# Kluwer International Tax Blog

## Old Bottles or New Bottles: Time to Break the Bottle! In Favor of Broader Source Country Taxing Rights

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For many years, I have been advocating a drastic change in the distribution approach for taxing rights in international taxation. The focus of my criticism has been Article 7 of the OECD and UN Model Conventions. My core argument continues to be that the so-called "permanent establishment principle" disregards the role of the infrastructure that is necessary for the development of a significant consumer market [1].

Indeed, Article 7 established an allocation regime that is blatantly disadvantageous for developing countries, which are generally net importers of capital, services, intangibles, and goods. For this reason, in an article published last year I posed the question "Why do developing countries include Article 7 in their treaties" [2].

Recent work by the United Nations with the inclusion of Article 12-A in the UN Model has dealt with this issue, at least regarding the allocation of rights to tax technical services. This article is certainly a move in the right direction. However, my proposal is broader: shared taxing rights for the taxation of all business profits.

The permanent establishment principle does not work alone. It has a "partner in crime" in the concept of value creation and its use as allocation key for distributing taxing rights among countries.

The determination of taxing rights based on the concepts of permanent establishment and of value creation takes into account primarily the contribution of the infrastructure for production. Therefore, the right to tax is allocated to the country where such infrastructure is located. As noted by Johannes Becker and Joachin Elglisch in a previous post, according to this traditional view "The *locus* of value creation is therefore where production takes place. According to this logic, consumers can only be assumed to be contributing to value creation if they take part in the production process."

This standard entirely disregards the contribution from the consumer market itself. It is as if production was an end goal rather than a means to an end: delivering benefits for the consumer.

The proposed EU Directives for tackling the challenges of digitalization of the economy have unveiled the shortcomings in the concepts of permanent establishment and value creation. Since these proposals have been released, some very interesting posts have been published in the Kluwer

International Tax Blog. In one of the latest posts, Jonathan Schwarz questioned whether there was anything really new about this debate. His question was: Is this old wine in a new bottle or new wine in old bottles? Our take on this debate is somewhat different: **it is time to break the bottle**.

In a Kluwer International Tax Blog post, Cristiano Garbarini stated that "It is true that in the digital economy, business models have dramatically changed, **but what has also changed is the situation of some States, which in the 'old economy' were capital exporters and have discovered themselves to be capital importers in the digital economy scenario.**" (Emphasis added.)

I could not agree more. In the traditional international tax regime, the roles of countries in the global economy were more or less well defined. The OECD Model's pattern – which primarily focused on allocating taxing rights to the residence country – was advantageous to developed countries. It is no longer the case in the digital economy. The possibility of exploiting a country's economy without having a physical presence has exposed developed nations to the same situation developing and emerging countries have faced for decades. Therefore, developed countries now face the challenge of formulating criteria to justify taxing non-residents with no physical presence in their territory. What's more, they need to do this without abandoning entirely the permanent establishment standard and the rationale behind value creation. Otherwise this change would also impact traditional "brick and mortar" transactions.

That is why the EU proposals for an interim measure and a comprehensive solution to the challenges of digitalization of the economy have tried so hard to create "something new", without rejecting the starting points of the so-called international tax regime. It was not that they were trying to impose taxation with no economic allegiance or value creation in the country of destination. It was just that in cases where the consumer takes part in the creation of value, the source country should also be entitled to tax some of the income generated in the transaction.

In this sense, it seems that, going back to Schwarz wine analogy, there is old wine in a new bottle. The standards are basically the same, but they have been dressed in new clothes to try to deal with the challenges posed by digitalization of the economy.

Notwithstanding this view, quoting Cristiano Garbarini's words, "If user-generated value justifies income taxation of business profits, as stipulated in the Directive, this should be true in all economic sectors, and not only those specific ones to which the new Directive should apply." It is for this reason that Johannes Becker and Joachin Elglisch state clearly that the Commission "had a certain 'politically acceptable' outcome in mind from the very beginning and then fabricated the justification of the tax that could match its intentions". Their goal was to make a huge change, without changing anything.

Thinking about wine bottles, we believe that it is time right now to break them! The moment has come for a new international tax regime, one that will recognize the inherent taxing rights of the source country to include the right to tax payments that are made regardless of a physical – or virtual – presence of the beneficiary in the source country's territory. It is an application of the principle of destination to the field of income taxation.

