

International Tax

REPORT

The monthly guide to international tax planning

Is cloud computing a challenge to the traditional concept of a permanent establishment?

Introduction – defining cloud computing

The term *cloud* is used by the information and communication technologies (ICT) industry to indicate, primarily, virtual platforms or infrastructures that allow the execution of codes (services, applications, among others) in various forms across multiple resources, with relevant data.[1]

In the legal field, clouds are defined as a *virtualised ICT service that is flexible, that can be accessible from anywhere (usually by virtue of the internet, but not exclusively) by one or multiple users (multi-tenancy), and that can be charged based on access or can be rendered for free, depending on the type of service.*[2] This is a service that has capabilities and characteristics that differ from other traditional outsourcing services.[3]

Clouds are *elastic* (capable of changing and adapting an infrastructure), *reliable* (meaning that the cloud service must work without problems of loss of data and no code reset during execution), *agile* and *adaptable*. [4] They are also supposed to be *easy to use*, to have an *independent infrastructure* from the user and, in many cases, to be in an *independent location*, without causing any damage to the data or service that is being hosted in that environment.

Economically speaking, cloud services imply a *reduction of costs* for enterprises, especially with the modification of a Capital Expenditure (CAPEX) that is usually needed to build a local infrastructure to an Operational Expenditure (OPEX) related to the capabilities outsourced without the need to capitalise assets.[5]

Clouds also represent a change in modern business activities and behaviour, since they are a new technology that makes it possible to substitute traditional transactions with goods (as with the purchase of a CD, in a physical support) held in a *physical environment*, for a simple download from a *virtual environment* through the use of the internet.

The virtual environment in which clouds are implemented makes it possible for enterprises to easily and remotely access a global market without the need to establish a physical structure in every place of business, maintaining the control of their activities in the headquarters or anywhere else they wish. In this sense, clouds can also be categorised as born global[6] business.

As a consequence of their features and benefits, clouds are spreading throughout businesses all over the world and increasing their market value. [7] The more they grow, the greater is their influence on economies, and, in the same proportion, the number of related legal issues grows. In this sense, the need for traditional law concepts, once applied to the ordinary market, to attend the new reality arises.

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Currently, there are few rules addressing cloud issues or there are rules that are applied to clouds but that relate to the ordinary market. Consequently, topics such as data privacy control, transfer of data, information ownership, data and service location and jurisdiction to tax such services, among others, are on the cloud agenda of most authorities around the world.

One of the main problems discussed by authorities is the jurisdiction related to such services. As clouds are a virtualised service, the lack of physical structure makes it possible for them to be rendered all over the world, with resultant difficulty as to tracking and control by local authorities. In this sense, authorities, in an attempt to solve practical problems, are regulating their transfer cross-border without proper care, thereby adding new problems to the existing ones.

The establishment of a legal framework to regulate the way such services are interoperating among countries is more than necessary. However, the regulation should not restrict business itself.

Recently, the European Economic Area (EEA) issued restrictions on the export of data within its territory for privacy protection purposes. The ruling is controversial, since instead of focusing on a technological mechanism of protection, such as encrypting storage and transmissions that make the data unintelligible for unauthorised parties, it established restrictions to business itself.[8] This is an example of how authorities are not addressing problems of the new digital era properly.[9] This became even more relevant when US and EU are discussing how to restore trust in relation to the data flow between the countries, due to Snowden case effects.

The concepts of transfer and data location are narrowly constructed. This is sensible when data is physically carried and stored in media across borders, but this is not the situation presently after the advent of the internet and remote access to data.[10]

The same problem is faced in international tax where traditional concepts and rules are addressing digital transactions without adequate consideration of their characteristics. As will be discussed, tax authorities tend to construct their system on the ordinary market, which is not prepared for the challenges imposed by the digital market in which clouds are inserted.

Considering such an environment, this article discusses the application of traditional international tax rules and concepts, which were constructed for ordinary services, to a virtualised environment, and addresses, in particular, jurisdictional tax issues in relation to cloud services.

For this purpose, the first part will introduce the main features of cloud services and the problem of the location of data. The second part will introduce current principles and concepts that involve cloud services and international taxation. The last part will introduce current proposals that supposedly better address the jurisdictional problems caused by digital services.

