MYKOLAS ROMERIS UNIVERSITY
FACULTY OF LAW
INSTITUTE OF PRIVATE LAW

ANASTASIYA KOPYLCHAK
(EUROPEAN AND INTERNATIONAL BUSINESS LAW)

OECD/G20 PILLAR ONE PROPOSAL TO ADDRESS TAX CHALLENGES ARISING FROM DIGITALISATION OF ECONOMY

Master thesis

Supervisor –
Lecturer
Ricardo Sergio Schmitz Filho

Consultant –
Professor dr.
Vaidas Jurkevičius

Vilnius, 2022

TABLE OF CONTENTS

ACKNOWLEDGEMENTS…………………………………………………………………… 3
INTRODUCTION…………………………………………………………………........ 4
LIST OF ABBREVIATIONS.. 9

CHAPTER 1. INTERNATIONAL TAXATION REGIME ………………………..….. 10
1.1. Cross-border taxation………………………………….……........................ 10
1.1.1. Background of the right of international jurisdiction on taxation…………....... 12
1.1.2. Allocation of taxing rights under current tax treaties……………………….….. 13
1.2. Fundamental principles of tax policy……………..……………………………... 14

CHAPTER 2. THE DIGITALISATION OF THE ECONOMY AND NEW CHALLENGES TO THE TAX SYSTEM ………………………………………………… 17
2.1. The definition of the digital economy……………………..………………......... 18
2.2. The (digital) economy: a relevant approach and its features…..........…..........….... 20
2.3. Positive impact of digitalisation…………..........….. 23
2.4. Identifying the main challenges in a digital world…......…………………...........… 25
2.4.1. Historical background of identifying challenges for a tax system ..………… 26
2.4.2. Traditional PE concept……………………………………………………….. 27
2.4.3. The impact of technologies and BEPS project ………………………………… 29

CHAPTER 3. CRITICAL EVALUATION OF LEGAL PROBLEMS ARISING IN PILLAR ONE…………………………………………………………………………….. 32
3.1. Development of "2020 Tax Compromise"………………………….……………...... 33
3.2. Radicality of the new approach to international taxation……………..……….......... 35
3.3. Pillar One Solution ……….………………………………………………………... 37
3.3.1. Report on Pillar One Blueprint 2020...………………………………………... 38
3.3.2. Statement on a Two-Pillar Solution 2021, namely Pillar One…………………. 40
3.4. Problems on the way of international tax reform through Pillar One Proposal approach…………………………..…………………………………………. 43
3.5. Assessment of Pillar One in light of the fundamental principles of tax policy………. 47

CHAPTER 4. PILLAR ONE: 'PLACEBO' OR 'MEDICATION' FOR TAX CHALLENGES ARISING FROM DIGITAL ECONOMY……………………………… 52
4.1. In search of the real purpose of the reform …………...……………………………… 52
4.2. Another way to reform the international tax system …………...…………………..… 56
4.3. Significant economic presence…………………………………………………….... 58
4.3. Pros and contras of the expanded PE concept in comparison with Pillar One……....... 60

CONCLUSIONS…………………………………………………...…………............. 63
LIST OF BIBLIOGRAPHY………………………………………………………........... 65
ABSTRACT..…………….…............ 73
SUMMARY..…………………………………….………..... 74
HONESTY DECLARATION………………………………………………………… 75

ACKNOWLEDGEMENTS

I want to express my profound appreciation to many people who supported, helped and defended me while writing this Master's thesis.

First, I am incredibly grateful to all the defenders of Ukraine who protect the independence of Ukraine and Europe. In particular, Oleksa-Mykhailo, who supported me in my decision to start the Master's degree programme at Mykolas Romeris University and is now fighting for Ukraine's freedom.

Second, I could not have undertaken this journey without my supervisor Ricardo Sergio Schmitz Filho. I highly appreciate your time and knowledge. After our discussions on my topic, I always had new unique ideas. You made my writing an easy and very interesting prosses. I am sincerely grateful for your support, encouragement and understanding.

Third, thanks should go to the Lithuanian people because even before the full-scale invasion, they showed their solidarity with Ukraine through various initiatives. In particular, I am grateful to Education Exchanges Support Foundation for receiving a Lithuanian State scholarship and tuition fee for my Full-time Master's degree studies at Mykolas Romeris University and to my head of the Master's programme Virginijus Bitė, for his sincere advice and guidance.

Fourth, I am also grateful to my parents, sister, and grandparents, who have always kindled the fire of love for science and new heights in me.

Last but not least, thanks to all my friends with whom I went this way with a smile and warmth in my heart. In particular, my incredible and dearest mates in Lithuania, great Erasmus+ friends at KU Leuven, and friends who waited for me and supported me from Ukraine

INTRODUCTION

"The Report on the Pillar One Blueprint] is designed to deliver a sustainable taxation framework reflective of today's digitalising economy, with the potential to achieve a fairer and more efficient allocation of taxing rights"

OECD/G20 Base Erosion and Profit Shifting Project, 2020

The relevance of the master thesis. Digitalisation shapes a more inclusive society as well as better business management mechanisms and expands access to various services and goods. Digital technologies are changing the way the economy functions, changing business models, and increasing the ability of companies to interact with customers in a particular market remotely or through a limited physical presence.

On the one hand, this has broad positive implications for trade and business. According to a study published by Harvard Business Review, nearly three-quarters of organisations are investing in digital transformation programmes[1]. This shift towards digital solutions is commonly referred to as the Fourth Industrial Revolution, a technological transformation of how we work, live, and interact[2]. Another recent research conducted by Ricoh Europe determined that workplace digitalisation may improve European Union and United Kingdom GDP by 3.4% over the next five years, equating to growth of $656 billion[3]. This is fascinating because it illustrates a direct economic advantage of digital transformation.

From another point of view, such digitalisation has challenged the fundamental rules of the international tax system, as shortcomings in the current rules create opportunities for base erosion and profit shifting[4]. Such activities have put a strain on international tax rules. In turn, this has drawn

[1] "Four Ways Digital Leaders are Accelerating Their Innovation Strategy," Harvard Business Review, Accessed 10 October 2022, https://hbr.org/sponsored/2022/06/four-ways-digital-leaders-are-accelerating-their-innovation-strategy

[2] Klaus Schwab, *The Fourth Industrial Revolution*, (New York: Crown Business, 2017), 12, https://law.unimelb.edu.au/__data/assets/pdf_file/0005/3385454/Schwab-The_Fourth_Industrial_Revolution_Klaus_S.pdf

[3] "European businesses could unlock €622 billion growth with digital transformation," Richon Europe, accessed 8 December 2022, https://www.ricoh-europe.com/news-events/news/european-businesses-could-unlock-eur622-billion-growth-with-digital-transformation/

[4] "Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report," OECD/G20 Base Erosion and Profit Shifting Project, accessed 7 October 2022, http://dx.doi.org/10.1787/9789264241046-en

attention to whether the existing principles of international taxation, which were formed more than a century ago, provide an effective way to tax international transactions[5].

The modern digital business models create many complex issues compared to business models in the 20s of the last century, as national borders of countries no longer matter for large digital multinational corporations. It is now possible for a business to make profits in a particular jurisdiction and still operate in that country with a minimal presence. Under current legislation, market countries have the right to tax only those physically present companies[6]. Therefore, multinational enterprises mostly do not pay taxes to market jurisdictions where profits are generated. For example, some digital companies such as Amazon and Google can operate exclusively without creating a physical presence in some jurisdictions, thus avoiding taxes in those countries. Multinational corporations can also exploit existing tax rules by placing their profits in low-tax jurisdictions, thus avoiding taxes in their home country where their head offices are[7].

Consequently, the proliferation of highly profitable high-tech business models, primarily based on digital technologies, gives rise to many broad challenges for international taxation, mainly related to allocating taxing rights between countries[8]. These and other tax challenges were first highlighted in the OECD/G20 Base Erosion and Profit Shifting (BEPS) project, which was subsequently documented in the 2015 BEPS Report entitled "Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report"[9].

Then, more than 130 countries that are part of the Inclusive Framework worked on a two-pillar approach, released by the OECD Secretariat in October 2020, containing a report on the Pillar One Plan[10] and the Pillar Two Plan[11]. Since then, Inclusive Framework participants have continued to work towards consensus on these proposed solutions. Later, on July 1, 2021, 134 jurisdictions adopted a joint Statement on a two-pillar solution to address tax challenges arising from the digitalisation of the economy, in which they agreed on the essential components of each Pillar[12]. Pillar One was concretely

[5] "Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS," OECD/G20 Base Erosion and Profit Shifting Project, accessed 7 October 2022, https://doi.org/10.1787/beba0634-en.

[6] "Model Tax Convention on Income and on Capital: Condensed Version 2017," OECD, accessed 7 October 2022, https://doi.org/10.1787/mtc_cond-2017-en.

[7] Reuven S. Avi-Yonah, Young Ran (Christine) Kim and Karen Sam, "A New Framework for Digital Taxation," *Harvard International Law Journal (2022 Forthcoming*) Vol. 72, No. 63 (2022): 1, available at SSRN: https://ssrn.com/abstract=4068928

[8] OECD/G20 Base Erosion and Profit Shifting Project*, op. cit.,* 5: 11.

[9] OECD/G20 Base Erosion and Profit Shifting Project*, op. cit.,* 4: 3.

[10] OECD/G20 Base Erosion and Profit Shifting Project*, op. cit.,* 5: 3.

[11] OECD/G20 Base Erosion and Profit Shifting Project*, op. cit.,* 4: 4.

[12] "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy – 8 October 2021," OECD, accessed 7 October 2022, https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm.

formulated to amend the allocation of taxation rights of business profits at the international level[13]. It consists of two components:

- First, Amount A gives market jurisdictions the right to tax profits from multinational enterprises (MNEs) using formula-based calculations.
- Second, Amount B aims to standardise the remuneration of related party distributors who carry out basic marketing and distribution activities[14].

Scientific novelty and overview of the research on the selected topic. Creating a mechanism for the proper taxation of multinational enterprises is one of the most challenging problems facing the international tax system. Given the rapid globalisation and digitalisation of the economy, there is currently a lack of scientific knowledge on how to tax digital giants operating in the international arena. At first glance, the newly formulated Pillar One contains significant proposals for future tax reforms. Meanwhile, it raises much debate among scholars. Namely, some scholars argue that Pillar One is contrary to long-standing standards for allocating business income taxation rights, such as the physical presence requirement to allow source taxation or the arm's length standard as mechanisms for allocating profits[15]. Other scholars mention a problem with tax certainty since it causes more tax complexity[16].

Thus, given this tension in the scientific and practical field regarding Pillar One, a significant **scientific research problem** arises: *'Does Pillar One have enough capacity to change the international tax system in the proposed way?'*

This master thesis aims to identify the main problems of implementation in practice of the "OECD/G20 Pillar One Proposal to Address Tax Challenges". Therefore, to identify if these problems uphold further international tax system reform and find other possible ways to address tax challenges**.**

To achieve the established goal of this master's thesis, **the following objectives must be carried out:**

1. To explore the existing international tax regime and its fundamental principles.
2. To determine the concept of a 'digital economy' and the challenges it creates for the current international tax system.
3. To evaluate problems arising from the implementation of Pillar One.

---

[13] Aitor Navarro, "The Allocation of Taxing Rights under Pillar One of the OECD Proposal," *OUP Handbook of International Tax Law (F. Haase, G. Kofler eds., Oxford University Press 2021 Forthcoming),* Vol.19 (2021) : 2, available at SSRN: https://ssrn.com/abstract=3825612 or http://dx.doi.org/10.2139/ssrn.3825612

[14] Ibid.

[15] Ibid.

[16] Lorraine Eden, "Pillar One Tax Games," *Tax Management International Journal*, Vol. 11, No.1 (2021): 1 , available at SSRN: https://ssrn.com/abstract=3758671

4. To assess other ways to deal with current tax challenges.

Significance of research. From a practical point of view, this study can be helpful for scholars, lawyers and governments of different countries involved in the discussion on the new tax reform proposed by the OECD/G20 to improve the developed international rules. This work also plays a vital role for large digital corporations carrying out cross-border business activities. They are stakeholders in this OECD project, as their activities cause global tax changes. This study will allow such corporations to understand whether they still fall under the taxation criteria.

During this master's thesis preparation, the following **research methodology** was used:

1. The *data collection method* is the primary source of collecting and processing information for this master's work. This method processed numerous legal documents, scientific articles, conclusions of international organisations, and judicial practices in the legal regulation of international taxes.
2. The following important method was the method of *data analysis*, which was used to analyse the object of research and further systematise the obtained scientific data into a single structure for a reasoned answer.
3. Another was the *comparative analysis method* to compare concepts such as 'economy' and 'digital economy', to compare the Pillar One proposal with the current international tax principles.
4. Next essential method worth mentioning is the *logical method*. This method is crucial in linking arguments to create sound scientific opinions.
5. Another method used in this master's thesis was the *historical method* to find the origins of certain concepts, for example, the backgrounds of taxation based on residence or source, or permanent establishment threshold.

Structure of research. The master thesis work is divided into four Chapters:

The first Chapter will discuss the concept of taxes and the historical background of the international tax system that is relevant today and fundamental tax principles.

In the second Chapter, the expediency of fencing off the digital economy from the general economy is investigated, its essential elements are considered, and the negative and positive impact of the digital economy on the international tax system is investigated. After that, the main problems that the historically formed international tax system cannot cope with will be identified.

The third Chapter of this research paper will analyse the response to the challenges associated with the digitalisation of the economy in the form of a Pillar One Proposal to address tax challenges from 2020 and assess the legal challenges that will be in the way of implementing the new tax reform.

The last Chapter will explore the need to reform the international tax system radically and the search for other possible and more effective solutions to tax challenges.

