Tax Challenges of the Digital Economy: An Evaluation of the New OECD Nexus Rule Based on Revenue Thresholds

The author, in this article, having established the general aspects regarding the new nexus rule based on revenue thresholds, evaluates the development of the rules as proposed by the OECD in Pillar One, Amount A, based on the revenue threshold that a non-resident company acquires in a foreign market jurisdiction.

1. Introduction

The creation and development of income tax that occurred between the 1800s and early 1900s has become one of the main sources of government revenue. In the OECD member countries, it is, for example, responsible for 34.3% of tax revenues.

However, income tax has now under great pressure given the possibilities for multinational enterprises (MNEs) to do business worldwide readily at the same time as they are able to transfer their tax bases to low-tax jurisdictions.

The technical foundations of the current international tax system were developed in the early 1920s. Specifically, in relation to the taxation of business profits in cross-border situation, most tax treaties allocate taxing rights to the state of residence of the company "unless the enterprise carries on business in the other Contracting State through a permanent establishment". Accordingly, the tax nexus is based on a qualified degree of the physical presence of the company in the market jurisdiction.

The development of technology that began in the 1990s brought about the new era of the digital economy (digitalization). This development was very much related to valuable mobile assets (intangible property) as well as advances in relation to information and communication technologies (ICT) and the manipulation of data. Having enabled the development of numerous business models, these changes have had a significant effect on the global economy.

MNEs, which are responsible for one-third of global trade, can be considered to be one of the greatest beneficiaries of the era of digitalization. This situation arises as MNEs can operate easily in a "scale without mass". In other words, MNEs, with an extensive involvement and influence in the foreign markets without having a significant physical presence, can engineer situations that give rise to business operations in market jurisdictions without being liable to tax in those jurisdictions.

The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project is a key initiative that has considered the primary practices relating to the international tax system. Such practices cost jurisdictions between USD 100 billion to USD 240 billion in lost revenue annually, being equivalent to 4% to 10% of global corporate income tax revenue.

The OECD/G20 BEPS Project started in 2013. In 2015, the OECD published a series of final reports setting out its finding and proposing reforms in relation to 15 Actions.

Following six years of debates, in October 2021, the OECD published its "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy". This statement forms the basis of this article, which aims to evaluate whether a new nexus rule based on a revenue threshold would be a satisfactory proxy to deal with the significant and sustained engagements that MNEs have with market jurisdictions in the absence of a qualified level of physical presence.

The article first considers the worldwide debate on the tax challenges presented by the digital economy (see section 2). It then examines the OECD’s proposed Blueprint for the new nexus rule under Pillar One.

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7. OECD. Action Plan on Base Erosion and Profit Shifting (OECD 2013), Primary Sources IBFD.
Amount A (see section 3). The conclusions are presented in section 4.

2. Global Debate on the Tax Challenges of the Digital Economy

2.1. Nexus concept overview and theoretical framework

The tax nexus is the qualified connection between the country that wishes to exercise its taxing power with a taxpayer or the facts that are connected to the origin of the taxable object. This situation is a relationship that, when present, gives a country the right to exercise its tax-imposing and tax-collecting powers. In other words, a “nexus describes whether a taxpayer, property, or activity has sufficient connection with a state to be subject to that state’s tax jurisdiction”.

From the perspective of international tax law, the nexus is divided into the two major groups based on the following principles: (i) nationality (a nexus based on the nationality or citizenship of the taxpayer); and (ii) territoriality (a nexus based on the connection of the taxpayer or income with the territory of a given state). In the territoriality principle, there is a subdivision between a source criterion, which relates to cases of a nexus created in relation to a given category of income with a connection to the territory of the country, and a residence criterion, which is the connection between the taxpayer that is beneficiary of the income and the territory of residence based on characteristics, such as domicile or place of incorporation.

Due to the problematic opposition of interest in cross-border taxation – i.e. two or more different sovereign states wishing to impose taxation on the income – scholars have long debated the theoretical basis for the taxation imposition where the principles of equity, efficiency and simplicity are paramount. In relation to tax equity, a number of theories have been developed to support and explain why and when states have the rights to impose taxation on non-resident persons. Some of these deserve analysis for the purpose of this article.

In an inter-taxpayer context, the debate concerns the distribution of the total tax burden between members of society. The general idea is that an individual connected with a specific society must contribute to its general costs. This concept represents the benefit theory, which is the most coherent justification for the imposition of taxation.

The benefit theory is the concept that “a jurisdiction’s right to tax rests on the totality of benefits and state services provided to taxpayers that interact with a country”. Consequently, when adopting this theory, states can base non-resident taxation on cross-border income (i.e. source taxation) when companies benefit from the services and conditions funded by the government. As noted by Hongler and Pistone (2015), there are several benefits provided by market jurisdiction governments that are used by non-resident companies (even in the absence of a physical presence). These benefits include the legal system, the enforcement of payment by customers, the protection of intellectual property (IP) rights, the maintenance of the digital environment, the supply of energy, waste recycling and the general infrastructure that support a connection with the market jurisdiction.