Cloud features and their challenges

Types of clouds

As mentioned above, cloud services are ‘*virtual, flexible, accessible from anywhere by one or multiple users and chargeable or rendered for free*’.[11] There are several types of cloud services that can be offered *individually or jointly* by the service provider, each one with specific characteristics and functionalities, as follows:

- Infrastructure as a Service (*IaaS*) – a type of cloud service that aims to provide enhanced virtualisation capabilities, or resources like (i) *Data & Storage Clouds* and (ii) *Compute Clouds*, which provides access to computational resources like Central Processing Units (‘CPUs’).
- Platform as a Service (*PaaS*) – offers ‘*computational resources via a platform upon which applications and services can be developed and hosted and it typically makes use of dedicated Application Programming Interface (APIs) to control the behaviour of a server hosting engine which executes and replicates the execution according to user requests (eg access rate)*’.[12] An example of such service is the Google App Engine.
- Software as a Service (*SaaS*) – offers specific functionalities, usually through software application and it may use infrastructure or a platform. It is known as *Service or Application Clouds*. An example is Google Docs that is an online word processor.[13]
- Network as a service (*NaaS*) – offers the use of network/transport connectivity services and/or inter-cloud network connectivity services. Accordingly, *NaaS* involves the optimisation of resource allocations by considering network and computing resources as a unified whole. It also includes virtual networks (VPN-VNO).[14]

Cloud services can be implemented or used through *private* (typically owned or leased by enterprises that have total or major control of the cloud), *public* (service used outside the enterprise and not exclusively), *hybrid* (combined private/public solutions), *community* clouds (restricted to the local infrastructure) or *special purpose* clouds.

As a combination of public and private types, *hybrid clouds* are more often used as a way to outsource services by an enterprise, because they make it possible for enterprises to maintain control over their relevant data resources through the private service and also reduce costs using public ones.

The service has a complex chain and can be offered to customers directly in a layered manner by *cloud providers* (via dedicated APIs, virtual machines or direct access to resources); by *resellers or aggregators* (aggregates cloud platforms); by *adopter or software vendors* who enhance their own services and capabilities by exploiting cloud platforms from *cloud providers* or *cloud resellers*.

An example of a public *PaaS* is the Google App Engine. This is an application rendered in a *public* cloud that lets customers run their own web applications on Google’s

infrastructure. With this application, the customer does not need to maintain any server and just uploads the application into Google's system. It then becomes a right available for the customers, clients or users.[15]

Cloud services may be rendered in an "unlayered" or in a "layered" manner.[16] There will be an unlayered cloud service if the provider offers a standard and direct *IaaS/PaaS/SaaS/NaaS* to a customer.

For instance, if a customer T chooses to use a Google App Engine cloud to perform its own services of data processing with its own software, it is an unlayered cloud service that is being provided by Google to T. T can even choose to use more than one type of Google cloud service at the same time. This will still be considered an unlayered service from Google's perspective.

On the other hand, from T's perspective, it is possible to identify a layered service being rendered by T to another customer C, since T may use Google's cloud service to provide its services to third parties. T's services are layered in Google's services, even though the customer C had only contracted with T.

Layered services may lead to discussions about the liability of services to the end consumer, as well on the liability for paying taxes, depending on which jurisdictions each of the parties is established or legally/economically connected. For instance, if T, Google and C are subject to the rules and taxes of different jurisdictions, there might be conflicts related to the cloud services rendered.

Another important aspect of cloud services is that they differ from traditional ICT outsourcing. The latter usually implies that the outsourcing service provider is an agent of the customer, since the customer may effectively transfer part of its core business to the control of the outsourcing provider.[17]

With clouds, this usually is not the case,[18] because the customer only chooses packages that are already designed for the public in general, without the possibility of customisation or control by the cloud provider, so that the customers can use cloud resources to directly process or generate information on their own account. In this sense, 'cloud services differ from traditional outsourcings in relation to the type and degree of user's control'.[19]

These differences have tax impacts in the sense that cloud providers cannot be treated as traditional outsourcing (or an agent) for tax purposes – in most cases – because they simply provide ICT services without any control on the customer's activities.

Another interesting feature that is being developed by public cloud providers is interoperability, which is the capacity of transit of data among different cloud providers, without the risk of loss or damage to data. This would generate a 'cloud of clouds' which mirrors the 'network of networks' that forms the current Internet model as we know it.[20] It is the 'inter-cloud' that can turn clouds more globalised, agile and flexible, and reduce costs for enterprises. However, this new feature makes the identification of location and providers by end users and

interested parties more difficult and, as a consequence, the determination of the jurisdiction to tax the respective service and income derived.[21]

Clouds and the problem of location of provider, resources and data

As mentioned above, one of challenges of cloud services is related to the jurisdiction to regulate and tax the service, income and parts involved. The problem is directly related to clouds features of flexibility, agility and virtualisation.

Clouds services deal, principally, with data storage, process, generation, which may be 'at rest' or 'in transmission' to/from clouds providers, customers and third parties anywhere in the world.

In a layered structure, the problem can be accentuated, because on many occasions the customer is not aware of the existence of a third cloud provider behind the one with whom it contracted. As a consequence, it is not uncommon for the customer to completely ignore the identification and location of all its service providers.[22]

Another feature of clouds is that, for security and consistency of the system, they must have flexible distribution of the data across multiple resources, which implies data replication within all their resources that may be located within multiple jurisdictions. This is the reason why Cloud services are referred to as a resource with 'unknown' location.[23] Additionally, it is often possible that a code and data use a cloud resource with an unknown location attributed and that is assigned to multiple users at the same time.