Defence statements. First, the phenomenon of digitisation of economic activity is an integral part of business development. The digital economy cannot be ‘ring-fenced’ from other business activities as more and more companies digitise their services and products. Therefore, the digital economy is an economy itself, and tax policies should be adjusted to technology, not vice versa.

Secondly, multinational cooperation is required to implement tax reform on a global scale. Accordingly, Pillar One is vitally dependent on the signing of an international convention, which as of December 2022, has yet to be developed. The signing itself will be a difficult political test, as the convention's provisions will, in some respects, deviate from traditional international principles and will also provide for the abolition of all unilateral taxes targeting digital corporations.

Thirdly, although Pillar One aims to create tax certainty and simplicity in the taxation of companies, the developed rules indicate the opposite: greater tax complexity, uncertainty and in addition, the established tax principles are on the stake.

Fourthly, Pillar One is serious, technical and promising work. However, implementing this revolutionary idea entails a disproportionate number of problems and costs, as opposed to other possible, more theoretically sound ways to solve these problems of the digital economy.

LIST OF ABBREVIATIONS

ADS	Automated Digital Service
BEPS	Base Erosion and Profit Shifting
CFB	Consumer Facing Business
CFC	Controlled Foreign Company
DST	Digital Services Taxes
DTA	Double Tax Agreement
EBIT	Earnings Before Interest and Taxes
e-commerce	electronic commerce
e.g.	for example
EU	European Union
GDP	Gross Domestic Product
IF	Inclusive Framework
IMF	International Monetary Fund
MLC	Multilateral Convention
MLI	Multilateral Instrument
OECD	Organization for Economic Co-operation and Development
OECD MTC	OECD Model Tax Convention
OECD MTC Com	OECD Commentary on the OECD Model Tax Convention
PBT	Profit Before Tax
PE	Permanent Establishment
UN	United Nations
UN MC	United Nations Model Tax Convention

CHAPTER 1. INTERNATIONAL TAXATION REGIME

It is becoming increasingly easier to set up and run a business in different parts of the world. This process is the result of rapid globalisation and digitalisation, which has led to the integration of national economies and markets. Now, it has become much easier to carry out cross-border transactions due to modern means of communication. Thus, for example, being somewhere in Europe, you can arrange the purchase of goods in Asia in a few minutes, invest in various foreign companies with the help of certain programs on your smartphone, or conduct your business in another part of the world. On the other hand, it has created pressure on the international tax system developed more than a century ago. The current tax system has revealed weaknesses in such circumstances.

In order to understand how new digitalised business models have become the driving force for new international reforms, it is worth examining how the international tax system has been shaped. Therefore, this Chapter's first part will analyse and reveal the origins of cross-border taxation and its driving force for international tax reforms in the 1920s. Consequently, the last part of the Chapter defines the main principles of tax policy, which became the foundation for future OECD work.

1.1. Cross-border taxation

Most governments in the world impose taxes. It is because governments have to supply certain services and goods to society. Such public services are inseparable, so all members of society use them regardless of whether they pay taxes or not. Examples are the country's defence capability, maintenance of law and order, and public and critical infrastructure - dams, highways, education, etc. All these areas should be provided through budget allocation[17]. Therefore, one of the essential functions of taxes is to finance such public goods[18].

At the same time, different countries have different human, natural and economic resources, which are very diverse from country to country. Each government, based on its resources, tries to develop rules that would fill its country's economy. Accordingly, the tax structure of each country reflects the philosophy of politicians who rely on the theory written and analysed by tax economists. After that, the theory itself is incorporated into laws by lawyers and attorneys who play an important role both in writing tax legislation and its interpretation through the judicial system. That is how the tax regime is formed in every jurisdiction[19].

---

[17] Parthasarathi Shome, *Taxation History, Theory, Law and Administration,* (Berlin: Springer Nature, 2022), 4.
[18] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 4: 20.
[19] Shome, *op. cit*, 17: 6.

Thus, sovereign countries impose that to finance their public goods and services in the areas of, among other things, law and order, health care, infrastructure, education, and security. In most countries, the revenue obtained through taxation is redistributed to support various members of society, including the aged, the sick, and the destitute. Meanwhile, if a business carries out its activities outside a purely national jurisdiction, potentially more than one jurisdiction may have a legitimate claim to tax the profits derived from those activities.

Therefore, with the increase in international business, it is necessary to distinguish between domestic and cross-border taxation. The last one is discussed further.

Nowadays, companies are increasingly resorting to cross-border business activities for many reasons. Typically, this is done in order to scale or optimise their business, to gain access to appropriate resources, such as more materials or cheaper labour, or to find more solvent sales outlets. An important driver in this process has been improved transport connectivity, as well as innovations in technology that enable immediate communication and rapid transfer of financial assets across national borders. As of 2014, world exports are 40% higher than in 1913. Due to this, the economies of different countries are becoming closer to each other[20]. Scientists called the process in which businesses, organisations and countries begin to operate internationally - globalisation. Such globalisation, liberalisation of commerce, the elimination of currency controls, and, more recently, technological advancements have all contributed to a significant increase in the volume of transactions that take place on a global scale. Because of this, over the course of several decades, there has been significant growth in the movement of capital investments between nations, resulting in the interconnection of national economies.

Elliffe C. considers that cross-border taxation of business profits is different from purely domestic taxation and occurs when:

(a) a resident of a certain jurisdiction conducts business abroad and the relevant jurisdiction decides to tax the resident on its worldwide income. Taxation of such income abroad is sometimes complicated because the tax laws of another country (source investment) may apply to this income.

(b) the government of one country taxes business carried on in its jurisdiction by a non-resident (inbound investment)[21].

[20] "Trade and Globalization," Our World in Data, accessed 28 September 2022, https://ourworldindata.org/trade-and-globalization#trade-has-changed-the-world-economy.

[21] Craig Elliffe, *In Taxing the Digital Economy: Theory, Policy and Practice*, (Cambridge: Cambridge University Press, 2021), 3.

When states conclude that they will continue to function on the basis of worldwide residence-based taxes and that they will tax non-residents on revenue originating in their jurisdiction, double taxation will inevitably result. This has become an important driver of change and the creation of certain international tax rules.

1.1.1. Background of the right of international jurisdiction on taxation

In the early 1920s, the League of Nations undertook to study the problem of global double taxation. The main goal was to develop international principles that would prevent double taxation. The results of the study conducted by the League of Nations Economic and Financial Commission in 1923[22] were the development of the concept of 'economic allegiance' and the aim to determine the existence and scope of economic relations between the taxpayer and the state[23]. This served as the foundation for the creation of the international tax system. Additionally, the study identified four factors that form 'economic allegiance':

(i) the origin of wealth or income,

(ii) the status of wealth or income

(iii) the security of rights to wealth or income, and

(iv) the residence or domicile of the person who has the right to dispose of the wealth or income[24].

Among these factors, the study also concluded that, in general, the greatest weight should be given to "the origin of the wealth [i.e., the source] and the residence or domicile of the owner who consumes the wealth [i.e., the place of residence]"[25]. In other words, the League of Nations suggested that tax jurisdiction should normally be divided between the state of origin and the state of resident based on the nature of the income in question. Therefore, two principals were developed to determine the possibility of taxation of income in a particular jurisdiction, based either on the connection with a person or on the relationship to the territory. The first is residence-based taxation, where income is taxed based on where a person lives in a particular country (residence), and the second is the source concept, where a person is taxed in a country on income derived from that country (source). This was one of the earliest principles of international taxation, which is still in force today[26].

---

[22] "Report on Double Taxation. Document EFS73 F19," Financial Committee, League of Nations Economic and Financial Commission, accessed 6 October 2022, https://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;chunk.id=item-1;toc.depth=1;toc.id=item-1;database=;collection=;brand=default .

[23] Ibid.

[24] Ibid.

[25] Ibid.

[26] OECD/G20 Base Erosion and Profit Shifting Project, *supra note,* 4: 25.

As a result, the compromise reached in the 1920s laid the groundwork for the modern international tax system, which was acceptable to the concept of allocating taxation rights by source jurisdiction. This was done on the basis that foreign-owned entities benefit from the advantages provided by the source state. The modern international tax system was acceptable to the concept of allocating taxation rights by source jurisdiction (e.g., public services and protection of property rights).

1.1.2 Allocation of taxing rights under current tax treaties

Thanks to the development of the OECD and UN Model Tax Convention, the international taxation system has developed bilateral tax treaties following the so-called 'classification and assignment of sources' method, according to which different types of income are subject to different allocation rules[27].

This planned character of the apportionment rules involves a preparatory phase in which the disputed income is first categorised into one of the income categories stipulated by the treaty. If a particular income comes under more than one category of income, double tax treaties use ordering rules to resolve the problem. Once the income category for the treaty has been determined, the treaty stipulates apportionment rules, which typically give one state party the exclusive right to exercise its national taxing rights or give one state party priority in exercising its national taxing right while leaving the other treaty state with residual taxing rights. If bilateral tax treaties give precedence to the taxing rights of the source jurisdiction, the resident state must provide relief from double taxation. Generally, bilateral tax treaties offer two mechanisms: the exemption technique and the credit method[28].

The rules of bilateral treaties also stipulate that a company's income from business activities is taxed only by its state of residency unless the company conducts business activities in the other state through a permanent establishment based there. In this case, the source state may only tax the earnings attributable to the PE. Thus, the PE concept is currently utilised to decide whether a contracting state has the authority to execute its taxing rights concerning a non-commercial resident's profits. The PE idea is a threshold for the amount of economic presence of a foreign business in a

---

[27] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 4: 26
[28] Ibid.

specific state using objective criteria. It outlines the conditions under which a foreign enterprise can be considered sufficiently integrated into the state's economy to warrant taxation in that location[29].

However, at the moment, the concept of permanent establishment is extremely outdated, as it was developed at a time when there were no huge digital giants. Now, international corporations can earn billions in a tax jurisdiction without having any assets, employees or even direct sales there (Facebook has none of these traditional elements, it only has users). This problem will be discussed in the following Chapter 2.

It is worth mentioning, that currently, there are approximately 3000 bilateral tax treaties in the world, which follow one of the two generally accepted models (being based on the same Organisation for Economic Co-operation and Development (OECD) and UN models) and they are approximately 80% identical to each other[30]. This is a sign that countries in international tax matters are obliged under the agreement to act in a certain way and accordingly cannot adopt legislation that would contradict such agreements.

Summarising all of the above, cross-border business activity in the 1920s was subject to double taxation due to the desire of each jurisdiction to tax the basis of worldwide income. In 1923, four economists published Report that proposed the theory of 'economic allegiance' to solve the problem of double taxation and create a fair income distribution between different jurisdictions. This theory became the basis for future MTCs to allocate profits between residence and source countries and is successfully used in over 3000 bilateral double tax treaties now.

1.2. Fundamental principles of tax policy

Several widely accepted fundamental tax policy concepts have traditionally driven the evolution of tax systems[31]. In 1998, a Report by the Committee on Fiscal Affairs "A Borderless World: Realising the Potential of Electronic Commerce" was presented[32]. In that Report general principles of taxation that should be applied to e-commerce were introduced. Since then, these principles have been referred to as "The Ottawa Taxation Framework Conditions"[33]. These principles include equity, neutrality, efficiency, certainty and simplicity, effectiveness and fairness as well as flexibility[34].

[29] Ibid.
[30] Ibid.
[31] Sven Hentschel, "The Taxation of Permanent Establishments a Critical Analysis of the Authorised OECD Approach and Its Implementation in German Tax Law under Specific Consideration of the Challenges Imposed to the PE Concept by the Digitalisation of the Economy," (doctoral dissertation, the Martin-Luther-University Halle- Wittenberg, 2021), 15.
[32]"A Borderless World: Realising the Potential of Electronic Commerce," OECD Committee on Fiscal Affairs, accessed October 3, 2022. https://www.oecd.org/ctp/consumption/1923256.pdf.
[33] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 4:20.
[34] OECD Committee on Fiscal Affairs, *supra note,* 32:4

However, these principles were established when there were no such large-scale electronic business models (for example, social networks), but their relevance is still very important and relevant nowadays. Moreover, the Final Report on BEPS Action 1 highlights that these principles remain relevant, even in the era of the digital economy[35].

Therefore, analysis of these overarching principles of tax policy represents a practical, theoretical framework that can be used to evaluate the suggested reform proposals to the international corporate taxation rules.

The next Chapter will explain in more detail from the historical point of view how they became fundamental for the digital economy. Still, at this stage, it is important to emphasise their adoption for the future as they became a basis for OECD Reports.

Those principles include the following:

- *Neutrality*. This principle stipulates that taxation should be neutral and equitable between all forms of business activity and taxpayers under the same conditions and the same transactions should have the same level of taxation.
- *Efficiency*. The principle suggests that compliance costs for taxpayers and administrative costs for tax authorities should be minimised to the greatest extent practicable.
- *Certainty and simplicity.* So that taxpayers may forecast the tax effects prior to a transaction, tax rules should be clear and straightforward to comprehend, including information on when, where, and how the tax should be recorded.
- *Effectiveness and fairness.* Taxation should generate the right amount of tax at the right time. The possibility of tax evasion and avoidance should be minimised while maintaining countermeasures proportionate to the risks.
- *Flexibility*. Tax systems must be adaptable and dynamic to keep pace with technology and commercial advances[36].

OECD/G20 Final Report (2015) also provides that *equity* is one of the important principles for tax policy frameworks. The following elements of equality are distinguished: horizontal and vertical. International equality is also differentiated.

- Horizontal equality implies that taxpayers in similar circumstances should bear a similar tax burden.
- Vertical equality is a normative concept, the definition of which may vary. It suggests that taxpayers in better circumstances should bear more of the tax burden.