In an inter-nation dimension, the debate relates to the fair allocation of taxing rights between different states, the economic allegiance theory being a coherent standard in this debate. As stated by Gadžo (2018), this doctrine advocates that “nexus norms should not deny taxing right to a country to which a taxpayer owes economic allegiance”, i.e. when there is a strong economic interest of the taxpayer within a country, and “a non-resident taxpayer owes economic allegiance to a country wherein his customer base is located, regardless of the location of income-producing factors”.

With regard to the second general principle, tax efficiency is associated with economic costs and benefits. The key concept is to maximize economic benefits, while, at the same time, minimizing general costs, also connected with the idea of tax neutrality, i.e. the tax system should try to eliminate as far as possible any distortion based on the design of the tax system with regard to the choices made by persons. Accordingly:

the nexus norm is aligned with the tax efficiency requirement only if it does not distort the continuum of choices at the disposal of the taxpayer with regard to the conduct of his economic activities abroad.

Lastly, with regard to the simplicity principle, as Gadžo puts it:

the nexus norm should be as certain and precise as possible, not causing difficulties in its interpretation and application by the tax administration and the taxpayers. Put simply, any unnecessary complexities should be avoided.

As a result, any proposal to create or modify the nexus rules must take into account these basic principles and their theoretical foundations so as to be aligned with long-standing national and international tax practice.

11. Id.
12. Id.
13. Id., at ch. 5.
14. Id., at sec. 5.1.3.
15. Id., at sec. 5.3.4.
18. Gadžo, supra n. 10, at sec. 5.1.4.
19. Id.
20. Id.
21. Id., at sec. 5.2.2.
22. Id., at sec. 5.3.1.
2.2. Nexus framework for business income taxation established in articles 5 and 7 of the OECD Model\textsuperscript{23} and the UN Model\textsuperscript{24} and its necessity of physical presence

Each state in its domestic legislation unilaterally stipulates the nexus rules that authorize the exercise of its taxing power in relation to a given person or economic activity. In cross-border transactions, there can be an overlap between such taxing powers. For instance, the first state applying a residence criterion and the second a source criterion, thereby giving rise to double taxation or non-taxation if the domestic rules do not deal with these issues.

In order to harmonize international taxation, international organizations have created models for double tax treaties for almost a hundred years. The most important of these models are the OECD Model and the UN Model, as more than three-quarters of the 3,000 tax treaties in existence have wording based on the models.\textsuperscript{25} Significantly, such tax treaties are integrated into the domestic law of countries.\textsuperscript{26}

With regard to business income, both the OECD Model and the UN Model provide in article 7(1) that:

\begin{quote}
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.
\end{quote}

In article 5(1), the OECD Model and the UN Model also define a permanent establishment (PE) as a “fixed place of business through which the business of an enterprise is wholly or partly carried on”. Article 5(2) of both model tax conventions provides a non-exhaustive list of examples of PEs (i.e. a place of management, a branch, an office, a factory, a workshop and a place of extraction of natural resources). Article 5(4) of the OECD Model and the UN Model contain a negative list of cases in respect of which a PE is deemed not to exist (i.e. preparatory activities). In addition, article 5(5) of the OECD Model and the UN Model defines a dependent agent that can constitute a deemed PE for a non-resident if all of the relevant criteria are met. This article also authorizes the source state to impose taxation on the income attributable to such a deemed PE.

Disregarding the differences between the OECD Model and the UN Model and adopting a systematic interpretation of the rules in both, it can be concluded that the taxation of business income is exclusively allocated in the state of residence of the company, unless it has a PE in the other contracting state (the source state), or a dependent agent. As its main characteristic, such a system requires the physical presence\textsuperscript{27} of the non-resident in the other country (the situs criterion).

With regard to this set of rules, the connecting elements relating to a qualified physical presence demonstrate the robust economic link between a person and the source state. This link justifies the exercise of taxing rights of that state.\textsuperscript{28} However, in the author’s opinion, these rules no longer work, or, maybe, never worked properly. The decision to use the place of residence or the existence of a PE for taxation makes it clear that the concept is to “protect” the tax base of capital-exporting states with regard to the operations of their companies in foreign markets. Such a concept disregards the digitalization of the economy that has increased the possibility for remote operations. As a result, all countries are now suffering from the effects of non-resident companies exploiting their market jurisdiction without paying tax in those jurisdictions. This state of affairs is why governments wish to change the current system.

2.3. The international debate on the design of the tax system for the digital economy

The term “digital economy” was first used in the western world by Don Tapscott in his best-seller book of 1995, “The Digital Economy: Promise and Peril in the Age of Networked Intelligence”.\textsuperscript{29} As a result, the digital economy can be conceptualized as:

\begin{quote}
the result of a transformative process brought by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardized, improving business processes and bolstering innovation across all sectors of the economy.\textsuperscript{30}
\end{quote}

Digital development has changed society, making possible the development of new business models and new strategies for companies. The main characteristics of these new business models are the:

- mobility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high-speed trading, and online payment services.\textsuperscript{31}

The most diversified types of business can benefit from technological advances, from improving the efficiency of the company and in being able to reach other market jurisdictions remotely. Given the great possibilities for non-resident companies to benefit from foreign markets without having a significant physical presence therefore,