The replication occurs because clouds deal with a huge amount of information from different customers located in different places, and this helps to maintain clouds functions and, particularly, to avoid loss of data.

In this sense, the replication, modification and mobility of data are not features that may be controlled or changed by authorities, or even penalised by submission to more than one jurisdiction and, as a consequence, to more than one tax. It is a feature to be protected, because it is one of the main reasons why such business is used extensively and is becoming profitable.

Also, data is constantly being added, removed or modified, and even new information may be generated in its environment by either the cloud provider, or the customer, or even by a third party contracted by the cloud provider of the customer. This may lead to a discussion of the ownership of the data created in the cloud environment.[24]

With such features, it is complex to 'establish a link between the data held in the cloud, the user device from which data was created, submitted to, or accessed from, the cloud service, and an individual user'.[25]

These cloud features bring up challenges to authorities in relation to their regulation and taxation. In a discussion about the future of cloud computing in the EEA it was stated that:

'With the cloud principally hosting data/code anywhere within the distributed infrastructure, ie potentially anywhere

in the world, new legislative modes have to be initiated and/or new means to handle the legislative constraints during the data distribution. (...) Clouds generally benefit from the globalisation in order to make use of cheaper resources in other countries.'[26]

It is clear from the above that legislation currently in force within the EEA is not able to deal with one of the main issues involving clouds: multiple hosting and, therefore, multiple jurisdictions to regulate clouds. This is the situation not only in the EEA, but in most of the world.

Because of their importance, cloud issues are the object of the Digital Agenda for Europe, headed by the European Commission, which has outlined actions to deal with clouds main problems – for example, the establishment of a framework, security and standardisation of clouds.[27]

The European Union's agenda has already occasioned the issuing of rules in relation to data protection that have some influence on the way cloud services are being provided in the EU.[28] Such regulations aim to avoid the misuse of data, restrict some actions related to cross-border transfers, avoid risks involving clouds such as the lack of control over data, insufficient information regarding processing itself, or lack of transparency in the services.[29]

Further, the Data Directive[30] establishes that with reference to services involving EU Member States, the identity of service providers involved in the chain of a cloud service shall be available to the customer in order to make it possible for him to verify where its data is located and by whom it is being managed.

This rule has an impact on cloud services, since cloud providers are obliged to render a service with transparency by making available information in relation to the location of the data they are handling as well as in relation to the identification and location of the resources used or of any other service provider involved in the chain of cloud services.

Such change in the regulation of clouds will help to develop a framework in which it will be possible to more easily identify all information in relation to the service and, in this sense, to establish the jurisdiction applicable to regulate and tax such services. In this sense, tax authorities and organisations should take advantage of the new framework to define their new policies and concepts.

In addition, the OECD has considered income tax concepts and principles for electronic commerce (e-commerce) pertinent to cross-border transactions that encompass clouds. Its discussions led to the publication of Discussion Drafts and Reports[31] that, in summary, concluded, initially, that traditional tax concepts and principles could be applied to e-commerce transactions.

However, the OECD's position recently changed, due to the increase in digital transactions, and their importance to the market and to the pressure from countries for a solution to tax conflicts over jurisdiction. In this respect, it has published the Base Erosion Profit Shifting Report (BEPS Report)[32] that related the need to evaluate digital transactions models under current

concepts and policies of e-commerce international taxation. The BEPS Report was followed by an Action Plan[33] (Action Plan) that indicates the scope of this tax agenda and provides that the first results should be presented by countries by September 2014. The BEPS Report and the Action Plan are considered in more detail below.

This is an undoubtedly important opportunity to evaluate a new approach for cross-border income taxation of e-commerce, introducing concepts and principles that are more in line with its nature and features, without causing any harm to business.

For this, it is necessary to evaluate the current concept of a Permanent Establishment (PE) and source taxation principles. The following parts of this article address these issues.

The concept of permanent establishment and cloud computing services

Background – International taxation concepts

A cross-border cloud computing service may give rise to conflicts of jurisdiction to tax by one or more states, since it is possible to trigger double taxation of the same taxable event (*economical*) and, in some cases, double taxation of both the same taxable event and the same taxpayer (*juridical*).[34]

Accordingly, countries are free to establish their own domestic tax rules in line with their sovereignty and are not allowed to enforce their tax legislation outside their own territory. Hence, when dealing with cross-border transactions the right to extraterritorial tax is not a consensus and international tax principles have been developed to orientate such taxation, aiming the most neutral and less harmful possible effect to cross-border business.

A recognised principle of international taxation is that business profits shall be taxed only in the *residence* of the enterprise. An exception to this principle which gives rise to a source *taxation* occurs when the enterprise has substantial economical presence in a country other than the one of its residence. In this situation, the enterprise is deemed to have a PE in that other country, with tax consequences in relation to its operations in that territory.