The position that we are advocating for such a situation is gross income taxation of business profits in general. As previously mentioned, this proposal goes beyond the United Nations' new Article 12-A. Our suggestion is that the right to tax business profits should be shared between the source and the residence countries [3].

Gross income taxation is usually met with resistance and mistrust, as it might lead to double taxation or – which may be even worse – taxation in situations even where there is no income earned. The entity could be producing losses but, nevertheless, be subject to taxation on gross income.

It is true that gross income taxation might trigger double taxation and inconsistencies. However, in a world in which income tax is in crisis and its collection capacity has been put in jeopardy, one might wonder whether double taxation has the same negative effect it might have had in the past. What I mean is: double taxation might not a problem itself. Whether double taxation is a real problem or not depends on the rates in the source and in the residence country. If the source country collects a 6% tax and the residence country another 20%/25% is does not seem that double taxation would lead to an unsustainable tax burden.

Hence, it seems that income taxation at source is the go-to solution for the challenges deriving from the digitalization of the economy – not in the form of some special and exotic tax that tries to encompass some of the digital services, but as the result of a broad allocation of taxing rights to the source country to tax business profits. If there are side effects and inconsistencies, they must be dealt with. But the we will only start discussing alternatives to deal with these issues when we accept taxing income at source as an valid option.

Even if it is rejected as a solution to the taxation of business profits in general, it is our opinion that taxation of gross income at source is the best alternative available to deal with the challenges of digitalization of the economy.

It is obvious that the implementation of such a solution depends on the modification of tax treaties based on the OECD and the UN Models, which allocate exclusive taxing rights to the residence country when business profits are generated without the presence of a permanent establishment. As I have stated in a previous text [4], this could be achieved through the implementation of a multilateral convention that changes bilateral tax treaties, following in the footsteps of Action 15 of the BEPS Project.

On the other hand, if a global withholding solution would require a global approach, many countries – specially developing countries – already have provisions in their treaties allowing the taxation of technical services at source [5]. Since most of the activities in the digital economy can be characterized as technical services, these provisions should be enough to allow taxation at source without a single change in current tax treaties.

It is interesting to note that deciding in favor of gross income taxation at source only overcomes the first challenge deriving from digitalization of the economy. Indeed, it might work well in business-to-business deals. However, in the digital economy many transactions are business-to-consumer. This fact poses a huge challenge in terms of tax administration.

As a matter of fact, in most countries establishing voluntary withholding obligations to individuals is a compliance nightmare. Attributing withholding liabilities to intermediaries, such as credit card administrators, is also challenging. The solution adopted by the EU in the Digital Services Tax proposed Directive is no less cumbersome: establishing a tax that must be voluntarily paid by a taxpayer that is resident in another country.

After many years of an international tax regime that allows a country's market to be exploited without corresponding taxation, it is interesting to see developed countries now suffering the same negative impacts that developing and emerging economies have long incurred. It is also interesting to watch tax regimes trying to solve new problems with old solutions. It is like fighting new diseases with medicine from the second decade of the 20th century, when the first double tax treaty models were made public.

Nevertheless, it seems that the solution proposed in this text is not being considered as an alternative. It looks like all bets are in favor of the digital permanent establishment – i.e. significant digital presence. This will be a tax administration nightmare – especially for developing countries.

**References:**

[1] See: S. A. Rocha, *The Other Side of BEPS: "Imperial Taxation" and "International Tax Imperialism"*, in *Tax Sovereignty in the BEPS Era* p. 190 (S. A. Rocha & A. Christians eds., Wolters Kluwer, 2017); S. A. Rocha, "International Fiscal Imperialism and the 'Principle' of the Permanent Establishment," (2014) 68 (2) *Bulletin for International Taxation*, pp. 83–87.

[2] S. A. Rocha, "Should Developing Countries Include Article 7 in Their Tax Treaties?" (2017) 71 (7) *Bulletin for International Taxation*, pp. 354–357.

[3] See: S. A. Rocha, "Should Developing Countries Include Article 7 in Their Tax Treaties?" (2017) 71 (7) *Bulletin for International Taxation*, pp. 354–357.

[4] S. A. Rocha, "Should Developing Countries Include Article 7 in Their Tax Treaties?" (2017) 71 (7) *Bulletin for International Taxation*, pp. 354–357.

[5] See: S. A. Rocha, *Brazil's International Tax Policy* pp. 59-60 (Lumen Juris, 2017). To access the book click here.

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