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\textsuperscript{23} Most recently, OECD Model Tax Convention on Income and on Capital (21 Nov. 2017). Treaties & Models IBFD.
\textsuperscript{24} Most recently, UN Model Double Taxation Convention between Developed and Developing Countries (1 Jan. 2017). Treaties & Models IBFD.
\textsuperscript{25} Gadžo, supra n. 10, at sec. 11.
\textsuperscript{26} Gadžo, supra n. 10, at sec. 1.1.
\textsuperscript{27} Id.
\textsuperscript{28} Id.
\textsuperscript{30} OECD, Action 1 Final Report (2015), supra n. 5, at p. 15.
the OECD has questioned if the current nexus rules are still appropriate.\(^3\)

For this author, the current regime is no longer working. The criteria established in another (past) economic reality now allow companies to choose where they will allocate their tax base, even if such companies derive very significant amounts of revenue from the most diverse of market jurisdictions.

In a study undertaken by KPMG in January 2021\(^3\) regarding taxation in the digital economy, that accountancy firm divided countries into the following six groups:

1. countries that have not developed any specific systems;
2. seven countries that are awaiting a global solution;\(^4\)
3. three countries that have not made relevant a public announcement;\(^5\)
4. nine countries that have made a public announcement and/or stated their intention to implement changes;\(^6\)
5. four countries that have published draft legislation and/or initiated public consultations; and\(^7\)
6. twenty-five countries that have enacted relevant legislation.\(^8\)

Despite the specific characteristics of each actual piece of legislation and/or legislative proposal, these unilateral measures can be divided into the following three categories:

1. withholding taxes;\(^9\)
2. digital service taxes (DST);\(^10\) and
3. digital PEs, which can be further divided into:

\[\text{(i) significant digital presences (SDPs); and (ii) significant economic presences (SEPs).}\]

In April 2021, The UN Committee of Experts on International Cooperation in Tax Matters (the “UN Committee”) approved a new provision to be included in the UN Model that is aimed at taxing the income derived from automated digital services (ADS). This new provision is article 12B of the UN Model (with eight paragraphs of provisions followed by sixty-two paragraphs of comment).\(^11\)

The nexus of this new provision is an existence of income relating to a specific service activity (ADS) that arises in the contracting state (the market jurisdiction), being a special rule in relation to the general rule in article 7 of the UN Model. However, the author does not favour this type of nexus rule for business income without any threshold, as he does not believe that such a nexus would be in line with the equity principle in relation to its international dimension\(^12\) and the efficiency principle regarding its neutrality standard.

Lastly, in March 2018, the European Commission (the “Commission”) proposed two Council Directives that are aimed at establishing new rules for the digital business taxation. The Commission’s proposal was divided into (i) long-term solutions; and (ii) short-term solutions.

The long-term proposal aims at the corporate taxation of an SDP, in proposing the creation of new taxable nexus rules in the absence of a physical presence of a digital business when one or more elements are present\(^13\) (i.e. revenue, number of users or number of business contracts). The new nexus rules based on SDP would use non-physical elements to create the PE-deeming rule, the revenue-based threshold and two other user-based factors (the number of users and the number of business contracts).\(^14\) However, the number of users or the number of business contracts would affect (adversely) tax certainty and the simplicity of

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\(^{32}\) Id., at p. 103.


\(^{34}\) Belgium; Finland; Singapore; South Africa; Sweden; Switzerland; and the United States.

\(^{35}\) Australia; Chile; and Germany.

\(^{36}\) Canada; China (People’s Rep.); Denmark; Egypt; Israel; Latvia; New Zealand; Romania; and Russia.

\(^{37}\) Brazil; the Czech Republic; the Slovak Republic; and Thailand.

\(^{38}\) Argentina; Austria; Costa Rica; France; Greece; Hungary; India; Indonesia; Italy; Keny; Malaysia; Mexico; Nigeria; Pakistan; Paraguay; Poland; Sierra Leone; Spain; Taiwan; Tunisia; Turkey; the United Kingdom; Uruguay; Vietnam; and Zimbabwe.

\(^{39}\) A nexus is created if a non-resident company has income accruing in or derived from the source state in relation to digital services or electronic (e-)commerce. In the author’s opinion, this rule without any threshold is not in line with the principle of equity of the nexus in its international dimension, as it is impossible to demonstrate the economic allegiance of the person with the market jurisdiction in the case of small amounts of revenue acquired there. The rule also deviates from the principle of efficiency in its neutrality dimension.

\(^{40}\) A specific income tax is created to be imposed on the gross income of certain digitalized activities, such as online advertising, streaming and data transmission (the scope and design vary country to country). Such a rule changes its design from country to country (the nexus considers the amount of revenue, the number of contracts and/or the users or the activity developed), and cannot give rise to a consensus and develop the stability desired to encourage economic development. In reality, these uncoordinated measures may have the undesirable effect of a reduction in the global GDP of 0.1% to 1.2% (see OECD, Tax Challenges Arising from Digitalisation – Economic Impact Assessment, p. 20 (OECD 2020) [hereafter the Digitalisation – Economic Impact Assessment]).

\(^{41}\) An SDP can be conceptualized briefly as a proposal that aims to support the creation of a PE when the non-resident has in a market jurisdiction a qualified digital engagement, such as many contracts, many customers, a website customized for the local market and the availability of payments in local currency. The author believes that these types of standards greatly harm tax certainty (simplicity) and neutrality, as the persons will be likely to change their business model only to avoid taxation and the standards are not clear sometimes.