The PEs international concepts and bases were developed when businesses relied on the existence of a *physical presence* (human element and a tangible production locality) or of a representative presence (usually an agent). [35] However, in modern business, which is becoming more and more globalised and without *frontiers*, where it is even possible to categorise a type of business as 'born global', principles and concepts relating to PEs need a reconceptualisation, paraphrasing Dale Pinto[36] that is able to address current problems without the erosion of tax revenues and jurisdiction.[37]

It is a reality that substantial activities are taking place with no necessity for human intermediaries or an infrastructure in order to produce an intangible good, or to render a service. By comparison, the virtual environment

is mobile and flexible, which makes it difficult to establish a fixed location and, therefore, jurisdiction to tax according to traditional patterns.

Cloud computing services are undoubtedly encompassed in this new 'born global' business, making it necessary to reevaluate PE concepts in order to properly achieve such services without harmful effects for governments and taxpayers.[38]

It is a reality that many global businesses are already running their systems within a cloud environment, which implies a complexity of taxing[39] issues that may be related to the sale of goods, to the rendering of services by internet, or even to the developing of an intellectual property right in a virtual environment.

The challenge is even worse, considering that cloud services are, by nature mobile, flexible and layered services, which means that several service providers render the services to one or multiple customers (multi-tenancy) who do not have a clue of the layered chain behind the provider with whom they have contracted and that such services are fragmented in several jurisdictions.[40]

Additionally, because of their flexibility and mobility, clouds may not have a known and fixed location, which in conjunction with the above mentioned characteristics leads to the problem of application of traditional international tax principles and domestic legislations. As indicated by Bird,[41] the *'anonymity and mobility associated to electronic commerce make both of these tasks more difficult. If the electronic world is indeed "borderless", how can "bordered" territorial jurisdictions identify what or whom they should tax?'*

Indeed, clouds make it possible for enterprises to conduct their activities in several jurisdictions without any physical presence and, because of that, in many cases without the obligation to pay income tax for the source country where the service is being delivered or developed. This is due to clouds' characteristics that are virtual and conducted mostly through the internet and automated functions.

This situation may cause erosion of taxation in source countries; a problem that, as already seen, has drawn the attention of the OECD. Its discussion on BEPS addresses issues related to digital transactions and their challenges for tax authorities and supposed harmful effects for such authorities, as well as those for taxpayers.[42]

Accordingly, the BEPS Report discusses the application of treaty concepts to profits derived from the delivery of digital goods and services. This has been followed by the Action Plan that aims to *'address the tax challenges of the digital economy identifying the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation'*. [43]

The Action Plan examines *'the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules'*[44] (which means, lack of physical presence and of the attribution of profits to a server PE considered on a factual and functions analysis).[45]

It analyses the *'attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.'*[46]

It is clear in the Action Plan that OECD member states have recognised that the economy is more globally integrated and that corporations are shifting from *'country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level'*. [47]

Moreover, the BEPS Report acknowledges the growing importance of digital services, in particular, those delivered by the internet have *'made it much easier for businesses to locate productive activities in geographic locations that are distant from the physical location of their customers.'*[48]

This description includes cloud computing that is virtual, layered, mobile, flexible services, and which reduces costs for companies by placing IAAS/PAAS/NAAS/SAAS infrastructures to multiple customers in several known and unknown locations.

The new environment leads to the erosion of tax revenue from countries. This harms governments (less revenue and higher costs for compliance), taxpayers (shift of income from the producing jurisdiction increases local taxpayers' taxes) and even business (reputational risk for multinational enterprises if tax rate is too low amounting to unfair competition).[49]

It is, therefore, necessary to analyse in depth this digital economy to prevent base erosion and profit shifting. This may be done by verifying that digital enterprises add value and make their profits in source and residence jurisdictions, taking into account the value attributed to the respective intangible assets used, massive use of data, and the adoption of multi-sided business models capturing value from externalities generated by free products.[50]

In this sense, the OECD and governments have accepted and recognised that the lack of action in relation to this digital economy, and, in establishing a new and especial tax treatment is due to weaknesses that put the *'existing consensus-based framework at risk, and a bold move by policy makers is necessary to prevent worsening problems. Inaction in this area would likely result in some governments losing corporate tax revenue, the emergence of competing sets of international standards, and the replacement of the current consensus-based framework by unilateral measures, which could lead to global tax chaos marked ...'* [51]

To achieve such objectives, one may question if digital services and, in this context, clouds can be 'bordered' and if it is necessary to have a physical presence to establish an economic link between the enterprise and source country where the cloud is producing consequences for tax purposes. Questions that arise are: how this link can be established in a virtual environment and if it can be established, how to measure this economical presence

and how to allocate tax jurisdiction when everything is literally ‘in the air’?[52]

This article now focuses on digital presence in the economy and on the nexus that it is necessary for source countries to establish a right to tax. To achieve this, it is important to analyse current international tax principles as applied to digital services, the foundations for source taxation and the existing proposals for changing and possibly reconceptualising the PE concept.