[35] OECD/G20 Base Erosion and Profit Shifting Project, *op. cit.,*4: 20-21.
[36] OECD Committee on Fiscal Affairs, *op. cit.*, 32:4; see also ibid.

- Inter-nation equity is related to the distribution of national profits and losses in an international context and aims to ensure that each country receives a fair share of tax revenues from cross-border transactions[37].

To sum up, these developed principles are the so-called benchmark for development of tax policy.

In conclusion, the Compromise of 1920s provided a theoretical basis for solving the problems of double taxation provoked by international business. At the moment, there are Model Tax Conventions that provide how profits should be fairly distributed between the resident and source countries. The theory of 'economic allegiance' greatly influenced this. An important rule that gives the source country the right to tax is the permanent establishment rule, which contains a certain threshold indicating the presence of economic presence in the source country. However, the modern concept of PE contains a specific 'physical' threshold for presuming economic presence, which could be more consistent with our time. Since modern business models, discussed in more detail in the next Chapter, can easily avoid this threshold and operate without PE in market jurisdiction. This calls into question the principles of international taxation, such as efficiency and fairness, flexibility, and others.

[37] OECD/G20 Base Erosion and Profit Shifting Project, *supra note,* 4: 20-21

CHAPTER 2. THE DIGITALISATION OF AN ECONOMY AND NEW CHALLENGES TO THE TAX SYSTEM

The development of digitisation of pre-existing goods and services, as well as the development of new purely digital goods, has created many benefits for society. However, it has also fundamentally changed the way in which an entire category of goods is produced, distributed, and consumed in the economy. Digital technologies have led to dramatic reductions in the costs of reproduction and distribution, leading to critical structural changes in the economy and potentially to a global increase in social welfare by increasing the quantity and variety of goods and services available in the economy. Although initially limited to a few types of goods (mainly software), the scope of digital technologies has gradually expanded to cover many types of goods: music, movies, photos, books, etc.

As mentioned in the previous Chapter, the existing international tax system needs to be adapted to modern realities. It is adapted to a less globalised economy and relies on the physical presence of enterprises in a territory, establishing a link between them and tax jurisdictions.

The European Commission estimates that digital companies pay taxes more efficiently than traditional companies. However, as this report argues, existing international tax rules still leave too many loopholes to be effective. For example, a joint study by the IMF and the University of Copenhagen found that 40% of global FDI is structured to minimize tax liabilities rather than actual business activities[38]. Thus, the digital sector of the economy uses the gaps in the current international system.

An important question arises in this case: 'How has the digitisation of previously known business models, products and services led to tax challenges and political debates on changes in the international tax system?'. The answer to this question should begin with understanding the notion of digital economy. It is worth noting that there is no unanimous concept of the digital economy. However, various scientists and international organizations have tried to find a single formulation and common features that distinguish this sector from other sectors of the economy and form a clear concept.

In this Chapter of the master's thesis, the first part will analyse what is known to date for the concept of the digital economy. The second part will outline the key elements of the digitalised economy. Then, the third part will identify the positive impact of digitalisation. The last part of this

[38] "Taxing the digital economy: New developments and the way forward," European Parliament, assessed 15 October 2022, https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698761/EPRS_BRI(2021)698761_EN.pdf.

Chapter will determine the creation of challenges today and what the proposals were to overcome them.

2.1. The definition of the digital economy

Finding a common definition is essential, as clear, and practical definitions are a prerequisite for any economic measurement system and determining relevant economic indicators[39]. Also, the importance of understanding the definition of the 'digital economy' or the 'digital sector' of the economy was emphasised in the International Monetary Fund (IMF) Report entitled "Measuring the Digital Economy". This Report states that the lack of a commonly accepted definition of these concepts and the lack of a classification of industries and products for Internet platforms and related services are obstacles to measuring the digital economy[40]. Therefore, this part of the master's thesis will analyse the concept of the digital economy from the first defined mentions in the scientific literature and subsequently in the OECD normative documents and relevant projects related to the OECD. Determining the notion will help us understand the framework in which the research needs to be continued.

Scientists Rumana Bukht and Richard Heeks note that the 'digital economy' concept contains the historical specificity of time and originates in the concept of 'information economy'[41]. In various works at the beginning of the 21st century, it was found that scientists of that time observed a phenomenon that went beyond just information ideas. Thus, the 'digital economy' began to be used in context and covered two types of economic activity. The first type of economic activity was informational and concerned basic tasks such as posting static information on websites. In contrast, the second type was related to communication, reflecting the more interactive Internet-enabled activities[42].

As for the first mentions of the concept in official OECD documents, in 2013, the OECD first used the definition of 'the digital economy' in the context of competition regulation in digital markets. The document stated the following:

---

[39] "A Roadmap toward a Common Framework for Measuring the Digital Economy," OECD Directorate for Science, Technology and Innovation and Statistics and Data Directorate, assessed 26 October 2022, https://www.oecd.org/sti/roadmap-toward-a-common-framework-for-measuring-the-digital-economy.pdf

[40] "Measuring the Digital Economy," International Monetary Fund, accessed 6 October 2022, https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/04/03/022818-measuring-the-digital-economy

[41] Rumana Bukht and Richard Heeks. "Defining, Conceptualising and Measuring the Digital Economy," *SSRN Electronic Journal*, Vol. 26, No 68, (2017): 4, https://doi.org/10.2139/ssrn.3431732.

[42] Ibid.

"The digital economy is the part of an economy where the trade of goods and services is performed through electronic commerce on the internet"[43].

In the context of fair competition regulation, such a definition can take place, as it allows to separate physical business, which operates in a certain place, from digital business, which is more mobile, faster, accessible and has a number of advantages over the physical one. However, from a business perspective, more and more physical companies are trying to digitise their products and services. In this case, the problem arises that, step by step, the digital economy is becoming not just a part of the economy, but the entire economy itself, with new means, enabling it.

It is worth considering this concept in the context of BEPS. After the G20 Finance Ministers called on the OECD to develop an action plan to address this issue, the OECD developed "BEPS, Addressing Base Erosion and Profit Shifting" (OECD, 2013a)[44]. It did not clearly define 'digital economy' but included certain features that characterise it. The document states that the 'digital economy' is characterised by an unprecedented dependence on intangible assets, massive use of data, widespread adoption of multilateral business models that capture value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value is created[45]. Subsequently, in 2015, a final report was published on the digital economy, BEPS and broader tax issues and recommended further steps. In addition, in the mentioned final report the concept under study was more clearly defined:

"The digital economy is the result of a transformative process brought by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy" [46].

This definition did not indicate that the digital economy is part of the economy.

An important document that contains the proposed common agreed definition of the 'digital economy' and shows clarity on the formation of a common position is the Report entitled "A Roadmap towards a Common Framework on Measuring the Digital Economy", prepared by the OECD Directorate for Science, Technology, and Innovation (STI) and Statistics and Data Directorate (SDD). It notes that the main problem of defining a single concept of the 'digital economy' is that different

[43] "The Digital Economy," OECD, accessed 15 October 2022, https://www.oecd.org/daf/competition/The-Digital-Economy-2012.pdf

[44] "Action Plan on Base Erosion and Profit Shifting," OECD, accessed 15 October 2022, http://dx.doi.org/10.1787/9789264202719-ehttp://dx.doi.org/10.1787/9789264202719-enn

[45] Ibid., 10.

[46] OECD/G20 Base Erosion and Profit Shifting Project, *supra note,* 4:5.

possible users (economists, lawyers, etc.) need different indicators for different purposes. Therefore, any 'digital economy' definition must provide sufficient flexibility[47]. However, at the same time, a definition that is too flexible and broad could add a lot of ambiguity, which could produce incorrect data or results. Therefore, according to the OECD, any definition of the 'digital economy' needs to include elements that are conceptually flexible but practically possible to measure accurately. Such a proposed definition is the following:

> *"The Digital Economy incorporates all economic activity reliant on, or significantly enhanced by the use of digital inputs, including digital technologies, digital infrastructure, digital services, and data. It refers to all producers and consumers, including government, that are utilising these digital inputs in their economic activities"* [48].

It is worth emphasising that this definition of the 'digital economy' proposed in this report provides some clarity for policy purposes. It also allows G20 members to develop the definition further by identifying and measuring specific actors, activities, products, and practices that are considered to be "dependent on or significantly enhanced by the use of digital resources, including digital technologies, digital infrastructure, digital services and data"[49].

It can be summarised that the digital economy is a product of the rapid development and spread of information and communication systems that have penetrated all aspects of modern life. Digital transformation of the economy is a constant and natural process of economic development. It concerns the development of various IT sectors in order to stimulate the creation of innovative technologies for cooperation and development at the international level. It is important to emphasise that the joint participation of the public sector, private sector and civil society in digital processes is necessary. According to this, if this phenomenon is observed in most economic activities and is related to the material world, should it be separated from other economic activities? The next part of this Chapter will explore this question.

2.2 The (digital) economy: a relevant approach and its features

An essential and critical conclusion of the OECD work is that the digital economy is increasingly becoming an economy itself. It is difficult, if not impossible, to separate the digital economy from the rest of the economy for tax purposes[50]. The exact position is supported by the

[47] OECD Directorate for Science, Technology and Innovation and Statistics and Data Directorate, *supra note,* 39:39.
[48] Ibid., 34
[49] Ibid., 39
[50] OECD/G20 Base Erosion and Profit Shifting Project, *supra note,* 4: 71

International Monetary Fund (IMF), which emphasises that all activities that use digitised data are part of the digital economy. In modern economies, it is the entire economy[51]. Accordingly, the digital economy should be discussed as a phenomenon characteristic of the modern economy. Accordingly, the digital economy is not about individual industries or just digital companies. The digital economy is, first of all, the current economy – all traditional industries and companies (manufacturing, agriculture, construction, transport, etc.), which, under the influence of digital transformation due to technological evolution, change their production and business processes and gain new opportunities for increasing the productivity and efficiency of the main (existing) business.

According to the OECD, specific characteristics and essential digitalisation features may potentially be relevant from a tax perspective. This conclusion was formed based on the analysis of numerous economic literature that has studied the economic impact of digitalisation. Scholars often relied on analysing markets, understood as offline or online, where two (or more) parties exchange goods or services. It is noted that digital (or online) markets differ from offline in that the aggravation of certain features characterises them. These characteristics are also inherent in offline markets but are more pronounced in digital markets. Therefore, the OECD underlines the consensus on some defining characteristics of digital markets, which are as follows:

1) *Direct network effects*. Consumers are believed to benefit from the number of other market participants in digital markets. Thus, the more extensive the network, the greater the benefit to the end user. An example is social networks and related messaging services. Individuals have more excellent utility when others are part of such a network. Another example would be an online marketplace, as the seller (or buyer) benefits from the most significant number of potential people with whom to transact.

2) *Indirect network effects.* This aspect is characterised by multi-sided markets. An example is a particular online platform (social network) in which one group of end-users, namely consumers of this platform, interact with another group of end-users, namely advertisers. Both groups benefit from interacting with each other on the platform, where the transactions between groups are concluded. The utility for one group of users increases as the size of the other group increases. More and more businesses use t multi-sided markets nature of the platform in different areas, such as renting housing or transport and buying online travel tickets. For example, AirBnB connects tenants and landlords from different parts of the world on its platform. Each end-user and a platform with a fee for transactions between users benefit from such cooperation.

[51] "Measuring the Digital Economy," International Monetary Fund, accessed 6 October 2022, https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/04/03/022818-measuring-the-digital-economy .

3) *Economies of scale.* Typically, digital goods and services production involves significant upfront costs but lower variable costs. For example, software development initially requires significant resources and investments in human labour and infrastructure, but later the costs of maintenance, distribution and sales are pretty low. The European Commission also notes that the digital economy allows the reproduction of a digital product at almost no cost[52]. Therefore, digitalised enterprises can earn high profits due to global distribution via the Internet and the combination of low marginal costs.

4) *Switching costs and lock-in effects.* End-users use different devices running on specific operating systems (e.g., Android or iPhone). Accordingly, a consumer may be strongly tied to a particular operating system once he/she has purchased a particular device for various reasons. One example of such reasons is the cost of such a switch, as a particular operating system contains a stored amount of information and personal data of the user (e.g., photos, contact lists, passwords to different platforms) stored by the provider.

5) *Complementarity*. Many goods and services complement each other. Therefore, the end user will benefit from using his laptop or smartphone with various related software, such as operating systems, applications, or games[53].

Professor Craig Elliffe also considers it appropriate to highlight one more feature, namely the *importance of data*. He emphasises that many market transactions can be analysed to determine consumer behaviour[54]. According to the EC, the digitisation of products and processes has made it possible to access a massive amount of data, making it possible to measure and analyse phenomena to a degree that was not possible before. Accordingly, it makes it easier to conduct controlled experiments and measure their success with great accuracy[55]. For example, Amazon and Google conduct hundreds of controlled experiments on the web interaction of their customers every day. This happens in the following way: after an individual creates an innovation, the company can share it more easily through various electronic channels: email, social networks, etc. Since products, services, and even business processes can be digitised, once experiments show that the approach works, it can be replicated with marginal costs close to zero, at any distance and to the desired extent[56].

---

[52] "Digital Economy – Facts and Figures," European Commission Expert Group on Taxation of the Digital Economy, accessed October 15, 2022, https://taxation-customs.ec.europa.eu/system/files/2016-09/2014-03-13_fact_figures.pdf .

[53] "Tax Challenges Arising from Digitalisation – Interim Report 2018 ," Inclusive Framework on BEPS, accessed 15 October 2022, https://www.oecd-ilibrary.org/docserver/9789264293083-en.pdf?expires=1668510817&id=id&accname=guest&checksum=783EDE3088AE4565CF9B2DB2710F2277 .

[54] Craig, *supra note,* 21: 58.