\(^{42}\) An SEP is a proposal that aims at the creation of a PE when a non-resident company exceeds a given revenue threshold in the market jurisdiction. This type of proposal is discussed more fully in section 3.


\(^{44}\) Due to the impossibility of demonstrating the economic allegiance of a non-resident person with the market jurisdiction in respect of which there is only minimum revenue evident in such places.

\(^{45}\) These elements are: (i) the proportion of total revenue derived in that tax period and resulting from the supply of those digital services to users located in that Member State in that tax period exceeds EUR 100,000; and (ii) the number of users of one or more of those digital services who are located in that Member State in that tax period exceeds 100,000; and (iii) the number of business contracts for the supply of any such digital service that are concluded in that tax period by users located in that Member State exceeds 3,000 (see PwC, EU Direct Tax Group, EU Direct Tax Newsalert European Commission Proposes New Rules on the Taxation of the Digital Economy (21 March 2018)).

the system. Moreover, as the Member States of the European Union are developed countries, the revenue threshold established of EUR 7 million would not be useable in small developing economies.

The short-term proposal would introduce a DST at a rate of 3% on gross revenue, derived in the European Union from specified digital activities, where the MNE in question has annual global revenue in excess of EUR 750 million and annual taxable digital revenues in a Member State of over EUR 50 million (also used as a revenue-based element for the nexus but with a great potential to avoid its application in small developing economies), irrespective of where the MNE was established (i.e. inside or outside a Member State).

From the foregoing, it is evident that the digitalization of the economy has made obsolete the nexus rules relating to a qualified level of the physical presence of companies in the market jurisdiction. This state of affairs is why the need for its modification is urgent. In addition, although countries and international bodies are developing a diversified set of rules that aim to update the tax system for the new digital era, the disharmony of the measures would be harmful to international trade, and capable of reducing global GDP. That situation is why the OECD’s idea to develop a global consensus based on the participation of over 140 countries as well as the assistance of stakeholders is very welcome, and deserves to be praised.

3. The Blueprint Proposal of the New Nexus Rule for Pillar One, Amount A

3.1. New nexus proposal overview

The OECD has been analysing the disruptive effects of the digitalization in the economy and to the tax system have been for more than 20 years. In this context, the following three OECD reports deserve emphasis:

2. “Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions”,
3. the Final Report on Action 1 of the OECD/G20 BEPS Project.

As a central point, these reports have the perception that the digitalization of the economy has been creating and expanding mechanisms for base erosion and profit shifting due to the characteristics inherent in the evolution of business models relating to “hypercommunication” and the possibility of enormous scale without mass, as well as the great mobility of valuable assets (intangibles). All of these factors make it possible that highly digitalized business models can participate actively in a given market jurisdiction without paying any tax due to the lack of a taxable nexus. Accordingly, the OECD, in combination with the members of the Inclusive Framework (being 140 countries) has been working on developing a global consensus regarding a new tax model that is trying to align the interests of developed and developing countries and to create a system based on the principles of neutrality, efficiency, tax certainty, simplicity, effectiveness, fairness and flexibility.

In October 2020, the OECD published the still unfinished “Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint Proposal”, a document that led to the international debate on the creation of a new nexus not dependent on physical presence, to be applied exclusively to Amount A (the stand-alone provision), without the application of the new rule to existing tax (for example, the current PE definition) or non-tax rules. The author agrees with this position of the OECD, considering that the profit attribution of the new rule as proposed so far (i.e. formulary apportionment) is not in line with the current rule. Accordingly, the author believes that the stand-alone design is advantageous in avoiding a spillover effect that might damage or even destroy international tax law stability.

In addition, as noted in the report and Chapter 2 (the scope) and Chapter 3 (the nexus) must be understood together, having as an objective to:

- capture those large MNEs that are able to participate in an active and sustained manner in the economic life of market jurisdictions through engagement extending beyond the mere conclusion of sales, in order generate profits, without necessarily having a commensurate level of taxable presence in that market (as based on existing nexus rules). In August 2021, complemented by the decision made in October 2021, the OECD released its “Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy”, which was agreed by 137 country members of the Inclusive Framework. Going beyond the rules in relation to persons in scope (being large MNEs with global turnover in excess of EUR 20 billion and profitability of over 10%, i.e. profit before tax/revenue) that are not the object of the present work, a proposal for the new nexus rules was made. This proposal was designed to capture for taxation an MNE that derives from a specific market jurisdiction at least EUR 1 million in revenue from that jurisdiction, or, for smaller jurisdictions with GDPs of less than EUR 40 billion, EUR 250,000 of revenue from that jurisdiction.

52. Id., at p. 123.
53. The current rule in article 7(2) of the OECD Model (2017) and OECD Model Tax Convention on Income and on Capital: Commentary on Article 7 para. 20 et seq. (21 Nov. 2017). Treaties & Models IBFD in relation to the comments in the summary connects the profit allocation to a PE in relying on significant people functions (SPFs), which is totally different from the methodology proposed for the new rules.
54. OECD, Pillar One Blueprint, supra n. 51, p. 65, at para. 187.
55. Id.
56. OECD, Statement on a Two-Pillar Solution, supra n. 9.
57. Id., at p. 1.