Source and residence taxation

It is a consensus in international taxation that the basis for claiming tax jurisdictions over foreign income is residence and source principles and conflicts on the establishment of one or another type of taxation is solved through unilateral (domestic legislation), bilateral (double tax conventions) that, on the other hand, indicate the method of relief on the double taxation.[53]

As mentioned, the right to tax cross-border cloud services deals with traditional international tax principles that are based on sovereignty of states and their jurisdiction to tax. The jurisdiction to tax entails discussions in relation to *source* and *residence*-based taxation and their respective foundations.[54]

Source taxation is a limited taxation based mainly on the territoriality principle,[55] irrespective of the residence of the taxpayer, which means that the right to tax of a country is founded on the occurrence of some taxable event in the country’s territory that can be the existence of a PE. Source taxation has two main aspects: the characterisation of income and the territorial location from which this income is earned[56] and this last one is the object of the present article.

Income can be characterised under both domestic and treaties rules with different source rules designed for each category. Generally, they can be categorised as business profits, dividends, royalties, capital gains, among others.

Business income is usually based on the location of the income earning activities and the test for verifying this is traditionally the verification of the existence of an *effective business in the territory* and a *place of performance of services*, and these concepts are found in domestic law and, in general, are based in physical presence.[57] Tax treaties also raise the threshold for source country taxation of business income, which currently requires a minimal physical presence for PE in relation to business services taxation.

The justification for source taxation has been grounded on several theories such as economic allegiance (EA), the benefit theory, the national rental theory and the territorial sovereignty (or entitlement), and it is founded in neutrality and equity policies.[58]

Regarding the *residence* principle, the nexus that gives rise to the right to tax is the residence of the taxpayer and is usually based on worldwide income taxation, irrespective of source income. Justifications of this type of taxation are based on the need to contribute to the country where the taxpayer resides.[59]

Countries usually use a combination of both *source* and *residence* to establish their right to tax in relation to cross-border transactions.

The source taxation, as mentioned, depends on the existence of an economical link, which in the case of analysis is the PE[60] that is founded in physical presence.

Source taxation foundations

As indicated, source taxation is founded in neutrality, equity or entitlement policies, as well as in EA, benefit and entitlement theories. All of them are intrinsically connected to the balance of allocation of taxing rights among states, which means that despite being used as a justification for the source country to tax, they also have regard to the distribution of tax revenue among the respective countries involved in the cross border transaction.

Neutrality

Neutrality is a principle to be achieved in tax, since tax should not interfere with factor distribution by market forces.[61] In order to avoid interference, countries should rely on a high degree of neutrality in their taxation when issuing unilateral, bilateral or multilateral measures, so that there would be no influence on the allocation of global resources. This neutrality is usually introduced in tax systems through policies of *Capital Export Neutrality* (CEN), *Capital Import Neutrality* (CIN), *National Neutrality* (NN) or *Inter-nation Neutrality* (IN).[62]

Through CEN, neutrality is realised when it will not matter *where* the investor will allocate its resources, in its home country or abroad, so that taxation does not influence the decision on the place of investment. This principle is closely linked to *residence* taxation and preferred by capital export nations. In practice, CEN requires high cost administration and cooperation between nations and it usually is observed in a manipulation of tax rates in order to make CEN more attractive.[63]

Conversely, opting for the CIN principle, country’s international taxation will not take into account *who* is investing in their territory, treating in the same way residents and non-residents. The rationale of the CIN is that it is an incentive to fair competition in the country and it encourages the efficient allocation of savings, since investors would have the same rate of return on similar investments in that market.

CIN is likely to be chosen by capital importing nations, because it is based on *source* taxation. Nevertheless, it also generates conflicts within countries, since methods to establish such taxation may lead to investments in low tax jurisdictions, influencing negatively the tax competition among countries.[64]

The NN is based on the nationality of the investor and the rationale is founded on the national prosperity and in the strengthening of the residence country’s right to tax.[65]

Finally, in reference to IN, the base to establish neutrality are not only taxes, but all administrative *net output*, including transaction costs and benefits.[66]

CEN taxation has been challenged and source-based taxation based on CIN has been suggested to prevail over

residence-based taxation, because CEN can distort relative prices and is non-neutral and inefficient.[67] In IN countries, Dale Pinto[68] indicates that there will be a tendency towards source taxation also, because with neutrality of administrative output, investors will opt for the respective locations and, in this sense, the source is the taxation to be chosen.

CIN and IN countries tend to establish source taxation unilaterally, via their domestic legislation, whereas CEN countries are likely to introduce a residence-based taxation.

All such neutrality principles are applicable to *cloud computing* services and may influence the way such services are to be taxed by each State and in bilateral measures, when dealing with international transactions.