[55] European Commission Expert Group on Taxation of the Digital Economy, *op. cit.,* 4.

[56] European Commission Expert Group on Taxation of the Digital Economy, *op.cit.,* 10.

The OECD also identified a number of the most important, common characteristics of digital enterprises. Thus, the most relevant characteristics are:

- Highly digitised enterprises can actively participate in the economic life of a jurisdiction without any significant physical presence.
- Such enterprises increasingly use and invest in Intellectual Property (IP) assets such as software, algorithms, websites, etc.
- Digitalised enterprises have greater user engagement and participation, network effects and the provision of user-generated content[57].

Due to the above characteristics, highly digitalised companies have many positive effects, which will be analysed in the next part of this Chapter.

To sum up, it is difficult, if not impossible, to tax the digital sector of the economy separately from the rest of the economy. First and foremost, the digital economy is the contemporary economy, which includes all traditional industries and businesses (manufacturing, agriculture, construction, transportation, etc.) undergoing a digital transformation as a result of technological advancement. Due to the Internet's global dissemination and the combination of low marginal costs, digitalised businesses can generate substantial profits. The digitisation of products and procedures has enabled access to vast quantities of data. This makes it simpler to conduct controlled analyses of customers' behaviour and accurately quantify their success.

2.3. Positive impact of digitalisation

Economic value is closely related to the production of goods and services. The essential issues determining economic value relate to how certain products are produced and distributed from this production would be allocated. The productive transformation of materials into goods and services creates wealth that can potentially be distributed in society. Production is based on different resources, such as labour, and different forms of capital, both physical and human[58].

Thanks to the features that are more manifested in digitalised companies, various companies have an unprecedented opportunity to reach the end-user faster, better, more accurately, and more efficiently through the Internet.

According to the European Commission, about a third of Europe's total industrial production growth is due to the introduction of digital technologies. In 2006, only one technology company was

---

[57] Inclusive Framework on BEPS, *supra note,* 53: 55.

[58] "Digital Economy Report 2019. Value Creation and Capture: Implications for Developing Countries," United Nations, accessed 11 November 2022, p.25 https://unctad.org/system/files/official-document/der2019_en.pdf

in the top 20, accounting for only 7% of market capitalisation. In 2017, 9 of the 20 largest companies by market capitalisation were technology companies, accounting for 54% of the total market capitalisation of the 20 largest companies. Between 2008 and 2016, the revenue of the top 5 e-commerce retailers grew by an average of 32% per year. Over the same period, revenues in the entire EU retail sector grew by an average of 1% per year. Therefore, the European Commission concluded that innovations would emerge rapidly thanks to a new generation of information technologies such as the Internet of Things (IoT), artificial intelligence, robotics, and virtual reality. Digital solutions are increasingly used and open up new opportunities for people, businesses, investors and governments[59].

Digitalising products and services have led to changes in long-standing business models. The OECD publication for 2018 listed four types of new business models. This classification is advantageous for understanding the basis of transactions and then analysing the tax implications. There are four types of significant business models in digital markets, namely[60]:

(a) *Multilateral platforms*: These types of businesses described below allow end-users to transact with each other while leaving essential rights and obligations of control with the end-user provider (and not the platform).

(b) *Resellers*: Businesses that buy products and services from suppliers and resell them to customers, controlling the price and assuming customer responsibility. Such enterprises include Alibaba, Spotify and Netflix (where it buys content).

(c) *Vertically integrated firms*: These companies have acquired ownership of their suppliers and hence have integrated the supply chain into their own companies. Examples of such firms are Netflix (where it produces its content) and Huawei (hardware and cloud computing).

(d) *Input suppliers*. These are firms that supply (as intermediaries) the inputs needed for producing goods or services in another firm. They interact only with the other firm and not with the final consumer. An example is Intel, a manufacturer of semiconductor chips[61].

Summarising the above, the development of the digital economy inevitably leads to a significant transformation of business and the creation of new business models. The essential advantage of the digital economy over the traditional one is its almost unlimited scaling without loss of efficiency, which significantly increases economic management efficiency (economic activity and

[59] "A Fair and Efficient Tax System in the European Union for the Digital Single Market," European Commission, accessed 15 October 2022: 4 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017DC0547&from=RO

[60] Inclusive Framework on BEPS, *supra note,* 53: 30

[61] Ibid.

resources of the country in various sectors) at the micro and macro levels. The G20 intensive discussion on the digital economy shows that it is a driving force for accelerating global economic development, increasing productivity, and creating new markets and industries.

2.4. Identifying the main challenges in a digital world

In the previous part, many benefits of digitalisation of the economy were outlined, for example, increasing prosperity in general. However, simultaneously, it creates many challenges for the world. These challenges are not limited to the problems of the international tax system and affect such areas as privacy, data protection, possible interference in the electoral process, violation of freedom of speech and others.

Speaking specifically in the context of the challenges of this master's thesis, companies have contributed to a particular jurisdiction through a wide range of taxes for decades. With the development of digital technologies, there is a way out that allows economic entities to operate in such a way as to avoid, eliminate or significantly reduce their tax liabilities on these grounds.

The business models behind the success of firms in digital markets can choose at their own will the location of central functions and value drivers, including jurisdictions that are neither the country where the end consumer resides nor the country where the parent company is resident[62]. Therefore, reliance on physical or representative presence raises the question of whether traditional tax allocation rules remain an adequate mechanism for preserving a market country's tax rights in a digital era that relies excessively on digital technologies to conduct main business activities. The decreasing need for a physical presence in the home country due to the digitalisation of business activities creates many challenges in international tax policy.

Establishing a link to the jurisdiction for taxing business profits. It also underscores the importance of designing corporate and consumption tax systems that promote growth and investment while reducing inequality and establishing a level playing field for all economic actors.

Currently, Article 5 of double tax treaties (DTT) does not allow home countries to tax the profits of a foreign company unless they are attributable to business activities carried on in the home country through a permanent establishment, i.e., through a fixed place of business[63]. So, Article 5 does not allow profits derived from virtual services to be taxed in the home country, resulting in significant

---

[62] European Commission Expert Group on Taxation of the Digital Economy, *supra note,* 52: 2.
[63]"Model Double Taxation Convention between Developed and Developing Countries," United Nations, accessed 26 October 2022, Art. 5, https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf ;*see also* "Model Tax Convention on Income and on Capital: Condensed Version 2017," OECD, accessed 7 October 2022, Art. 5, https://doi.org/10.1787/mtc_cond-2017-en.

revenue losses for the home country. In this context and for these reasons, the need to create a new permanent establishment based on 'significant economic presence' to reallocate taxation rights between source and residence countries is currently being considered[64].

2.4.1. Historical background of identifying challenges for a tax system

As Cockfield Arthur notes, since around the mid-1990s, academics, government officials, and others have explored the tax challenges associated with global e-commerce, which mirror the current debate around BEPS and global digital taxation[65]. After the Internet became a viable commercial environment, issues related to the relationship between taxation and technology development began to be widely considered by the authors of many tax publications.

In a 1996 article, David Tillinghast first raised the question of whether traditional international tax laws and policies are sufficient to confront the challenges of cross-border e-commerce. Other scholars supported and followed his opinion later[66]. Subsequently, government authorities and other observers began investigating how this new form of commerce could facilitate aggressive international tax planning, which could lead to revenue losses for high-tax countries. Discussions on these issues followed, and many possible reforms were proposed. In their papers, scholars concluded that global digital trade poses a challenge to traditional international tax law and policy but disagreed on the scale of these challenges and hence the appropriate policy response[67].

Over time, the debate also began in the international arena. At the first OECD global meeting on e-commerce in 1997 in Turku, Finland and another ministerial meeting in 1998 in Ottawa, Ontario, tax authorities generally did not advocate departing from traditional laws. They established policies unless there was evidence that technological change significantly undermined vital interests[68]. It is noted that national governments if they responded to tax challenges at all, did so cautiously, as there was little evidence at the time that traditional values (e.g., the collection of revenues from cross-border transactions) were seriously threatened[69].

---

[64] OECD/G20 Base Erosion and Profit Shifting Project, *supra note,* 4:100.
[65] Arthur Cockfield, "BEPS and Global Digital Taxation," *Tax Notes International*, Vol. 75, No. 11. (September 15, 2014): 933 – 934, https://ssrn.com/abstract=2507872.
[66] Ibid., p.934.
[67] Ibid., p.934.
[68] OECD Committee on Fiscal Affairs, *supra note*, 32.
[69] Arthur J Cockfield, Walter Hellerstein, Rebecca Millar, and Christophe Waerzeggers, *Taxing global digital commerce*, (Alphen aan den Rijn: Wolters Kluwer Law & Business, 2013), chapters 4 and 6.

In their early article, Howard E. Abrams and Doernberg noted that e-commerce implies that technology, not politics, will determine the tax rules of the 21st century[70]. It is worth noting that technological changes, not political issues, have caused this unprecedented global tax cooperation. Therefore, in the framework of this international tax cooperation, the OECD has initiated several steps aimed at addressing the global tax challenges of e-commerce, which will be described below after analysing the traditional concept of PE.

2.4.2. Traditional PE concept

As mentioned in Chapter 1, "1.1.1. Background of the right of international jurisdiction on taxation", the principles of taxation of non-resident entities that earn profits from business activities in a foreign country have been in place since the 1920s. Developed in the early twentieth century, the increase in cross-border trade drove it.

Thus, the main focus was on the elimination of double taxation. The 1923 Report, which supported residence-based taxation and was less favourable to source-based taxation, was modified in the 1925 and 1927 Reports of the Technical Experts. The 1925 Report recognised that the new division was made for purely practical purposes, and no conclusions as to economic theory or doctrine should be drawn from this fact[71]. These groups of technical experts of 1925 and 1927 introduced the concept of "permanent establishment" so that business profits earned in the source country would be taxable only if the foreign enterprise had a sufficient connection with that country.

Now, under the OECD and the UN model tax conventions[72], countries have agreed not to tax business profits earned in their jurisdictions by non-residents unless such foreign entity has crossed the permanent establishment (PE) threshold in the other state. Therefore, its activities can no longer be characterised as not closely connected with the economy of that jurisdiction[73]. In the absence of a PE, business profits earned by a non-resident in the source country are exempt from taxation and, accordingly, taxable only in the country of residence.

According to Ekkehart Reimer, there are three objectives behind this permanent establishment concept[74].

---

[70] Howard E. Abrams and Richard L. Doernberg, "How electronic commerce works," *Tax Notes International 14* (1997): 1574.
[71] Cockfield et al., *op. cit.,* chapter 4
[72] OECD, *supra note*, 62; *also* United Nations, *supra note,* 62.
[73] Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective*, (Alphen aan den Rijn: Wolters Kluwer, 2018): 34.
[74] Ibid.

The first goal is that from the point of view of international justice, it is necessary to grant the right to levy taxes in exchange for the efforts of the state to create, maintain and protect favourable economic conditions for foreign investors. According to Reimer, this is especially important in conditions when there is an agreement on avoiding double taxation between developed and developing countries. The scientist notes that this is since when it comes to two developed countries, it is assumed that there is a relatively equal investment flow. In a situation of reciprocity between the two countries, the issue of the amount of source taxation becomes somewhat irrelevant. However, in a developing country, the breadth of the permanent establishment definition (or the lowest threshold) becomes very important for allocating source country taxation rights[75].

The second objective is to put the permanent establishment on a level playing field with the resident business owner and thus ensure neutrality between residents and non-residents.

Finally, there is a practical rationale for using the permanent establishment principle as a threshold. Small operations or infrequent and limited interaction with the country may result in foreign businesses incurring unnecessary compliance and administrative costs.

Concerning the notion of the permanent establishment, it is defined in Article 5 of the OECD Model Tax Convention and the UN Model Tax Convention. They involve three categories. The first is the test of physical "suits" test, which is generally defined in paragraph (1) and specifically listed in paragraph (2) of Article 5. This category also includes a building site, construction or installation project if it lasts for a particular time (twelve months in the case of the OECD Model Convention and six months in the case of the UN Model Convention). However, software, a website or other intangible assets may not constitute a permanent establishment because they do not have the necessary material connection with the source state[76].

The second category is the contractual or relationship "deemed" test. The dependent agency rules in Article 5(5) require that an enterprise shall be deemed to constitute a permanent establishment if any person acts as a dependent agent and/or otherwise acts in such a way as to conclude contracts habitually or plays a leading role in the conclusion of contracts[77].

In the case of the UN Model Convention, the actions of a "dependent agent" may constitute a permanent establishment even without having or exercising the usual authority to contract on behalf

[75] Reimer et al., *supra note,* 73:39.
[76] "Commentaries on the Articles of the Model Tax Convention," OECD, accessed 11 October 2022, p.110 https://www.oecd.org/berlin/publikationen/43324465.pdf.
[77]Ibid.,110.

of the enterprise if that person habitually maintains stocks of goods or products and regularly makes deliveries from those stocks (paragraph 5(b))[78].

The third category is the temporary or physical presence test. The Commentary to the OECD Model Tax Convention specifies that a permanent establishment can exist only if the fixed place of business has a certain degree of permanence and is not purely temporary[79]. For example, activities carried out at a construction site, construction or installation facility are a permanent establishment only if the required period of time (six or twelve months) has elapsed.

It is noted that only the provision of services for the required time in the country of origin by personnel employed by the enterprise is the criterion for determining a permanent establishment. In other words, there is no requirement to have a fixed place of business (as in the case of the first category above).

2.4.3. The impact of technologies and BEPS project

Some business activities have many benefits as a result of digitalisation, namely: they increase the ability to operate remotely; increase the speed with which information can be processed, analysed, and used; expand the number of potential customers (as distance forms a much smaller barrier to trade); processes that were previously carried out by local staff can now be carried out across borders, either by a centralised team or, more likely, by automated equipment, a change that has resulted in a reduction in the number of people physically required[80].