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3.2. Revenue threshold as an indicator of “significant and sustained engagement with market jurisdiction”

3.2.1. In general

The first question to be considered in relation to the OECD proposal is whether the revenue test is an accurate way of demonstrating a qualified connection between a certain taxpayer with the market jurisdiction. In this regard, it should be noted that some scholars do not consider the volume of revenue to be an indicator that can demonstrate the sustained and significant involvement in the economy of a specific market jurisdiction. For instance, according to Samari (2020), any new nexus should be created based on functions and/or cost with an emphasis on marketing in the local market, and should not be based on sales.

However, as noted in section 2.3, several countries and the Commission, have been proposing new nexus rules based on revenue. The OECD and these countries consider that this rule would be a reliable indicator of a company’s engagement in a given market jurisdiction as a result of the disregarding of commercial frontiers caused by technological advances. Such a position is also followed by some scholars and in this article.

An important observation is that several countries have introduced and/or proposed the taxation of the digital economy using a revenue threshold for the nexus. These countries include: Austria (EUR 25 million); Belgium (EUR 5 million); Brazil (BRL 100 million); Canada (CAD 20 million), the Czech Republic (CZK 100 million); France (EUR 25 million) India (INR 200 million); Italy (EUR 5.5 million); Nigeria (NGN 25 million); Spain (EUR 3 million); Turkey (TRY 20 million); the United Kingdom (GBP 25 million); and Zimbabwe (USD 500,000). This is a characteristic that permits the conclusion that revenue is a reliable and internationally widespread indicator of a qualified connection between companies and market jurisdictions.

Depending on the volume revenue that a company has in a given market jurisdiction, it is possible to assume its engagement in that state. Such a position arises by taking into account the fact that it is very unlikely that a company can derive a considerable amount of income without making an investment in marketing, staff and the modification of webpages or software to suit the profile of the user and/or consumer established in that location.

In addition, when considering the nexus theoretical basis (see section 2.1.), the revenue volume that a non-resident company acquires can demonstrate:

- in an inter-taxpayer dimension, the benefit that this business has acquired in a market jurisdiction (the protection of IP rights, the maintenance of the digital environment, the supply of energy, waste recycling, etc.);
- on an inter-nation basis, the economic allegiance with the taxpayer and the market jurisdiction;
- its neutrality in considering that, depending on the volume of revenue, companies would not change their decisions as a result of the nexus (if profitability is greater than cost companies would prefer to pay tax in a market jurisdiction instead of terminate their foreign operation); and
- its simplicity, considering its easy administrability.

In the same vein of thinking, Gadžo has stated that:

the most appropriate solution lies in the use of de minimis revenue thresholds. The new PE-deeming rule proposed by Avi-Yonah and Halabi (the “significant economic presence PE”) is highly desirable from a normative perspective, it is founded on the idea that the total amount of revenue that a non-resident derives from customers located in a country signals that he enjoys significant benefits linked to the existence of the market therein (inter-taxpayer equity perspective) and that the location of the demand for the relevant goods and services is a legitimate proxy for the source of income (inter-nation equity perspective). Furthermore, it was argued that such norm, even if inherently arbitrary, would cause fewer distortions of taxpayers’ behaviour in comparison to traditional PE nexus (efficiency perspective).

Despite there being other factors that can demonstrate this significant and sustained engagement, the revenue test can be considered to be the mechanism that has more
positive aspects due to its simplicity and neutrality. Such a situation accords with the principles sought by the OECD.

3.2.2. What is significant?

3.2.2.1. Initial remarks

The objective of the OECD working group is to develop new nexus rules able to demonstrate that a large MNE (the person in scope), even with the absence of its physical presence in a given market jurisdiction, has a significant and sustained engagement with that economy, thereby giving rise to a taxable presence. The proposal has a central point in creating a new nexus based on the gross revenue that a company has in a market jurisdiction. It has as a theoretical background, something with which the author agrees, the fact that, primarily when a company has a large amount of revenue in a country, it also has given correlated “engagements” with a country. Such engagements with a country include investment in staff, advertising, distribution, collecting and decoding data (the inter-national equity dimension), as well as, among other things, investment in a business structure that would justify that country levying taxes. A country has such a right, as the MNE would be taking advantage of the market jurisdiction without financially contributing to its development (the inter-taxpayer equity dimension).

The literal interpretation of the wording “significant” results in the intention of the proposal to create a nexus only for MNEs that have a substantial revenue in a market jurisdiction, whether or not that revenue is not very significant as a percentage in the company’s overall revenue. The proposal, in aiming to prevent small amounts of revenue from giving rise to a nexus, notes that, in some scenarios, the imposition of small thresholds may generate more costs for a tax administration in the collection of tax than the tax revenue derived. For the companies involved, this situation would apply as well as greater compliance costs than profits realized (which would affect the principle of neutrality).

