June 17, 2024

To: Mr. Ramy M. Youssef
Chair of the Ad Hoc Committee to Draft Terms of Reference for a United Nations Framework Convention on International Tax Cooperation

Delivered by e-mail to: ahc-tax@un.org

**Re: Comments by Assaf Harpaz on the Bureau's Proposal for the Zero Draft Terms of Reference for a United Nations Framework Convention on International Tax Cooperation**

Dear Chair Youssef,

I am writing in response to your public invitation to provide written comments on the Zero Draft ToR for a United Nations Framework Convention on International Tax Cooperation. I am an Assistant Professor at the University of Georgia School of Law. I teach tax-related courses, and write primarily on international taxation.

My comments focus on two areas of the proposal: (1) Substantive Elements, including Priority Issues, and (2) Principles.

Please note that the comments are written in my personal capacity and do not represent the views of the University of Georgia.

## <u>Substance and Priority Issues</u>

The Zero Draft ToR incorporate broad, substantive commitments to address several priority issues in the multilateral process. My submission comments specifically on the commitment to the fair allocation of taxing rights, including the equitable taxation of multinational enterprises. This issue materializes in most priority areas, including taxation of the digitalized and globalized economy; taxation of income derived from cross-border services; and tax-related illicit financial flows.

I contend that the new framework convention should consider revisions to the widely utilized permanent establishment doctrine. Specifically, negotiations should evaluate the inclusion of a "virtual PE" standard or thresholds that would reflect digital activity in a market jurisdiction. Subject to this standard, a significant digital presence could constitute a permanent establishment without a physical presence, giving rise to taxing rights on business profits in a contracting state.

The permanent establishment standard, like other principles of international taxation, is largely grounded on the business practices of a twentieth-century, brick-and-mortar economy. It was adopted by the League of Nations 1928 model draft, later by the OECD and UN models, and has been broadly applied in bilateral income tax treaties. Under Article 5 of the aforementioned models, a permanent establishment generally requires a "fixed place of business" to give rise to taxing rights in the source state, although other forms can include construction and dependent agency PEs.

The permanent establishment definition and its scope are key parts of any bilateral treaty because it determines the allocation of taxing powers between countries. In negotiating the framework convention, the UN's chief task is to ensure the equitable allocation of taxing rights with a special focus on the tax challenges of digitalization. Addressing the permanent establishment standard with explicit attention to significant digital presence is an important step towards a fairer international tax structure. In a digital economy, companies often do not require a physical presence in the location of their consumers (e.g., in the form of a branch; office; factory; workshop). Value is increasingly created through user-generated content such as the sale of data; advertising; streaming; and the platform economy. A narrowly construed permanent establishment definition (present case) renders it difficult for the source (market) economy – where income arises – to tax those profits.

Thus, I recommend the adoption of model treaty language that recognizes significant digital presence as satisfying permanent establishment criteria. Specific language can include relevant indicators, services, and thresholds, that can be negotiated bilaterally. For example, significant digital presence ("virtual PE") could include a threshold of online users; business contracts concluded for digital services; sale of user-generated data; and online advertising in the contracting state.

It is acknowledged that there have been prior multilateral efforts to address the tax challenges of digitalization that have contemplated these matters. Namely, the OECD's Base

Erosion and Profit Shifting Project (BEPS 2.0) has culminated in a two-pillar solution that includes a reallocation of taxing rights on profits (Pillar One) and a global minimum tax on offshore income (Pillar Two). Moreover, the UN added new Article 12B to its model convention, preserving the right of source countries to tax income arising from automated digital services. Nevertheless, the decision to negotiate a new framework convention within the UN recognizes that more work is required in these areas. Namely, neither solution revisits or replaces the permanent establishment standard. For example, the OECD's Pillar One (*Amount A*) scope is limited to a subset of companies satisfying extremely high thresholds. In addition, both Pillar One and 12B currently face implementation hurdles.

Different variations of "virtual PE" have been proposed in the past, including a 2018 European Commission proposal, and the OECD under BEPS Action 1, in 2015. Still, there is no uniform standard or rule that deems significant digital presence as constituting a permanent establishment. Furthermore, some measures that address the digital economy, like unilateral digital services taxes (DSTs), are required to be suspended in light of the Pillar One agreement. And, as abovementioned, Pillar One addresses this issue only on a limited basis. To ensure a fair international tax system in the digital era, it is paramount to standardize online presence within the permanent establishment doctrine on a multilateral level.

## Principles

I welcome the effort to promote an international tax framework that is fully inclusive and effective. Building on the proposal's enumerated goals, I recommend that the framework convention embrace inter-nation equity as its overarching standard. Throughout the past century, the global tax structure has faced considerable scrutiny over its lack of democracy and unfavorable outcomes, especially with respect to developing economies. A commitment to inter-nation equity is an important step to remedying inequities ingrained in cross-border taxation.

The inter-nation equity principle generally refers to the equitable allocation of taxing rights between countries. Procedurally, inter-nation equity can be interpreted as equal-footed participation. Participants (member states) must be able to contribute to the decision-making process and partake in the negotiation of tax principles, beyond merely being present for the diplomatic endorsement and implementation stages.

Substantively, inter-nation equity requires the fair division of tax revenues between jurisdictions (acknowledged as a substantive element in the proposal). A fair allocation means that taxes should be paid where income is earned, and reflecting the level of contribution to the activities that produce those benefits. In a digital economy, assessing such contribution is challenging when multiple jurisdictions may have a legitimate claim to tax the same income. Historically, the international tax framework has favored residence-based taxation, while restricting taxation at source. The UN model convention has struck a compromise between residence and source-based taxation but does not materially depart from the OECD model or the 1920s principles. Thus, inter-nation equity and a fair allocation of taxing rights must take into consideration modern business practices in a twenty-first-century economy. This includes the value created by users and income arising in the market, often irrespective of physical presence.

Sincerely,

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