Therefore, the customer base in some countries does not require the same level of local infrastructure and staff that a similar business would have required ten to fifteen years ago. Multinational enterprises are much freer in choosing where to locate their business operations. While some may locate core resources close to markets, others are increasingly locating their staff, information technology infrastructure, and decision-making capabilities (much of which may be automated) far from markets.

To response on these changes, the OECD launched the BEPS project to develop government cooperation in 2013. In July 2013, the OECB adopted the Action Plan on BEPS[81], which consists of 15 Actions and is designed to close gaps in existing international tax rules that allow large businesses to shift profits to low or zero-tax jurisdictions.

---

[78] United Nations, *supra note,* 63.
[79] OECD, *supra note*, 62:141.
[80] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 4: 105
[81] OECD, *supra note,* 44:3

The most important and appropriate for analysis in the context of this master's thesis research is Action 1 of the BEPS project, which addresses the digital economy's tax challenges.

Thus, according to the OECD, the main policy challenges in the field of taxation can be divided into three categories:

1) *Nexus*: The ever-increasing potential of digital technologies and the decreasing need in many cases for a significant physical presence to conduct business, coupled with the growing role of network effects generated by customer interactions, may call into question the appropriateness of current rules for determining the nexus with jurisdiction for tax purposes.
2) *Data*: The increasing sophistication of information technology has enabled companies in the digital economy to collect and use information across borders on an unprecedented scale. This issue raises questions about determining the value created by data generation through digital products and services.
3) *Characterisation*: The development of new digital products or means of providing services creates uncertainty about the proper characterisation of payments made in the context of new business models, especially in connection with cloud computing[82].

The OECD notes that it is the main challenges that call into question whether the current international tax system remains fit for purpose to accommodate the changes brought about by the digital economy and new business models it enables, as well as related to the allocation of taxation rights between source and residence jurisdictions. These challenges also raise questions about the paradigm used to determine the place of economic activity and value creation for tax purposes based on the analysis of functions performed, assets used, and risks assumed. At the same time, these challenges create opportunities to achieve double taxation[83]. Therefore, the OECD discussed creating a new connection with a permanent establishment in its Report on BEPS Action 1, but no political agreement was reached.

Regarding the effectiveness of this mentioned BEPS project, Sven Hentschel stated that the measures developed by the OECD under the BEPS project in 2015 help to combat specific manifestations of BEPS[84]. However, none of the BEPS measures has become a minimum standard[85]. According to the scientist, one of the problems was that these OECD recommendations were non-binding. Therefore, the implementation process took a long time as countries implement those

[82] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 4: 99.
[83] Ibid. p.99-100.
[84] Hentschel, *supra note*, 31:331-333.
[85] For an overview of the minimum standards of the BEPS project see OECD, BEPS Project – Explanatory Statement, para. 11.

measures that work in their favour and ignore those that will decrease overall tax revenues[86]. Moreover, Sven Hentschel has drawn several key conclusions regarding BEPS project effectiveness in addressing the challenges posed by the digitalisation of the economy and its implications for the permanent establishment concept in particular:

Firstly, the results of BEPS measures have led several highly digitised MNEs to restructure their international business structures so that online sales by MNEs with "domestic" customers are recognised within a local entity (i.e. PE or Subsidiary). This restructuration should have resulted in a more significant share of the MNE group's revenue being attributed to the market jurisdiction in which the actual customers are located. However, the BEPS measures did not answer the question of dealing with tax issues arising from highly digitalised business models, such as multilateral platforms Google or Facebook. These business models benefit significantly from data collected from users in different jurisdictions[87].

Secondly, although the title of BEPS Measure 7, " Preventing the Artificial Avoidance of the Permanent Establishment Status," it has been demonstrated that the scope of BEPS Measure 7 went beyond aggressive tax planning strategies, which are mainly carried out by high net worth MNEs. Instead, the measures introduced to extend the scope of the permanent establishment concept to benefit market economies, regardless of whether the established structure seeks to engage in any tax abuse[88].

So, the work carried out by the OECD within the BEPS project framework during 2013-2015 helped to combat specific issues of highly digitalised multinational companies. However, most critical challenges faced by highly digital companies remain primarily unaddressed by BEPS measures. In this regard, the problems remained, and a holistic solution still needed to be achieved.

In conclusion to this Chapter, the digital economy cannot be separated from the whole economy as more familiar goods and services are digitised. The OECD identifies some advantages digitised multinational corporations enjoy, enabling them to make large profits due to their mobility. This process has both positive consequences, such as new business models, and negative ones, such as erosion of the profit base and avoidance of establishing a permanent establishment in a particular market jurisdiction.

[86] Hentschel, supra note, 31:332.
[87] Ibid.
[88] Ibid. 333.

CHAPTER 3. CRITICAL EVALUATION OF LEGAL PROBLEMS ARISING IN PILLAR ONE

The first Chapter of this research work examined the basic principles of international tax law. Subsequently, the second Chapter identified and characterised the specific and main challenges for the tax system in the context of the new threat posed by the digitalisation of the economy and how these threats have begun to level the fundamental principles of international law. This Chapter of the master's thesis analyses from the legal point of view the possible response to these challenges in the form of the Pillar One Proposal and the legal challenges that this new reform posed to the international tax system.

As stated in the preceding Chapter, the BEPS Action 1 Report could not find a solution to the problems caused by the challenges mentioned earlier. In response to the G20's request, the Inclusive Framework continued its work. In January 2019, members of the Inclusive Framework agreed to examine suggestions in two key areas, which were anticipated to serve as the foundation for a consensus-based solution to the tax difficulties posed by digitalisation[89]. The first aria focuses on nexus and profit allocation, while the second focuses on a global minimum tax designed to address the remaining BEPS issues. Subsequently, a Work Programme on Pillars One and Two was adopted in May 2019 and subsequently endorsed by the G20 in June 2019[90].

This master's thesis focuses mainly on Pillar One. Therefore, this Chapter examines the critical elements proposed in it to identify what fundamental changes are proposed and assess the feasibility of their implementation from a legal point of view in the context of the existing system of cross-border tax rules.

Thus, the first part of this Chapter will provide the historical background of international tax reform and the development of a new compromise to address tax challenges in the global digital economy of the 21st century. The next part will examine the radical nature of the approach proposed by Pillar One, and the third part will outline its essential elements. The fourth part will explore the key challenges that arise from the proposed global changes. The Chapter will conclude with a critical analysis of the proposed approach through the prism of the fundamental principles of tax policy outlined in Part I of this research paper.

---

[89] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 5:3.
[90] Ibid.

3.1. Development of "2020 Tax Compromise"

The permanent establishment rule dates to the 20th years of last century and is found in almost all tax treaties concluded since then. Currently, permanent establishment provisions are included in almost all bilateral tax treaties. The basis of the PE rule is the requirement of physical presence directly (e.g. office, factory or employees) or through a dependent agent. However, in the 21st century, PE rules are outdated, as multinational corporations can earn billions in a tax jurisdiction without having any assets, employees, or direct sales (Facebook has none of these traditional elements, it only has users).

After the G20 and the OECD failed to reach a consensus on several issues, the most critical of which was Action 1 relating to the digital economy in 2014[91], European Union members proposed a model of "significant digital presence" to make changes to the existing tax rules on "permanent establishments" (PEs) but faced resistance from the United States to any attempts to impose additional taxation on its tech giants such as Amazon, Apple, Facebook, Google and Netflix[92].

As a consequence of the lack of a joint international consensus on the taxation of international digital corporations, countries have unilaterally started to take measures. The United Kingdom developed a new complex tax for tech giants that built their businesses in such a way as to avoid establishing a permanent establishment in their jurisdiction in 2015. Thus, the United Kingdom became the first jurisdiction to develop a diverted profits tax ("DPT"), which imposed a tax on the profits of avoided permanent establishments[93].

The United Kingdom was subsequently followed by Australia, which adopted a "Netflix tax"[94] and India, which adopted the first "digital services tax" [95]- a tax on the provision of digital services, as well as on the use of local consumer data to sell targeted advertising (thus applying the business models of Amazon, Facebook and Google).

In response to these developments, in 2018, the G20 and the OECD started working on BEPS 2.0 in a new format, as the project expanded to include both developed and developing countries. This was because the new international tax reform would be successful only if supported by the

[91] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 4:3.
[92] Ruth Mason, "The Transformation of International Tax," *American Journal of International Law* Vol. 353 – 402, No. 114 (2020): 355.
[93]"Diverted Profits Tax: Navigating your way," KPMG, assessed 1 November 2022, https://assets.kpmg/content/dam/kpmg/pdf/2015/09/diverted-profits-tax-navigating-your-way.pdf .
[94]"Tax and Superannuation Laws Amendment (2016 Measures No. 1) Act 2016," Federal Register of Legislation, accessed 15 November 2022, https://www.legislation.gov.au/Details/C2016A00052 .
[95]"The Finance Act No.28 of 2016," Ministry of Law and Justice, accessed 15 November 2022, https://www.cbic.gov.in/resources/htdocs-cbec/fin-act2016.pdf .

international community[96]. As a result, 140 countries are currently participating in the OECD/G20 Inclusive Framework on BEPS 2.0 to develop consensus, long-term solutions[97].

Therefore, within the framework of the "reformed" BEPS 2.0 project, a solution consisting of two Pillars was proposed[98]. Published in October 2020, the OECD's drafts on the taxation of the digital economy (Report on Pillar One Blueprint and Pillar Two Blueprint) envisage the introduction of new tax rights, nexus definitions and dispute resolution mechanisms. The proposals are ground-breaking but also radical and disruptive as they challenge more than eight decades of international tax principles, norms, rules and procedures[99].

Pillar One concerns the modification of profit allocation and nexus rules. This Pillar aims to assign part of the residual profits of corporations to market jurisdictions, even if the corporation has no PE in these countries[100]. The provisions of the Pillar Two are a direct extension of the "Global Intangible Low Tax Income (GILTI)" and the "Base Erosion and Anti-Abuse Tax (BEAT)" [101].

The draft states that radical changes in the international tax system are necessary for two reasons.

The first reason is that MNEs abuse loopholes in the tax system to erode the tax base and profit shifting (BEPS). Such actions lead to significant, frequent, and contentious tax disputes between MNEs and the state and between jurisdictional tax disputes. While the first round of changes in the OECD BEPS policy has reduced the scale of this problem, the Action Plan argues that these changes do not go far enough, and that further action is needed[102].

The second problem is that existing international tax rules were not designed to tax the profits of "digital" MNEs; the difficulties in taxing profits from digital activities are particularly pronounced in jurisdictions where MNEs engage in distance selling but do not have a permanent establishment and, therefore no taxable entity[103].

An overwhelming majority of Inclusive Framework members have agreed on a package that will bring the most significant changes to international tax rules in more than a century. This two-part package will ensure that the largest and most profitable companies pay taxes where their customers

---

[96] "Composition of the Steering Group of the OECD/G20 Inclusive Framework on BEPS," OECD, accessed 15 November 2022, https://www.oecd.org/tax/beps/steering-group-of-the-inclusive-framework-on-beps.pdf
[97] Reuven S. Avi-Yonah et.al., *supra note*,7:13.
[98] Inclusive Framework on BEPS, *supra note*, 53.
[99] Lorraine, *supra note,* 16:1.
[100] OECD/G20 Base Erosion and Profit Shifting Project, *supra note,* 5:8
[101] Ibid.
[102] Ibid.
[103] Ibid.

are and create the conditions for tax competition by introducing a global minimum corporate tax. This package results from intense discussions over the past few years and compromises on all sides[104].

In the framework of this scientific work, Pillar One will be investigated from the legal point of view since it is the object of research and the derivative Statement, which became an organic continuation of Pillars One and Two.

In summary, the permanent establishment norm stretches back to the 20th century and is present in nearly all international tax agreements. The basis of the PE rule is the necessity of direct or indirect physical presence (e.g., office, factory, or employees). Multinational firms can earn billions in a tax jurisdiction without assets, staff, or direct sales in the 21st century, rendering PE regulations obsolete. The OECD draught on the taxation of the digital economy (Report on Pillar One Blueprint and Pillar Two Blueprint) proposes the introduction of new tax rights, nexus definitions, and dispute procedures. As they contradict more than eight decades of international tax standards, the suggestions are revolutionary but also radical and might disruptive. Members of the Inclusive Framework have agreed on a package that would introduce the most substantial revisions to international tax standards in more than a century. This two-part legislation will ensure that the largest and most profitable corporations pay taxes in mostly their customers' locations.

3.2. Radicality of the new approach to international taxation

Earlier it was mentioned about the reasons for radical changes. This part determines precisely how this radicality is manifested. According to Professor Craig Elliffe, there are three main reasons (at least) why this is so[105]:

Firstly, Pillar One Proposal propose a new allocation of taxing rights. As discussed in Chapter 1 of this thesis in part "1.1.2 Allocation of taxing rights under current tax treaties", under the DTT, the concept of permanent establishment is currently used to determine whether a treaty state is entitled to exercise its taxing rights concerning business profits of a non-resident. However, the new digital mechanisms currently used by MNEs, as defined in Chapter 2, provide an opportunity to generate significant profits by circumventing a permanent establishment in a particular jurisdiction. Thus, new proposals have been developed to give more tax rights to the jurisdiction of the market where the users (customers) are located[106].

[104] "Addressing the tax challenges arising from the digitalisation of the economy," OECD/G20 Base Erosion and Profit Shifting Project, accessed 2 November 2022, p.8, https://www.oecd.org/tax/beps/brochure-addressing-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf?utm_

[105] Elliffe, *supra note*, 21: 117-119.

[106] Ibid.