Conversely, if the threshold is set at elevated amounts, it could hinder the realization of a global consensus, given the restraining effect of small developing economies to benefit from the new system. The result would be that countries would continue to take unilateral measures when designing their tax systems for the digital economy. Accordingly, the proposal is set out in a way that deals with both interests, i.e., ensuring low administrative cost and the protection of the economies of small developing economies. The aim is to bring about a wide, long-term, commitment to the proposals that would not damage tax neutrality and reduce economic activity.

3.2.2.2. Global consensus or country-by-country (CbC) decisions?

Following on from the decision to use a significant revenue threshold as a factor in new nexus rules, the next step is to decide how the amount should be set. In other words, should the amount be set in the form of a global consensus or be settled by each country individually?

Initially, the simplest way to set the rules, based on the sovereignty of countries, would be that each country, in observing its own interests and economic and administrative factors, would take a unilateral decision as to what would be the revenue threshold in its territory. The threshold decided on would be based on certain international tax principles and guidelines.

However, such unilateral decisions can result in an undesirable lack of a correlation between a country’s economy and the revenue threshold set. For instance, a developed and large economy country could set a low threshold, while a small developing state, with an inefficient tax administration, could establish higher amounts.

Another damaging point to unilateral measures would be the cost of tax compliance for companies that would fall within the scope of the system. For instance, Netflix provides streaming services in more than 190 countries. In a scenario of multiple thresholds, this situation would require constant vigilance on the amount of revenue derived in each country and certainly greater complication for the system. Such a state of affairs would go against the principle of tax certainty, which is the aim of the OECD and the stakeholders.

As a result, the author believes that, although the adoption of unilateral decisions regarding threshold would be a simple solution in political terms, the search for a global consensus, although complex, would appear to be the best alternative so as to align digital taxation with the desired principles and objectives.

3.2.2.3. Revenue thresholds and small developing economies

As the proposed new nexus would use, as its primary criterion, the revenue value that a non-resident company would derive in another market jurisdiction, the most sensitive aspect of the proposal relates to the decision on the level of the amount of the threshold. The OECD has emphasized that the proposed design is intended to “protect the interests of smaller jurisdictions, and in particular developing economies, and their desire to benefit from the new taxing right.” This aim is the reason why the OECD has identified the need to evaluate an eventual requirement to set a reduced nexus for smaller developing economies.

Accordingly, it is clear that the developed rule must take into account the interests of small economies. Such an objective should apply, even at risk of not reaching a global consensus and of encouraging the creation of uncoordinated unilateral measures, and, on the other hand, adversely affecting compliance costs and the general efficiency of the system.

One way to resolve this impasse would be to analyse what proposals are being considered, and, by way of a balance, arrive at a proposal that would please all parties and create a more efficient model. The OECD also carried out studies regarding the potential economic effect, in respect

76. OECD, Pillar One Blueprint, supra n. 51.
77. Id., at p. 66.
of which it considered three proposals (EUR 1 million, EUR 3 million and EUR 5 million), as well as dividing countries, based on their GDP, into five large groups. The first option would be to follow the UN proposal (see section 2.3.), in which the new nexus does not depend on the amount of the revenue, i.e. a digital company, regardless of the revenue derived in the other market jurisdiction, would have already a qualifying link with that country. Although this is the nexus standard that most favours the inclusion of small developing countries in the system, it has as a major disadvantage in the greater complexity for taxpayers and tax authorities. This disadvantage arises for the following two reasons: (i) a tax liability would arise in all of the countries in which revenue derived would be linked to digital activities; and (ii) there would be an obligation to monitor all of the companies that derived any revenue in a given territory, which would give rise to problems in that compliance costs could be greater than the revenue earned.

Another point that could make it impossible to create the nexus based on a very low or non-existent values threshold would be the fact that these rules would violate the theoretical background to the creation of the new nexus. The author believes that a minimum or no threshold would not be able to demonstrate an economic connection (see section 2.1.) of a person with a market jurisdiction. Such a situation would break the demonstration of the SEP of a non-resident company in another market jurisdiction. A second proposal could be to set the revenue threshold at a sufficiently small minimum level. As analysed by the OECD in its economic impact assessment:

the application of a revenue nexus threshold of EUR 1 million is estimated to reduce the amount of allocated residual profit by 13.2% to 61.1% on average among the first group of jurisdictions (i.e. the smallest jurisdictions, which have a GDP below USD 4.3 bn).

The foregoing should be compared to a previous situation without any revenue nexus threshold. Despite the reduced threshold values, the proposal is in line with the theoretical framework of the nexus. This proposal aligns with the personal economic connection with the market jurisdiction in which persons derive that amount of revenue, with the efficiency principle (as this value would be expressive, it would outweigh evidently the administration costs, such that companies would not be prone to change their choices to operate in the market jurisdiction) and simplicity.

When the threshold values were raised to a median level of EUR 3 million, the difference in relation to the distribution of residual profits for small developing economies increases to 35% to 80% compared to a system with no minimum threshold amount. This change occasioned a greater reduction in the distribution of tax revenue and a probable lack of commitment to the proposed model by small economies. The third proposal would be to set the revenue threshold at values close to that proposed by the Commission at EUR 7 million (see section 2.3.). A point that should be noted is the fact that the European Union only has developed countries as Member States, which, in itself, makes it clear that the proposed model is not in accordance with one of the main objectives of the OECD, which is to protect small developing countries. Close to the revenue threshold of EUR 7 million, the OECD, in its impact assessment, did analyse the effect of the application of a revenue threshold of EUR 5 million. Such a proposal is estimated to reduce the distribution of residual profits by something around 50% to 90% on average among the smallest jurisdictions. Following this state of affairs, the proposal can be regarded as not being in line with the concept developed by the OECD to include and/or protect the interests of small developing economies. Such a situation clearly makes the adoption of this parameter impossible.

