This approach ties in more closely with the current transfer pricing model, which ultimately seeks to apportion the tax base by determining a fair market value for each unit of the various functions performed. This is most evident in the case of the ‘profit split method’, which apportions profit on the basis of the relative contributions of functions performed. ‘Payroll formulary apportionment’ is a less intricate alternative for the current transfer pricing system and would apportion profit *pro rata* by reference to salaries paid, and thus also by reference to the supply side. Transfer pricing – particularly if profit is apportioned by the ‘profit split method’ – and ‘payroll formulary apportionment’ are ultimately not very different from each other, at least not in an analytical sense. Transfer pricing attributes profit by determining the value added by each unit of the various functions performed; in effect, a flat-rate apportionment based on the underlying idea of positive correlation between the functions performed and the profits generated (a correlation which, in reality, does not actually exist; hence the use of the words ‘flat-rate’). ‘Payroll formulary apportionment’ meanwhile apportions profit in line with salaries paid; in effect, it, too, comprises a flat-rate apportionment, based on the underlying idea of positive correlation between salaries and profits (a correlation which, again, in reality does not actually exist). Both approaches end up at the labour factor (i.e. origin), given that functions involve work being performed by significant people and these same people receive salary from the business in return for their work.³⁰ In other words, both approaches end up at the same source: labour, or origin. The effect of using a model that has the supply side (the source of the income) as its sole point of reference is that there is no scope whatsoever for attributing the tax base to the market jurisdiction. And that ultimately is not much more than just making a choice, given that profit itself has no geographical location.

Taking the demand side as the point of reference for apportioning profits, including, for example, online profits, means making reference to the location of the customer. And customers can be ‘geolocalized’ (through their IP, invoice or delivery addresses or, for example, through bank or credit card details). This indeed is what the VAT system already does when establishing the place of supply for online services.³¹ There, the idea seems to have taken hold that the market, too, comprises a source of income. And this in turn may create an opening for a fundamental reform of how the taxable base for profits taxes is apportioned internationally.

3.2 Realistic? At a crossroads ...

²⁶ See Hellerstein, *supra* note 20; Avi-Yonah, *supra* note 20; McLure, *supra* note 20, and Pinto, *supra* note 20. For a comparison, see Lambooj, *supra* note 18.

²⁷ For the formulas used in the US formulary systems as at 1 January 2015, see the overview on the website of the American Federation of Tax Administrators: taxadmin.org/fta/rate/apport.pdf.

²⁸ For a comparison, see Multistate Tax Commission, *Federalism at Risk, A Report of the Multistate Tax Commission*, June 2003, Appendix D.

²⁹ See Kemmeren, *supra* note 7.

³⁰ For a comparison, see Reuven S. Avi-Yonah and Ilan Benshalom, ‘Formulary Apportionment – Myths and Prospects; Promoting Better International Tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative’, 3 *World Tax Journal* 371 (2011), p. 393.

³¹ See the provisions on the place of supply of digital B2B and B2C services in EU value added taxation.

Is it realistic to propose fundamentally reforming profit tax systems? Perhaps it isn't, but perhaps, on the other hand, it is. Whatever the case, dismissing any suggestions for reforming the system by saying 'That'll never happen' is, in my view, a far too easy response. It was not all that long ago, after all, that we thought that way about bank secrecy laws and the automatic exchange of financial accounts information between countries. The OECD stated in its 'September 2014 deliverable' that the digital economy could not be treated separately from the rest of the economy.³² In other words, 'ring-fencing' the digital economy is not an option. Indeed, the fact that the overall economy is increasingly becoming digital means that devising rules specifically for the digital economy may well be inappropriate. That will simply create complex issues of delineation. But is that a reason to continue seeking a solution only in the existing framework? Or is that exactly why we should now start looking outside that framework, and then not only for the digital economy, but also for the economy as a whole? After all, the digital economy is not the only challenge facing international tax law at present. 'Online profits' are certainly not an isolated problem, but should perhaps be seen more as a symptom of a failing tax system.

We seem now to have arrived at a crossroads. Should we allow our international profit tax systems to change in line with economic developments, or just carry on as before? A time may come when we will simply be forced to change and will no longer have the option of choosing to do nothing, at least not if we want to continue being able to impose corporation tax at a country (or supranational) level. This is because the more global the market and the more mobile production factors become, the more elastic the tax base will be. And this ever-increasing globalization and digitalization mean company profits, too, are likely to become ever more mobile. This may mean differences in effective tax rates having an ever-greater impact on where international businesses choose to locate their investments. And this will serve to increase tax competition between countries even further, with the potential dangers of an even faster 'race to the bottom'.

3.3 *Taxation in the destination jurisdiction?*

More and more of the discussions on nexus and profit allocation in the context of internet companies are now moving in the direction of taxation in the market jurisdiction. The digital economy simply cannot be ring-fenced off from the 'ordinary' economy. That means that the alternative to the approach proposed by the OECD (i.e. 'do nothing') is not only to allow profits from *digital* business activities to be attributed to the market jurisdiction, but also to extend this principle to profits from *all other* international business activities. In other words, to attribute the taxable base for profits tax on the basis of the destination principle. Just like in VAT, the 'crowning glory' of all taxes and praised for its inelasticity and ability to promote neutrality. That would not transform profit taxes into a form of VAT, however.³³ Just like VAT is not transformed into income tax or profit tax when it is imposed on the basis of origin. The tax base would continue to be profit-based, with the only change being a different geographical allocation of taxable base.

Another attractive thing about attributing the tax base to the market jurisdiction is that this will promote an efficient use of production factors. This is because, for profit tax purposes, it will then no longer matter which jurisdiction a business chooses to invest in as tax will no longer have the investment location as its point of reference. In addition, markets are far less mobile than production factors as they are largely outside multinationals' sphere of influence. Attributing the tax base to the market jurisdiction will thus effectively result in a taxation that is inelastic and that at the same time promotes economic efficiency. It is

³² See OECD, *supra* note 23, p. 12.

³³ For a comparison, see Peter Mieszkowski and John Morgan, 'The National Effects of Differential State Corporate Income Taxes on Multistate Corporations', in Charles E. McLure, Jr. (ed.), *loc. cit.*, p. 257: "a tax on capital is a tax on capital is a tax on capital."

therefore worth considering attributing the tax base to the location of the customer as a general principle, and not just for 'online profits.'

4 Concluding remarks

Globalization and digitalization mean we are now living in a 'global village', in which everything and everyone is 'online connected'. Profit tax systems, however, are still based on the economic reality of a century ago. And the defects in these systems are particularly evident in the case of online profits, which we are now simply unable to tax effectively. The extent of this problem is growing in line with the digital component's increasing share of the overall economy. Is it fair, for example, that the old-fashioned record shop, insofar as it still exists, is able to be taxed here, but not the digital store or e-record shop that offers its music streaming services online? Isn't it the same product – the new album by your favourite artist – that is being sold? Perhaps the time is not yet ripe for a fundamental reform of taxation systems, but that does not mean, in my view, that we should not now start thinking about the direction in which countries' corporation tax systems should be moving. Suggestions from various sides all point in the direction of establishing tax jurisdiction in and attributing the tax base to the market jurisdiction; in other words, to corporation tax based, either wholly or partially, on the destination principle. And there may certainly be something to be said for choosing to go down that route. After all, the market is also a source of income. A different source, admittedly. But the world has changed substantially over the past one hundred years. And maybe it is now time for tax law and practice to reflect those changes.