The Inclusive Framework suggests that such a reallocation of tax rights reflects situations where value is created by business activity through participation in the customer's jurisdiction or market, which is not currently recognised in the existing rules[107]. According to Craig Elliffe, this is controversial as the market has not traditionally been seen as a sufficient link to create a nexus for taxation. Factors involved in income production related to supply rather than demand (obviously related to the market) have historically been the factors in which income has been located. They override the limitations on taxation rights defined by reference to physical presence (of persons or locations). This has generally been accepted as the cornerstone of the current rules, and the definition of permanent establishment has a long history dating back to the 1920s and is a compromise. However, the theory of creating precisely the type of connection that is proposed today with a particular jurisdiction could not have existed at that time, as digitalisation was unknown to mankind[108].

Accordingly, this is the main difficulty since, firstly, as already mentioned, the Inclusive Framework tries to revise some long-standing and fundamental principles of the international tax system. Despite all its shortcomings, the existing system has existed for a long time. The new solution should reflect a balance between precision and practicality (bearing in mind the wide gap of opportunity between the largest and most developed countries and the smallest and developing countries) with a sound conceptual and logical economic basis. The rules should neither lead to taxation where there is no economic gain nor lead to double taxation.

The second reason is the lack of a common starting point and competitive pressure between different countries. For example, developed countries and developing countries. The IMF Report notes that the only consensus in the original OECD/G20 report on digitalisation and taxation was that attempts to isolate the "digital economy" for special treatment are inappropriate, given how pervasive these technologies are and how unpredictable their future development is[109]. Countries have very different perspectives in anticipation of a long-term solution: some see targeted unilateral action as a political imperative, given domestic perceptions of under-taxation, while others see unilateral action as simply unilateral measures, and others see any unilateral action as merely an attempt to extract revenue from a few well-known and most US companies[110].

---

[107] "Base Erosion and Profit Shifting Project: Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note," OECD/G20 Base Erosion and Profit Shifting Project, assessed 15 November 2022, p.2, https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf

[108] Elliffe, *supra note*, 21: 117-119.

[109]"Corporate Taxation In The Global Economy," International Monetary Fund, accessed 5 November 2022. https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650

[110] Ibid.

Thirdly, the task is highly challenging, and so is the timeframe. The plan is to provide a long-term consensus-based solution in 2020. In addition, each jurisdiction will need to implement the new rules into local law through an appropriate legislative process. This means drafting and adopting laws in many jurisdictions over a relatively short time. As noted earlier, the new rules will come into force in 2023, which leaves very little time for legislators to rewrite the rules so that they take into account existing systems and tax frameworks. Tax authorities will have to deal with the administration of the new laws, including implementing systems and processes for the enforcement and collection of taxes[111].

Therefore, for the above reasons, the proposed reform is indeed radical.

3.3. Pillar One Solution

Pillar One aims to adapt the international corporate tax system to new business models by amending the profit allocation and nexus rules applicable to corporate profits. The OECD believes that Pillar One will rectify outdated international tax rules of the 21st century by offering market jurisdictions new tax rights for MNEs, regardless of whether or not they have a physical presence[112].

In the view of the OECD, it will extend the tax rights of market jurisdictions via active and sustained participation of a business in the economy of that jurisdiction through activities in, or remotely directed to that jurisdiction. Pillar One targets about 100 of the largest and most profitable MNEs and provides for the distribution of a portion of their profits to the countries where they sell their products and provide their services[113]. The proposal also provides for certain mechanisms to ensure the prevention and resolution of disputes in order to eliminate any risk of double taxation, and in order to avoid disputes, it contains a proposal to suspend and abolish unilateral measures, such as digital services taxes (DST), in order to avoid disputes.

Additionally, it is essential to note that at the outset of the BEPS 2.0 negotiations, Pillar One was intended to propose new rules of nexus and profit sharing for the digital sector of the economy. The division of tax rights relating to corporate revenues could no longer be established only by physical presence, especially on digital platforms where user participation in market economies is vital. The new BEPS 2.0 standards should be based on taxation on a net basis, avoid double taxation, and be as straightforward as feasible[114]. However, following multiple rounds of discussion on the

[111] Elliffe, *supra note*, 21: 117-119.
[112] OECD, *supra note,* 12:1.
[113] Ibid. p.12
[114] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 5: 10.

suggestions and publishing the draught Pillar One, Pillar One no longer exclusively targets the digital economy. Instead, it targets any business sector that satisfies a threshold amount of income and profitability, even if it is not digital. Consequently, its application will not be restricted to a small number of MNEs in a particular industry. This is entirely unexpected, given that the Statement's title still indicates its intention to address tax challenges stemming from the digitization of the economy[115]. Consequently, it will be applied widely and will not be limited to a small number of MNEs in a particular industry[116]. This is somewhat surprising, as the Statement's title still declares the goal of addressing tax issues arising from the digitalisation of the economy.

3.3.1. Report on Pillar One Blueprint 2020

The Pillar One called "Tax Challenges Arising from Digitalisation - Report on Pillar One Blueprint", published in October 2020, is the first comprehensive proposal to extend the tax rights of market jurisdiction[117]. It contains elaborated new concepts called Amount A, and Amount B.

While Amount A focuses on a new tax entitlement for market jurisdictions to tax a portion of residual profits calculated at the MNE group level (Amount A), Amount B allocates specific amounts of fixed profits from marketing and distribution activities to market countries where companies have a physical presence. Another essential objective of Pillar One is to improve tax certainty significantly and dispute resolution mechanisms and eliminate related unilateral measures[118].

In the following part, these new concepts will be considered more specifically for further analysis. It should also be emphasised that the analysis of these concepts will be carried out from a legal point of view, not from a technical one.

Therefore, listed below are the primary design components of Amount A that have undergone the most significant change as a result of later negotiations.

Scope: Amount A is applicable solely to consumer-facing firms (CFF) and businesses performing automated digital services (ADS)[119].

Revenue Threshold: Amount A is applicable to companies only if they meet both a worldwide and a local revenue threshold. The particular amounts of these thresholds have not been established, and no information has been released other than a comment stating that "there may be little value in

---

[115] Reuven S. Avi-Yonah et.al., *supra note*,7:12.
[116] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 5: 12.
[117]"Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy," OECD/G20 Base Erosion and Profit Shifting Project, accessed October 22, 2022, https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf.
[118] Ibid.
[119] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 5: 99.

choosing a barrier lower than the existing €750 million threshold." Approximately 2,300 international corporate organisations would be subject to Amount A at this threshold[120]. The local in-scope revenue criterion is examined so as to exclude enterprises that are predominantly domestic.

Nexus: The new nexus rule determines which market jurisdictions qualify for Amount A regardless of PE creation. A nexus will be established if the local income of in-scope enterprises exceeds a particular threshold. Nonetheless, no precise number has been proposed.[121]

Profit Allocation: The Report on Pillar One Blueprint outlines a three-step procedure for calculating quantum of Amount A:

Firstly, determine the amount of "residual profit," which is defined as profit beyond a profitability threshold (pre-tax profit divided by revenue). This amount is eligible for-profit allocation.

Secondly, multiply a “reallocation percentage” to residual profit. This amount is reallocated mostly from residence countries to market countries because physical presence requirement is eliminated[122].

Thirdly, if there are numerous market nations, an "allocation key" based on local in-scope revenues is used to distribute Amount A across eligible jurisdictions.

Therefore, Amount A is a purpose to reallocate a portion of a group’s profits to the market countries where the end consumers are located and there are associated with those profits. It targeted the situations where this profit was not in those countries but was somewhere else, and it was viewed that standard transfer pricing rules could not address this situation.

A primary purpose of Amount B is to prevent transfer pricing issues regarding marketing and distribution operations at the base level by utilising agreed standardised returns to objectively specified activities supported by quantitative data. Disputes about the application of Amount B (such as whether a taxpayer meets the description of "baseline marketing and distribution operations") that create the risk of double taxation would also be subject to binding dispute resolution. After exhausting all other disagreement prevention and resolution methods. Mandatory dispute resolution is necessary to safeguard the benefits of Amount B, which will be jeopardised if certainty is confined to the remuneration of baseline operations and there are unresolved issues over whether particular arrangements or structures are within the scope of Amount B[123].

---

[120] Reuven S. Avi-Yonah et.al., *supra note*,7:16

[121] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 5: 64.

[122] Ibid.

[123] Ibid, p.155

To sum up, Amount A under Report on Pillar One Blueprint is a new taxing right over a portion of residual profits allocable to market jurisdictions and has been held to be the major response to the tax issues of the digitalisation of the economy. Therefore, as noted above, Amount A has several highly innovative features, including the creation of a new tax right that will extend to the market jurisdiction and reflect the activities (related to marketing intangibles and the user base) carried out by certain companies in that jurisdiction. This is a fundamental change from the position reached in the OECD Model Convention as a result of the 1920s Compromise (taxation rights did not extend to the market on the sale of goods and services but were essentially retained by the country of residence and production). Meanwhile, Amount B attempts to unify, in accordance with the ALP, the remuneration of related party distributors.

3.3.2. Statement on a Two-Pillar Solution 2021, namely Pillar One

On October 8, 2021, the latest Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy was released. One hundred thirty-seven countries and jurisdictions supported it, and their support amounts to more than ninety per cent of global GDP[124]. The critical aspects of the Statement will be described in more detail below.

All MNE groups with gross revenues of more than EUR 20 billion and profitability above 10 percent (pre-tax profit/revenue) fall within the scope[125]. Accordingly, the companies will be deemed to be subject to taxation under Amount A. Pillar One is to be reviewed seven years after it enters into force. If its implementation is deemed successful, the turnover threshold will be reduced to EUR 10 billion[126]. The Statement does not include extractive industries (non-renewable resources such as oil and minerals) and regulated financial services (banking, insurance, and asset management services).

It is worth emphasising that Report on Pillar One Blueprint 2020 has defined that MNE groups with revenues exceeding EUR 750 million falls under its scope. In addition, MNEs that exceeded this threshold had to belong to one of two categories: Automated Digital Services (ADS) or Consumer Focused Business (CFB). ADS and CFB were defined accordingly[127]. However, the G/20 and OECD did not reach a consensus on such scope. Therefore, the change in the scope of Amount A was a notable difference between the Statement and the previously published 2020 Pillar One Action Plan. The Statement abandons the industry-based approach and adopts a quantitative approach based on

[124] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 12:1.
[125] Ibid.
[126] Ibid
[127] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 5:22.

businesses' gross revenue and profitability[128]. This dramatically reduces the number of businesses covered, namely from 780 to 78 of the world's largest companies[129]. It is also envisaged that Amount A will be implemented by a multilateral instrument (Convention), which is expected to be drafted and opened for signature in 2022 and enter into force in 2023[130]. The problems and challenges that follow from this will be revealed further.

So, Amount A in the new joint Statement allows certain jurisdictions to tax remote sales of goods and services, provided a nexus exists. Consequently, the Inclusive Framework also proposed to change and make more detailed nexus requirements for taxation so that the new right to tax could arise in the market jurisdiction[131]. Therefore, new thresholds of market income of EUR 1 million (for developed countries) [132] and EUR 250,000 for jurisdictions with GDP less than EUR 40 billion (for developing countries) [133] to the Group's income earned in the market jurisdiction within the scope of its activities were applied. Market income will be determined and assessed in accordance with the rules for determining sources of income. It is worth noting that for smaller market jurisdictions, a lower threshold of connection will be applied so that they can also benefit from Amount A. The nexus rule is supported by detailed sourcing rules, which provide a methodology for determining where the Group's revenues are derived based on reliable indicators or "allocation keys"[134].

The calculation of Amount A itself is planned to start with the consolidated profits of multinational groups. The rules include a limited number of adjustments between accounting and tax accounting and a system allowing groups to carry forward losses[135]. This is a fundamental difference, as previously, the international tax system operated on the basis of a strict entity accounting system that attributed profits earned globally to specific entities (usual companies) within a multinational group located in specific jurisdictions[136]. Therefore, the tax base will be determined using the adjusted profit before tax (PBT) derived from the reported consolidated financial statements of the MNE groups.

---

[128] Reuven S. Avi-Yonah et.al., *supra note*, 7: 17.

[129]Michael P. Devereux and Marti Simmler, "Who will pay amount A?", *EconPol Policy Brief*, No. 36, https://www.econstor.eu/bitstream/10419/236737/1/176520884X.pdf

[130] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 12:3.

[131] Ibid.

[132] As per the Statement issued by Inclusive Framework on 1 July 2021

[133] Ibid.

[134] "Progress Report on Amount A of Pillar One: TWO-PILLAR SOLUTION TO THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY," OECD/G20 Base Erosion and Profit Shifting Project, accessed 1 December 2022, https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf

[135] Ibid.

[136] Elliffe, *supra note*, 21: 192.

Use of formulas and agreed-on proportions to allocate taxation rights. The profit allocation rules are based on a formula whereby 25% of the Group's profit in excess of 10% of the Group's revenues is allocated to the relevant market jurisdictions. This profit is allocated to the market jurisdictions in proportion to the number of Revenues generated by the Group in that jurisdiction. It is subject to any adjustments arising from the Marketing and Distribution Safe Harbour (MDSH). The latter adjusts the allocation of Amount A for market jurisdictions that already have existing rights to tax the Group's residual profits[137].

The Statement also emphasises the rules for the elimination of double taxation. It is noted that these rules will be applied to eliminate any double taxation arising from the application of Amount A as a supplement to the existing profit-sharing system. The rules will be applied on a quantitative and jurisdictional basis to identify the granting jurisdictions that will be responsible for eliminating double taxation[138].