During the negotiation process, the OECD examined a number of possible solutions, including setting lower values for the revenue threshold or creating two nexus rules, one for small developing countries (based on GDP) and a further barrier for the other countries (non-small developing countries). The author believes that the creation of smaller and unique threshold values for the new nexus, understood to be EUR 1 million, is the best solution. Nevertheless, the author understands that the OECD proposal of EUR 250,000 for small developing countries, in line with the proposal of EUR 200,000 made by the IBFD, is positive, as it would include more countries in the new tax nexus, as well as being a simpler and easier rule to which to commit. On the other hand, this standard, given its broader scope, would result in higher compliance costs. These increased compliance costs would have to be analysed in the future if they exceeded the benefits derived from the new revenue generated.

In conclusion, the OECD’s goal is to create a global consensus where the interests of countries with weaker economies are protected as well as to observe the principles of neutrality, tax certainty and efficiency. The author believes that the most reliable design would be to create a unique nexus with a low threshold (EUR 1 million), as such a measure would be that which best meets the objectives pursued. Moreover, the complexity that it might generate ultimately would not be a sufficient reason for countries to refuse to adopt this model. However, the author also does not think that it would be absurd for the proposal to set the threshold value at EUR 250,000 for small developing countries. Nonetheless, it would be necessary
to ensure that, in the future, this small amount resulted in more advantages than disadvantages.

### 3.2.3. What is sustained?

A further essential element of the new nexus as proposed by the OECD is that a company’s engagement in addition to being significant should also be sustained, i.e. one that lasts for a specified period, thereby avoiding the creation of a nexus in respect of one-off transactions. The author welcomes such a proposal to take into account that a time period test would make clear the benefit that a company indirectly derived in a market jurisdiction and also to quantify its economic commitment to a jurisdiction (see section 2.2.). These are requirements that would be unclear in the absence of such test.

An important current example that is present in the Commentary on Article 5 of the OECD Model that should be followed in the new nexus rules is where it is made clear that, as a main rule, isolated business activities that run for a short period of time should not give rise to a PE. However, the OECD Commentary on Article 5 also makes it clear that, if a business carried economic activity in one specific state for all of its life, such an activity could give rise to a PE. For instance, if a non-resident company in State B is created to provide a service only in State A for only four months and after that its operations are ended, it can be concluded that the nexus existed, such that state A could levy tax.

Based on the target principles listed by the OECD, being primarily simplicity and certainty, after the comments of stakeholders have been taken into account, the following three basis proposals should be noted with regard to the time that a business activity is carried on in a jurisdiction:

1. a year-by-year basis;
2. two to five years consecutively; or
3. three years with the test being carried out over a five-year period.

These basis proposals are examined in the order in which they are listed.

The annual basis test, which has also been proposed by the Commission, is the first proposal. This proposal is the simplest, given the lack of a need to track an MNE’s group reporting for more than a year, as well as being the easiest to bring about a consensus for small developing countries, considering its ease in bringing about a taxable presence of more companies for those countries. However, there may be some difficulty for the proposal to create a consensus of the acceptance that a one-year test of activity could demonstrate the fulfilment of the requirement of “sustained” and to remove one-off transactions from the nexus.

The second proposal encompasses a time threshold of between two to five years. The proposal has the advantage that it would not apply the application of the new nexus to one-off transactions, and could demonstrate clearly that the company in question has significant revenue in that market jurisdiction. Nevertheless, the proposal has the disadvantage of complexity due to the need to obtain reports from companies for a specified period of time, the difficulty in reaching a consensus with smaller economies given the increased difficulty in the creation of taxable presence and its creating the possibility for unwanted tax planning. With regard to the latter, consider, for example, a temporal test carried out over three consecutive years, where, in the third year, the MNE in question reduces its sales revenue or defers receivables, thereby avoiding the new nexus.

The third proposal is for a consecutive time threshold within a set period of time test, for example, the proposal made by Deloitte, which would be the use of three years within the last five years. This proposal has the advantage of its evident qualification to encompass only sustained activities and its ability to counter tax planning. However, it also has the disadvantage of administrative complexity and additional costs that would require the verification of the accounting of companies in different time thresholds.

The statement published by the OECD in October 2021 is silent on these matters. In the author’s view, all of the three proposals for including a time threshold have advantages and disadvantages regarding their implementation. Nonetheless, the proposal for a year-by-year basis is the most efficient to achieve the aims pursued, being tax certainty, simplicity and an incentive for the commitment of small economies. It is, therefore, the rule that should be adopted.