CIN and IN may impact on the establishment of a source taxation on clouds, since their principles rely on the neutrality of investment and on the local economy. In this sense, a CIN or IN policy will consider that a country's e-commerce income taxation shall not affect the business itself because it is a foreign business, remaining neutral for the cloud provider decision on where to provide services.

Equity

With reference to equity, a tax shall be considered equitable depending on the individual (position of taxpayer) or the inter-nation (gain and loss of residence and source countries)[69] perspectives.

Under the individual perspective, a tax shall be equitable if it is grounded on legitimization (justified), equality, integrity and redistribution. Under an inter-nation equity, the rationale is that the source taxation derives from the fact that *each country should receive an equitable share of the tax revenue from cross-border transactions*,[70] depending on the *allocation of the tax base between the source and residence countries, and the tax rate in the source country*. [71]

Moreover, such IN taxation should be regarded in a minimum integration, meaning at least a presence through a PE, in the source country. However, inter-nation equity may give rise, *per se*, to a source taxation because the economic element involved is likely to justify. [72] It is the case, for instance, of marketing through the internet whose role, undoubtedly, contributes to the sales of a product in that country.[73]

Benefit theory

Through *Benefit theory*, the right to tax derives from benefits and services that the source state provides to the individual or entity that is making a transaction with such a country. In this sense, taxes are considered a price paid for such benefits and services that may be general (security, availability of labour, infrastructure, etc) or specific (legal framework that protects rights to render services, intellectual property rights, specific infrastructure to services related to the business).

It is regarded that without such benefits and services, the business would not be able to run in the respective country and as they have a cost, this cost should be borne by the foreign investor that is making use of it, through source taxation.[74]

Economic allegiance

Under *EA*, source taxation is possible to entail a fair and equitable distribution of tax burdens between nations. [75] This theory indicates that source taxation is based on the mere consumption or business activities and the respective tests to verify EA with the source country are: (i) the acquisition of wealth (where was the yield physically and economically produced?); (ii) the location of wealth (where are the final results of the process as a complete production of wealth to be found?); (iii) the enforceability of rights to wealth (where can the rights to the handing over of these results to be enforced?); and (iv) the consumption of wealth (where is the wealth spent, consumed or disposed of?).[76]

All factors should correspond to the place of taxation and each of them can be established in different places, posing different jurisdictions. The acquisition of wealth was considered by the League of Nations as the most important one in determining the tax jurisdiction. However, the problem is to determine where it is produced.[77]

Accordingly, when evaluating the theory, the League of Nations indicated that it shall be EA to a community the *economic life of which makes possible the yield or the acquisition of the wealth*. [78] Additionally, the economic link described by the League of Nations would be attributed to human relations that would help in creating such yield and not to some immaterial or objective element.[79]

As concluded by the League of Nations, EA is the base of the right to tax of a country and is founded on the existence of an economic link between the business activity and the country's territory which would be attributed to the 'production' related to the business. Such production would require a physical presence and some structure to run in the territory. Therefore, there would be the economic link, if the existence of a physical structure running a business in the respective territory was verified.

Those factors indicated by the League of Nations are the bases of the current traditional distribution of taxation incorporated by international taxation and respective tax treaties. In this sense, they influenced the establishment of the traditional concept of PE and the current source taxation of electronic services and clouds.

However, it is currently discussed that the EA also entails the source-based taxation even with minimum or null human or physical presence in the territory where the economic link is intended.

In consonance to this approach, it is possible to allocate tax revenue to the country without physical presence requirement, because production and economical presences are different and, therefore, could be in different jurisdictions. As observed by TADMORE: *'physical situs is of importance in EA only to the extent that it reinforces economic location'*. [80]

Additionally, it would be possible to have an EA with both the residence and source states, since one does not exclude the concomitant EA of the other, being necessary to establish criteria to attribute the proportion to each of the countries.[81]

Realistic doctrine

By this doctrine, the jurisdiction to tax derives directly from the power to tax, and countries sovereignty and powers could not be limited by international rules.[82] This is a practical approach, by which independent of foundations to a source or residence taxation, countries will exercise their right to tax and they should discuss the most effective manner, placing a limit to each other's right to tax in order to coexist. It is based on withholding taxation, since it is an effective method to achieve its objectives.[83]

Entitlement theory

This theory conceives that source taxation derives from the entitlement to tax income, which arises from its geographic borders even if the income accrues from non-residents. This is because the source country would be the place of income generating activity, paraphrasing Peggy Musgrave.[84]

With regard to e-commerce and clouds, which lack physical presence, Dale Pinto indicates that scholars such as Charles McLure and Avi-Yonah have been advocating that the entitlement theory supports taxation in source countries even in the case of virtual business if the right to tax is based on the economic presence rather than on physical presence.[85]

Dale Pinto clarifies that the economic presence in e-commerce could be determined *by reference to a regular and systematic direction of activities in a country*, whose nexus will depend on whether the activities of non-resident vendors were 'purposed or directed' at source-country customers, by means of asking the following questions[86]:

- (1) Did the taxpayer 'purposefully avail' itself of the benefits of a taxing state?
- (2) Did the taxpayer's conduct operations in the taxing state rise to a level where it should have reasonably anticipated being haled into court?
- (3) Were the taxpayer's in-state activities a continuous and systematic part of its general business in the state?