The recent "Progress Report on Amount A of Pillar One" Report, which was formed following a public consultation that ran from 11 July to 19 August 2022, envisaged that Amount A would also include a simplified administration process and innovative tax certainty processes for the new rules included in Annex A and any Annex A related matter[139]. In addition, it is also planned to develop a Convention that will contain provisions requiring the elimination of all existing digital services taxes (DSTs) and related similar measures for all companies, as well as contain a definitive list of these existing measures. It is envisaged that the agreement will also contain a commitment not to introduce DSTs or relevant similar measures if they provide for taxation based on market criteria, are limited to foreign companies and companies with foreign capital and are outside the scope of the profit tax system. The commitments will not apply to value-added taxes, transaction taxes, or repatriation taxes, which are considered to be taxes covered by tax treaties, as well as to rules concerning the abuse of existing tax standards. The development of the MAP will include work to develop the definition of an ECT further and related similar measures and will also include the removal of allocations under Amount A for jurisdictions that introduce future measures that fall within the scope of this commitment[140].

---

[137] OECD/G20 Base Erosion and Profit Shifting Project, *supra note,* 12: 25.
[138] Ibid.
[139] "Progress Report on Amount A of Pillar One. TWO-PILLAR SOLUTION TO THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY. Public consultation 11 July – 19 August 2022," OECD/G20 Base Erosion and Profit Shifting Project, accessed 2 December 2022, https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf .
[140] Ibid.

3.4. Problems on the way of international tax reform through Pillar One Proposal approach

*"The most significant implication of the growth of electronic commerce for tax policy may be that **technology rather than policy will determine the tax rules** of the 21st century"*

Howard E. Abrams and Richard L. Doernberg

The introduction of the new tax rights envisaged by the revolutionary concept set out in the OECD Secretariat's Pillar One Proposal inevitably necessitates changes to the existing international tax system. Such changes will be required both at the level of domestic legislation and at the level of public international law relating to double taxation treaties. It is also essential to ensure that clear rules for the avoidance of double taxation are established, as this may prove to be a significant issue. Given the scale of the changes, further deliberations on the new rules relating to dispute resolution and dispute prevention are needed.

After years of intensive negotiations to update and fundamentally reform international tax rules, 137 members of the OECD/G20 Inclusive Framework joined the Statement, which was released in October 2021[141]. As of December 3, 2022, 137 out of 141 member countries and jurisdictions of the IMF have agreed to the Two-Pillar proposal to reform the international tax system[142]. The reaction of world leaders, journalists, tax organizations, business leaders and civil society organizations has been overwhelmingly positive. However, according to Avi-Yonah, Reuven S. and Kim, Young Ran (Christine) and Sam, Karen, the United States, the European Union and other supporters of a global tax agreement must first address several significant obstacles to its implementation. Significantly, many sensitive and substantive issues related to Pillar One have been deferred to a potential multilateral instrument, a draft of which should be ready by the end of 2022[143]. However, this has not yet been drafted at the time of writing this master thesis.

Therefore, this part will explore the key challenges that stand in the way of reforming the international tax system through the implementation of Pillar One.

[141] OECD/G20 Base Erosion and Profit Shifting Project, *supra note,* 12: 1.
[142] Ibid.
[143] Reuven S. Avi-Yonah et.al., *supra note*, 7: 23

Firstly, ***a solution has not yet been developed***. There is still a public consultation on adopting Pillar One as of December 2022. The Digital Economy Task Force (DETF), a subsidiary body, is tasked with advancing the work required to implement Amount A. The Statement itself merely outlines the political consensus on the critical components of Pillar One and Pillar Two and assigns the Digital Economy Task Force (DETF) to implementing Amount A. Specifically, the TFG is responsible with drafting a Multilateral Convention and accompanying Explanatory Memorandum, as well as Model Rules for National Legislation (Model Rules) and associated commentary, through which Amount A will be implemented[144]. This Statement, which was supported by 138 jurisdictions[145], is only an 8-page document discussing in general terms both Pillars, while the overall plan for both Pillars is about five hundred pages long. According to scientists Reuven Avi-Yonah, Young Ran (Christine) Kim, and Karen Sam, this Statement only reflects the political and diplomatic desire to encourage as many countries as possible to join the Statement[146]. The world has reached agreement on this Statement precisely because it avoids sensitive issues. Therefore, it can hardly be considered a long-awaited solution for international tax reform[147].

It is also important that since the adoption of Pillar One, significant changes have already taken place, as noted above, in particular, a radical change in the scope of Amount A. The concept of Pillar One has been criticized as a compromise of too many previous proposals, as too complex and as moving away from the primary tax problem of the digital global economy. Given that the Statement takes another important step in changing the scope of Amount A, it should contain a policy explanation for this step. However, the Statement is silent on the reasons for this change, let alone its implications for tax authorities and taxpayers, which prompts the critical assessment in this article.

Secondly, this ***Statement clearly makes the taxation of multinational enterprises (MNEs) the BEPS project's main goal and almost completely neglects all other goals***. The radical change in the scope of Amount A evidence this. According to Yariv Brauner, this particular focus on MNEs is problematic for several reasons[148]:

- the portrayal of multinationals as the enemy and sole culprit for the state of the international tax regime seems to be a populist move that tries to disguise the failure of BEPS to deliver reform that would make the international tax regime fairer and more legitimate;

---

[144] Reuven S. Avi-Yonah et.al., *supra note*, 7: 23.
[145] 138 member jurisdictions have agreed to it as of 16 December 2022.
[146] Ibid.
[147] Ibid.
[148] Yariv Brauner, "Editorial: Agreement? What Agreement? the 8 October 2021, OECD Statement in Perspective," *Intertax* 50, no. Issue 1 (2022): 4, https://doi.org/10.54648/taxi2022001.

- the largest digitalised multinational corporations are constantly proving that they are resilient and adapt very well to changes in tax legislation;
- the proposed reform is very complex, and multinationals are more efficient in dealing with complexity than other firms, leaving the general public to bear the burden of losses caused by such complexity.

Thirdly, ***the implementation of Pillar One poses many political challenges***. It is envisaged that Pillar One will be implemented by a multilateral instrument, i.e., a treaty expected to be signed in 2022 and enter into force in 2023[149].

The "Cover Note by the Inclusive Framework to the Progress Report on Amount A of Pillar One As approved by the OECD/G20 Inclusive Framework on BEPS on 1 July 2022" notes the importance of balancing the political interest in rapid implementation with the need to properly finalise the development of innovative new rules that will be in place for decades. The Inclusive Framework also emphasises that the content of these rules should be fully stabilised until a multilateral convention ("MLC") is developed and finalised, to be signed and ratified by Inclusive Framework members. It is envisaged that the MLC will set out the legal obligations of parties to implement Part A in a coordinated and consistent manner[150]. The Convention will enter into force only after its ratification by a majority of countries.

However, ratification of multilateral instruments and tax treaties faces various challenges, such as reaching a consensus. As already mentioned, it is one thing to endorse a general joint statement and another to endorse a complex, technical and innovative international treaty.

In addition, each nation has distinct legal system regulations, political realities, and implementation and compliance issues. In the past, finding a consensus within the international community has proven to be challenging. For instance, international deliberations on the BEPS 1.0 project lasted over eight years without consensus on how the worldwide tax system should be altered[151]. There have been relatively few international tax treaties that have been successful, and the extant multilateral accords tend to have a narrower scope and fewer member states. In addition, it takes time for each country to ratify revisions to the treaty, even after an agreement is established. In the case of the 2015 modification to the BEPS 1.0 tax treaty, several nations have signed the

---

[149] OECD, *supra note,* 12:3.
[150] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 12: 3.
[151] Gary B. Wilcox and Warren Payne, "Hitching Biden's Corporate Tax Proposals to the Global Tax Bandwagon," *TAX NOTES* (June 21, 2021), https://www.taxnotes.com/tax-notes- today-federal/corporate-taxation/hitching-bidens-corporate-tax-proposals-global-tax-bandwagon/2021/06/21/76lr5?highlight=ratification%20challenges%20multilateral%20trea ties#76lr5-0000040

multilateral agreement for months to years. However, others, including the United States, have not approved it[152]. Therefore, one of the severe threats to the implementation of Pillar One is its complete dependence on the conclusion of a future multilateral convention (MLC).

Fourthly, ***implementing Pillar One should be accompanied by eliminating existing DSTs and potential digital taxes.*** This means that the possibility of a delay in the adoption of Pillar One by the United States adds even more uncertainty to the issue of the European Union's digital tax levy and the unilateral DSTs that many countries have enacted. The first component may be at risk if the European Union continues to implement the digital tax and some of its members delay the abolition of their unilateral DSTs[153]. Many commentators expect those countries with an DSTs- such as France, Canada, Italy and India - may not rush to repeal, at least until the United States implements the first component[154]. In addition, the European Union is preparing a new digital levy, claiming that the new digital levy will be compatible with the two-part proposal[155].

Fifthly**, *the agreement requires a consistent reliance on financial accounting statistics, with only a minimal number of revisions, as a basis for at least the metrics pertaining to the Pillars*[156]**. This is a significant departure for nations such as the United States, where tax accounting strives for more accuracy even at the expense of conservatism, acknowledging the very different goals of financial and tax accounting. This is a significant departure for countries such as the United States, where tax accounting strives for more accuracy even at the expense of conservatism. The level of alterations that are permitted, which Yariv Brauner opinion anticipates will be more than simply the bare minimum, will be the determining factor in determining how successful this endeavour will be in its current setting[157].

It is beyond reasonable doubt that multinational corporations will concentrate a significant portion of their efforts regarding tax planning on the manipulation of the new tax accounting. This could put countries under pressure to make adjustments to their domestic versions of tax accounting or even financial accounting to the greatest extent possible. These guarantees may lead to a corruption of financial accounting standards, which is an extremely unfavourable outcome, and they may also alter the centre of tax rivalry. The extremely precarious equilibrium that the OECD works so hard to

---

[152] Reuven S. Avi-Yonah et.al., *supra note*, 7: 23

[153] Reuven S. Avi-Yonah et.al., *supra note*, 7: 26.

[154] "Digital Taxes May Linger After Global Deal, Panelists Say," LAW 360, accessed 4 December 2022, https://www.law360.com/tax-authority/articles/1407499/digital-taxes-may-take-on-permanence-despite-global-accord

[155] "A fair & competitive digital economy – digital levy," European Commission, accessed October 7, 2022, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12836-Digital-Levy/public-consultation_uk

[156] Brauner, *supra note,* 148: 5.

[157] Ibid.

achieve in this area may be further undermined by the special agreements that are provided to various countries. Since these accords have already been given to nations inside the inclusive framework that are unwilling to join the agreements, it is reasonable to anticipate that there will be a large number of them (Ireland, etc.). The problem with these special deals goes beyond the applicable accounting standards, of course, and there is no reason not to expect that a significant number of them are permitted (or taken) by other countries. There is also no reason to not expect that a significant number of them are taken by other countries[158].

Sixthly, another important issue and possible potential problem is ***the contradiction or non-compliance of the established international tax rules and principles*** that are the basis for the formation of tax policy in the field of e-commerce. It should be highlighted that these principles, which are enshrined in the Ottawa Taxation Framework Conditions and then then supplemented by the OECD BEPS project are fundamental principles that were formed to respond to a wholly new and unexplored phenomenon of digitalisation. Therefore, the next part of this Chapter will analyse the proposed tax reform or the so-called "2020 Tax Compromise" through the prism of the fundamental principles.

Seventhly, ***the agreement relies on a future binding dispute settlement mechanism***. The OECD failed to reform the treaty dispute resolution regime under BEPS. It made another attempt by including in the MLI a mechanism of binding arbitration by agreement of the parties, to which only some of the signatories responded. So, now the future of the complex compromise represented by the agreement will depend on an effective dispute-resolution mechanism, the nature of which has not yet been explored. Unfortunately (in the author's opinion), the developing world does not approve of binding arbitration in tax treaty disputes. The question arises of how the OECD will resolve the issues under the new agreement[159].

To sum up all the above, there are quite a few complex and challenging issues in the way of Pillar One implementation. It is important to note that this reform's future depends on policymakers' ability to overcome them.

3.5. Assessment of Pillar One in light of the overarching fundamental principles of tax policy

At the time of writing, Pillar One is not expressed in a specific international instrument and is not ready to be implemented into the law of international double tax treaties and national tax laws. In

[158] Brauner, *supra note,* 148: 5-6.
[159] Brauner, *supra note,* 148: 4.

addition, as mentioned above, the process of signing and implementation may take a long period of time, but at the current stage, the path envisaged by the Inclusive Concept for the promotion of Pillar One seems to be quite clear after the release of the Report on Pillar One Blueprint and already allows for its assessment in terms of the general tax policy principles described in Chapters 1 and 2. In this context, the assessment through the tax policy principles not only identifies the advantages and disadvantages of Pillar One but also justifies why some aspects could be further improved to be more compatible with the general tax policy principles.

The first principle mentioned was the principle of *neutrality*. The principle pursues the goal that taxation should be neutral and fair in relation to all forms of business activities and taxpayers who are in the same conditions, and the same transactions should have the same level of taxation. With the release of the Report in 2020, this fundamental approach was applied to a wide range of businesses (CFBs and ADSs), as it was believed that these forms of business would benefit most from the digitalisation of the economy. However, the Statement changed the scope dramatically and supported the proposal to extend this application to all MNEs with a certain level of consolidated revenue. In this case, traditional business models are put on an equal footing with enterprises operating under highly digital business models. This contradicts the very purpose of Pillar One, which, even in its name, contains the goal of combating the challenges posed by the digital economy. Creating such a scope of Pillar One does not contribute to the principle of neutrality.

Another essential principle is *efficiency*, which implies the minimisation of compliance costs for taxpayers and administrative costs for tax authorities. However, the new right to taxation adds an additional layer of complexity and, on the contrary, increases compliance and administration costs. The proposed rules for determining the sources of income, namely Amount A, are very complex and require detailed documentation. On the other hand, Amount B can potentially reduce compliance costs for taxpayers. However, it is unlikely that the increase in compliance and administration costs associated with the application of Amount A can be offset by the simplification measures introduced by Amount B.