### 4. Conclusions

Digitalization is the present and the future of the world economy until another innovative mechanism comes along that has the same disruptive check on all of the premises previously adopted. The digital tools so developed have enabled a major change in society and especially in the structuring of the business. Currently, hyper-communication, the valuation of intangible assets and the great value inherent in data has created new and valuable business models, as well as brought about the erosion of the tax base and the transfer of profits to other jurisdictions. These are all characteristics that have put pressure on the current international tax system.

The tax dogmas developed almost 100 years ago are outdated with regard to the new business models, thereby necessitating the breaking of old paradigms where the tax nexus rule is one of the most important elements. The systematic application of articles 5 and 7 of the OECD Model and the UN Model relying on the taxation of business profits on a qualified physical presence does not encompass digital business models. The result is the demand to update the concepts underlying international taxation.
The unilateral measures taken by countries demonstrate that this way is not the best mechanism for updating the international tax system. Such moves could have a negative effect on the global economy and, therefore, would be a modification under which all stakeholders would be harmed.

Despite its inherent complexity, the OECD position to reach a consensus basis agreement is to be welcomed in the international scenario. This position arises because it would be capable of encompassing the targeted principles of simplicity, efficiency, tax security and low compliance costs.

The current article makes it possible to conclude that, despite some important points of attention, the creation of the new nexus rule based on revenue threshold that a non-resident company derives in another market jurisdiction is a reliable element to demonstrate the significant and sustained engagement of that company in the foreign market. It, therefore, deserves appropriate deference in the decision made by the OECD to not include other elements (plus factors), due to the clearly greater complexity that otherwise would be generated under the proposed system.

With regard to the value of the revenue threshold, given the desire to integrate small developing economies into the new tax system, the amount set should be the lowest possible. Based on economic impact studies, it can be deduced that a value of EUR 1 million would be sufficient. Such an action would mean that it would not be necessary to create two nexuses – one for small developing economies and another for non-small developing economies. This state of affairs is true despite the fact that the OECD’s decision to create a specific rule (EUR 250,000 for small developing countries) does not sound extreme, considering its easy political acceptance.

Finally, with regard to the time test, given the intention of the new rule to demonstrate sustained engagement and to avoid the application of the new nexus rule in cases of one-off transactions and to reach a global consensus, the time threshold should be set at one year. However, note should be made of the non-application of this threshold to one-off transactions.

Cumulative Index

Articles

China (People’s Rep.)

Cui Xiaojing and Chen Jingxian:
Building a Belt and Road International Tax Dispute Prevention and Resolution Mechanism 170

European Union

Marco Dietrich and Cormac Golden:
Consistency versus “Gold Plating”: The EU Approach to Implementing the OECD Pillar Two 183

Stefan C. Hammerl and Lily T. Zechner:
Administering Profit and Consumption Taxation in Market Jurisdictions: Selected Similarities in the Digital Era 2

Grahame R. Jackson and Harriet Brown:
The Role of Context in Interpreting International Tax Instruments: A Solution to the Erosion of Internal Cohesion of Domestic Tax Systems by International Law? The EU Directive on Administrative Cooperation Version 6 (DAC6) – A Case Study 54

Ronald Russo, J.J. Engelmoer and Mário H. Martini:
Cooperative Compliance in the European Union: An Introduction to the European Trust and Cooperation Approach 83

India

Bob Michel:
International Association of Tax Judges Webinar: Tax Procedures and Landmark International Case Law in India 14

International

Mark L. Brabazon:
Non-Discrimination and Transparent Entities 133

Richard S. Collier and Ian F. Dykes:
On the Apparent Widespread Misapplication of the OECD Transfer Pricing Guidelines Risk and Post-BEPS Problems for the Arm’s Length Principle 20

Cui Xiaojing and Chen Jingxian:
Building a Belt and Road International Tax Dispute Prevention and Resolution Mechanism 170

Pitamber Das and Amedeo Rizzo:
The OECD Global Minimum Tax Proposal under Pillar Two: Will It Achieve the Desired Policy Objective? 44

Marco Dietrich and Cormac Golden:
Consistency versus “Gold Plating”: The EU Approach to Implementing the OECD Pillar Two 183

Erik Guedes Franklin Dantas Lourenço:
Tax Challenges of the Digital Economy: An Evaluation of the New OECD Nexus Rule Based on Revenue Thresholds 197

Stefan C. Hammerl and Lily T. Zechner:
Administering Profit and Consumption Taxation in Market Jurisdictions: Selected Similarities in the Digital Era 2

Grahame R. Jackson and Harriet Brown:
The Role of Context in Interpreting International Tax Instruments: A Solution to the Erosion of Internal Cohesion of Domestic Tax Systems by International Law? The EU Directive on Administrative Cooperation Version 6 (DAC6) – A Case Study 54

Belisa Ferreira Lisotti:
Limits of International Cooperation: The Concept of “Jurisdiction Not to Tax” from the BEPS Project to GloBE 63

Michelle Markham:
Action 14 of the BEPS Project: Taking the Pulse of Tax Certainty and Determining the Effectiveness of the Peer Review Process Five Years On 96

Bob Michel:
International Association of Tax Judges Webinar: Tax Procedures and Landmark International Case Law in India 14

Ronald Russo, J.J. Engelmoer and Mário H. Martini:
Cooperative Compliance in the European Union: An Introduction to the European Trust and Cooperation Approach 83

[continued on page 216]