Dale Pinto concludes, citing McLure, that entitlement may be a base even when accounting profits are used by enterprises, rather than economic profits, since the right to tax should exist any time the enterprise avails itself of the productive resources or the market of a country.[87]

Finally, the entitlement theory can provide grounds for the source taxation of e-commerce and, in this sense, of clouds, if a substantial economic presence is verified. As Dale Pinto observed, the '*mechanics of how source may need to be (re)defined to accommodate the characteristics of electronic commerce is a secondary consideration to theoretically establishing the proposition for the continuation of source-based taxation in an electronic commerce context*'. [88]

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BRICS and article 12: international tax policy implications: Part 4

In this final part, Peter Wilson concludes his discussion of Article 12. Parts 1-3 appeared in the previous three issues of ITR.

Beneficial ownership

The beneficial ownership sub-article contained in art 12 is relevant when a resident of a second contracting state seeks to avoid or minimise a source country corporation tax or withholding tax from a first state, by using a conduit company in a third state to receive a payment from the first country. In respect of granting a right to use technology, how will the BRICS react to the use of a conduit company by another BRICS in order to obtain a reduced tax charge?[209]

If the first state investigates whether the registered shareholder is the beneficial owner, how that investigation is conducted is becoming more important.[210] In conducting those investigations, will the other BRICS behave like Russia where illegally obtained information was not permitted to be produced as evidence to support a claim of a related party transaction, or will preventing tax evasion justify the means?

The BRICS do not have a unified international tax policy addressing this question and in the absence of such a policy significant questions to be answered include the nature and degree of substance to be absent or present in an arrangement for the tax authority to ignore the intermediary's existence.

[211] In India, for example, a statement of tax residence from the receiving tax authority was conclusive evidence of tax residence, but whether this will be acceptable going forward is in doubt.[212] In any event, is this an acceptable means of dealing with such a difficult issue?

Each of the intra-BRICS DTCs art 12 provision contains a limitation of benefits provision and maybe it can be expected that those provisions will be varied if the ultimate beneficial holder resides in the same DTC country or in another BRICS country.

The OECD has also increased its interest in beneficial ownership as discussed in Public Discussion Drafts on arts 10–12[213] and it remains to be seen how the BRICS respond to and use this information. The position currently adopted by China in rulings and the local tax bureau decisions is an advanced and sophisticated approach to the problem. It is not immediately apparent though whether any BRICS members participated in the preparation of that Draft as members of Working Party 1.

Alienation versus letting

An outstanding fundamental question amongst the BRICS is whether a payment for an alienation is a royalty.[214] This question has been extended to consider whether a limited alienation (by region or by years) will be accepted as a letting or alienation. Additionally, in the Russia/South Africa DTC, an alienation payment is considered to be a royalty[215] which contradicts the general OECD principle.

Arm's length

Since Brazil applies a transfer pricing (TP) methodology, which in some respects is at variance with the other BRICS, and because the BRICS (except broadly Russia) have a different approach to the OECD countries[216] there is room for conflict between Brazil and the other BRICS over the arm's-length price for a royalty or fee for a technical service.[217] In this eventuality, there may be an inability to make compensatory adjustments if the competent authorities are unable to agree on an acceptable transfer price.

This potential problem needs to be removed through a change in existing BRICS international tax policy if the free exchange of IP and equipment is to take place unimpeded by taxation issues.

The BRICS acknowledge the seriousness of TP and in a January 2013 meeting,[218] agreement was reached to produce a common TP methodology intra-BRICS and then to provide this to international tax governing bodies (including the OECD and the UN) for discussion and inclusion in the major tax governance DTCs.

In agreeing to work together in this manner, the BRICS have further evidenced their seriousness in this area particularly in view of their collaboration in the production of the Appendices to the UN Transfer Pricing Manual.[219]

Economic ownership of assets

With increased OECD, G20 and G8 emphasis on considering methods of profit shifting and base

erosion,[220] there is increased consideration by academics, practitioners and governments[221] of the appropriateness of 'cost contribution agreements' as a means of sharing costs and revenue between multinational enterprises. This may lead to further identification of the economic owners of intangibles, potentially leading to re-allocation of royalty and profits from the country of sale to the market country.

In looking at the economic ownership question, therefore, the BRICS should consider the totality of the commercial arrangements[222] entered into by the parties including the implications of payment versus accrual in determining whether tax is to be deducted.[223]

Audits

If the BRICS increase the number of international tax audits on MNEs to pursue tax avoidance and evasion, then it will become important for them to avoid obtaining evidence in a legally unacceptable manner.[224] If they wish not to follow accepted international procedure then the procedures they adopt should be widely publicised in order to assist compliance. Currently, the BRICS art 12 international tax policy is not substantially developed in this area.

Rates

If the BRICS settle on the source and residence approach, then it would be helpful for the limited rates to be standardised between the BRICS and for different categories of royalties to have a harmonised rate. The analysis of the existing BRICS DTCs contained in this article confirms the differences in rates and definitions and calculation methods.

In relation to the extension of the meaning of royalty to include equipment usage, it seems sensible for the calculation basis to be net (due to the costs associated with ownership and operation) and not gross and for a uniform allowance to be agreed upon in order to standardise the tax calculation.

Conclusion

The purpose of this article has been to investigate the BRICS international tax policy both intra-BRICS and with third parties that are applicable to cross-border payments for the use of intellectual property, knowledge and assistance including payments which apply to the use of equipment covered by art 12 of the OECD Model and bilateral DTCs.

This investigation is important in the light of the BRICS' intention to re-emphasise the sharing of knowledge, services, information and equipment so that their economies continue to grow unimpeded by unacceptable tax interference.

The precedents considered in this article show differences of approach at the judicial (and in the case of China, at the local Bureaux) level, and in the reservations and positions to the OECD Model DTC art 12 and its Commentary, show divergences of opinion and the DTCs already in place are not consistent. The differences in TP methods are of substantial concern as they may lead to economic double

taxation on royalty payments that is not resolved through compensatory adjustments. Additionally, the lack of an effective DTC between Brazil and Russia is a concern.

The implications of these matters for BRICS international tax policy as a whole that influence the flow of science, technology and innovation is concerning. If this flow is to be unimpeded by tax differences so that IP can gravitate to the location and user of best use, then substantial changes need to be made to remove impediments and to streamline interpretation.

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Endnotes

209. For example, if a Russian licensor provides IP to a Chinese company through a Hong Kong company.
210. *Universal International Music BV*; *Azadi Bachao Andolan* (263 ITR 706); *Moody's Analytics Inc*, AAR No. 1186 of 2011 and the *Monteka* case.
211. Both China and India have some recent examples of precedent on beneficial ownership including *Mudan* (July 2010), *Chongqing* 2010, *Fujian* (June 2010) in China (authority for the principle that where non-China-holding companies have no substance the beneficiary shareholder will be the individual owning the holding companies) and *Universal International Music BV* in India.
212. *Microsoft Corporation and Microsoft Regional Sales Corporation* (ITA No.1392 (Del) of 2005 is authority for the proposition that when companies are issued residency certificates by foreign tax authorities the entities are neither fictitious nor shams. The *Microsoft* decision was based on *Arabian Express* (212 ITR 31) which held that when a sovereign state recognises the legal existence of an entity by issuing a tax residency certificate, another sovereign state is required to recognise the residency and it was not open to the tax authorities to declare these entities to be a sham.
213. See, the OECD Discussion Draft dated 29 April 2011 and revised on 19 October 2012.
214. *Dishnet Wireless Ltd and BP Southern Africa (Pty) Ltd*.
215. Art 12(2) of the Russia/South Africa DTC.
216. The issues are described in the separate chapters provided by the countries appended to the UN Practical Transfer Pricing Manual for Developing Countries issued in October 2012.
217. Also relevant here are cases where unjustified benefit is claimed as in the *Monteka* case and if the parties were Russia and Brazil with a payment from Russia to Brazil with additional taxation in Russia it is unlikely compensatory adjustments could be made in Brazil.
218. In their January 2013, Delhi meeting, the Heads of the Revenue of BRICS Countries identify seven areas of tax policy and tax administration for extending their mutual co-operation. They issued a joint Communiqué on 18 January 2013.
219. Chapter 10 of the UN Practical Transfer Pricing Manual for Developing Countries, issued in October 2012.
220. The OECD's BEPS Project.
221. Statement by Paul W. Oosterhuis, Partner, Skadden, Arps, Slate, Meagher & Flom LLP at Testimony Before the House Committee on Ways and Means, 13 June 2013; Testimony of Professor Edward D Kleinbard, at Hearing Titled 'Tax Reform: Tax Havens, Base Erosion and Profit Shifting', US House of Representatives Committee on Ways and Means 13 June 2013 and Testimony of Pascal Saint-Amans, Director, Centre for Tax Policy and Administration, OECD before the US Ways & Means Committee Hearing on 'Tax reform: Tax Havens, Base Erosion and Profit Shifting', 13 June 2013 and "Stateless Income" – A Threat to National Sovereignty' Address to the Tax Institute of Australia's 28th National Convention, Convention and Exhibition Centre, Perth Friday 15 March 2013, by The Hon David Bradbury MP.
222. *SAB Miller case*, see above, 22.
223. *Booz Allen & Hamilton (India) Ltd & Co KG*.
224. *Monteka* – Element Trade.

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