There are many criticisms of the *certainty and simplicity* principle. For example, its study "Pillar One Tax Games" concluded that the search for tax certainty, a key benefit promised and mentioned 121 times in Pillar One of the Action Plan, is a mirage that leads the OECD/Inclusive Framework in the wrong direction. In its quest to find tax certainty - the proverbial "oasis in the desert" - Pillar 1 Annex A will lead to even more tax gaming and greater tax complexity than existing international tax rules. Considering that providing tax certainty is an essential element of the first level, believed that Amount A is based on weak and unprincipled principles and should be

abandoned[160]. As already mentioned, Amount A aims to introduce an additional link that does not breach the permanent establishment threshold. This, in turn, does not simplify the international tax system but also creates a lot of misunderstandings, which were described in the previous part of this Chapter and will accompany many problems in the implementation. For example, the difficulty of agreeing on a single common decision, a long signing period by different countries, amendments to many international tax treaties, increased tax disputes due to the complexity of calculations and others.

Amount A is a superstructure over the current system based on the arm's length principle and, as such, does not contribute to the simplification of the international tax system. Many unresolved issues indicate that the rules for profit allocation under Amount A do not yet provide tax certainty for taxpayers. Amount B has the potential to simplify the application of transfer pricing rules and increase tax certainty. The binding nature of the dispute prevention and resolution mechanisms for Action Plan A and beyond is a critical factor for increasing tax certainty.

Therefore, the approach and proposed mechanisms envisaged in Pillar One do not respond to this one of the main principles of tax policy.

The following principle is the principle of *efficiency and fairness*, which implies taxing the right amount of taxes at the right time and minimising tax evasion. On the one hand, reforming the international tax system is expedient because, as already mentioned, digitalisation calls into question the effectiveness of the current rules. However, it is questionable whether Pillar One can cope with this. On the one hand, the approach of basing the new right to tax mainly on sales seems to be a pragmatic approach reflecting the active and sustainable participation of business in the economy of a market jurisdiction. Nevertheless, on the other hand, the creation of a new right to taxation creates risks of double taxation of the same income. Therefore, the implementation of these rules should keep pace with changes in the existing concept of residence and source, as the international tax system should not only offer solutions to new problems but also not create new ones.

The next principle is the principle of *flexibility*. As noted earlier, tax systems should be flexible and dynamic to ensure that they keep pace with technological and commercial developments. The broad scope of the new taxing power in the 2020 Report and its targeting of digital companies is questionable whether the principle of flexibility was pursued. The rationale of keeping pace with new developments that can be captured through sales figures, whether through the emergence of new business models, changes in business practices or other changes brought about by technological or commercial developments, has had some success.

[160] Eden, *supra note,* 16:4.

However, given how fast the digitalisation of business activities is taking place, as early as 2021, the Statement foresaw that such a fencing off of specifically defined activities also has the disadvantage that such definitions may quickly become outdated in the future. Therefore, in terms of flexibility, the 2021 Statement is more conducive to the principle of flexibility than the 2020 Report. Also, the formulaic approach within the amount A in the allocation of tax rights makes the approach static to reflect the dynamics of the digitalisation of the economy, and the mechanism of potential differentiation proportional to the generation of income in certain jurisdictions will increase the flexibility of such a formulaic approach. Unfortunately, a fixed rate of return for Amount B does not provide the flexibility to take into account individual circumstances and facts in each case. However, differentiated rates of return by region, industry and functional intensity for Amount B would increase flexibility.

The following analysis will be conducted through the prism of the *equity* principle. From an inter-national equity perspective, the new taxation right does not depend on the physical presence of the enterprise in the market jurisdiction. It thus aims to overcome the shortcomings of the permanent establishment concept. The approach recognises that interaction and engagement of customers/users can significantly increase sales of enterprises and thus can justify the new taxation right for market countries. Thus, the chosen strategy for the new taxation right seems to provide a stable basis to which profit-sharing rules can be tied.

Furthermore, the profit-sharing rules themselves, created on a formulaic basis, seem to be a sensible approach to compensate market countries for the active and prolonged activities of MNEs in the market jurisdiction. In addition, a preliminary impact assessment by the OECD suggests that all groups of high-income countries, except for investment centres, will experience an increase in corporate income tax revenues, which can be seen as enhancing cross-national equity Amount B aims to simplify the calculation of profits from volume activities and make it easier for countries to obtain their share of tax revenues - the success of the new profit sharing rules depends to a large extent on the ability of the Inclusive Framework to develop improved mechanisms.

Concerning vertical and horizontal (between taxpayers) equity, on the one hand, the new taxing right adds an additional layer of complexity, which also introduces additional uncertainty and inconsistency and may lead to the over-taxation of the taxpayer.

Therefore, Amount A creates additional opportunities for the over-taxation of the taxpayer. On the other hand, the foreseen elimination of unilateral measures in the framework of a consensus decision may reduce cases of over-taxation. The approach's overall assessment depends on the

Inclusive Framework's ability to develop binding and enforceable dispute prevention and resolution mechanisms. Therefore, Pillar One potentially questions this principle.

To sum up the current part of this Chapter, it can be concluded that most of the principles of tax policy, which OECD used in their Reports, may be at risk of non-compliance in the future. It is worth highlighting as well that using revenue as the main reference point for determining the nexus and allocation of the residual profit portion of Amount A between different market jurisdictions is likely to be an efficient and effective approach to facilitate policy compromises. Moreover, the use of formulaic elements to allocate residual profits between market jurisdictions seems to be necessary in light of the objective of Amount A. In this respect, the basic idea of the Amount A may lead to a more equitable distribution of taxation rights between jurisdictions.

However, it needs to be seen whether the benefits introduced by the new taxing right can outweigh the future problems associated with violating the basic principles. Furthermore, the analysis has shown that the Pillar 1 approach does not contribute to simplifying the international corporate tax system. Most other elements, especially the reallocation mechanism under Pillar A, raise many procedural and technical questions. Given the tight deadlines and the many other issues that need to be addressed, it seems very ambitious to resolve all issues in the near future.

Overall, in view of all the problems and challenges that follow from the proposed reform, the next Chapter of this research paper will investigate whether the violation of established international tax principles, the complex and long way of technical and legal development of new international mechanisms in the form of a multilateral convention and other challenges mentioned above in this Chapter justify the need for reform through Pillar One Proposal to Address Tax Challenges?

CHAPTER 4. PILLAR ONE: 'PLACEBO' OR 'MEDICATION' FOR TAX CHALLENGES ARISING FROM DIGITAL ECONOMY

After a comprehensive scientific analysis, it is undeniable that the current international tax system needs reforms. These reforms should be effective and comprehensive. Moreover, cover specific problems and "curing" them.

It should be realised that the approach proposed by Pillar One requires many other tasks, such as finding a compromise between jurisdictions, signing and ratifying the MLC, repealing other unilateral measures that jurisdictions have introduced, etc. Creating policies that require significant and radical changes is a complicated task.

In the previous Chapter, it was identified what exactly are the challenges that the proposed Pillar One reform provokes. This Chapter discusses whether it is necessary to reform the international tax system in such a radical way through Pillar One Proposal and whether there are other possible and more effective ways to address these challenges.

4.1. In search of the real purpose of the reform

The solution to the problems faced by the international tax system cannot be simple and quick. Furthermore, in the new digital reality, it is necessary to realise that creating a new tax policy will require certain costs. However, it is crucial to observe a certain proportionality so that the risks or losses the new international tax system could incur are less than the benefits the international community will receive from the reform. Therefore, this part of the current Chapter examines whether the revolutionary method of reform in the form of Pillar One justifies all the risks and potential costs.

It is worth starting with the fact that the primary goal of Pillar One was to adapt the international corporate tax system to new business models by amending the profit allocation and nexus rules applicable to corporate profits[161]. Thus, from the initial goal of the new Proposal, it was clear that the primary purpose and goal are business models that take advantage of the mobility provided by digital technologies. However, in order to achieve this goal, as originally proposed, the OECD has resorted to deviating from certain fundamental principles of tax law. If Pillar One was created to change the most fundamental principles of international taxation, one would expect that there would be some departures from centuries of international taxation, namely, for example, about principles of taxation at source, as was discussed earlier. Moreover, if such deviations were still justified by some

[161]OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 5: 4.

severe theoretical basis. Instead, several justifications were offered, none of which were particularly convincing and some of which contradicted each other[162].

Professor of Taxation Law Graeme S. Cooper stated that international tax principles had served their purpose well in the past, but rapid technological advances had rendered them obsolete[163]. From his point of view, the idea that digitalisation posed problems to the PE concept is erroneous, or at the very least, misleading, since the capacity of firms to function in other jurisdictions without a physical presence was a problem even before the internet. The internet has made this problem just far worse. Several different industries, including travel and tourism, insurance and reinsurance, freight and logistics, airlines and shipping, telecommunications, international capital markets, and even sales of goods through mail order, had all shown that it was possible to flourish without needing a sizeable physical presence in the countries of their customers. These industries had all demonstrated that thriving without a physical presence was possible. Typically, these businesses functioned by having an established network of local agents who were frequently financially and commercially dependent on the principal despite appearing to be independent. In other words, they functioned like a branch or subsidiary in substance, even if their formal structure did not reflect this. When it comes to pricing, an "(in)dependent agent" poses the same challenges for the nation where the agent is based, as does a genuine subsidiary or PE[164].

Despite this, there is one aspect in which the new business models posed a new challenge to the previously established norms. In traditional business models, companies sell their wares directly to end users. In the realm of big tech, customers supply inputs to businesses, and the operators of digital platforms use these inputs in various ways to derive significant value. Customers also provide inputs to businesses in the form of feedback and ratings. For example, users of search engines willingly provide their data or allow their viewing behaviour to be tracked around the internet. The operator of the platform then uses this information to promise its advertising customers a more tailored audience, or else the information itself is sold by the operator of the platform to its customers. Similarly, people contribute value to a company in the form of entertainment or reviews submitted to a website (referred to as user-generated content). This draws in additional viewers to the website (referred to as network effects), and then that audience can be monetised.

[162] Graeme S. Cooper, “Building on the Rubble of Pillar One, ” *The Bulletin for International Taxation,* (November/December 2021): 535, https://www.ibfd.org/sites/default/files/2022-08/oecd_un_.-building-on-the-rubble-of-pillar-one-ibfd.pdf
[163] Ibid.
[164] Ibid.

However, Wolfgang Schön believes that even though there are specific changes in business models, it does not necessarily follow that the tax regime should also be changed, especially in such a radical way. The scientist notes that at the initial stage, this only means that the profits of a foreign seller of goods or a foreign service provider are not taxed in the country where the buyers are located but are taxed in the country of residence of the supplier or another "source country" where the supplier's business functions are performed[165]. Given the high growth rate of the digital sector and the high profitability of some internet companies, this also means that an increasing share of business income from cross-border sales or services will not be taxed in the market jurisdiction. Nevertheless, this is insufficient to justify such a tax reform. According to Wolfgang Schön, to understand the problem of the international tax system, it is worth analysing in more detail the political and scientific publications on this topic. The scientist identified three important positions that justify the reform of the tax system, in particular[166]:

1. New business models have created concerns about uneven competitive advantage with companies with a more traditional business model. It has been argued that MNEs operating in the digital economy can benefit not only from the absence of substantial taxation in a market country but also - due to the mobile nature of their business - from no or low taxation in other countries, as they successfully hide their assets and profits in tax havens or use other preferential tax regimes[167]. A striking example is Amazon competing with the local bookstore or Booking.com competing with the travel agent next door. From this point of view, a change in the taxation of digital goods and services is not primarily about shifting taxation rights between countries, but about providing a fiscal “reserve” in the market country in case, the residence country (or another source country) does not levy a significant tax burden on the corporate income of MNEs.
2. Another equally important issue is that large multinationals such as Apple, Google or Amazon, which appear to make huge profits, are not subject to significant taxation in market economies. Market countries try to show that the tax base is really connected to their jurisdiction, and so they claim a share in the revenues[168]. However, the market country is one of many jurisdictions that are really connected to that income. Both the taxpayer's country of residence and any

[165]Wolfgang Schön, “Ten Questions About Why and How to Tax the Digitalized Economy,” *Working Paper of the Max Planck Institute for Tax Law and Public Finance* No. 2017-11. (December 21, 2017): 2-5 https://ssrn.com/abstract=3091496 or http://dx.doi.org/10.2139/ssrn.3091496
[166] Ibid.
[167] Ibid.
[168] European Commission, *supra note*, 58:2.

country where the taxpayer maintains production sites in a broad sense - including data centres or research and development units - will also be able to point to a similar nexus of the same income with their jurisdictions. They all have competing claims - a situation that could easily lead to double taxation unless a bilateral or multilateral agreement is reached on the allocation of tax rights in the future.

3. Another point of view is the improvement of tax principles, which for a long time provided the basis of the international tax regime and which should now guide politicians and legislators to adjust the related factors, as the previous scattered rules are no longer relevant.

Accordingly, the scientist argues that it may make sense to develop special rules for the digital economy, these rules should be consistent with general assumptions about the scope and structure of the international tax regime and the distribution of tax rights between countries. This can only be achieved by examining the digital elements of a technology or business model in detail to identify those factors that may lead to the need for new international tax rules. A specific option of "fencing" a certain subgroup of taxpayers is aimed at taxing large companies - for example, those MNEs whose annual turnover exceeds the threshold of EUR 750 million. This would create a problem because small companies should be taxed where they reside - regardless of their participation in foreign markets - while large companies should be subject to a specific tax regime. It is also likely to contradict the principles of equal treatment[169].

As already mentioned, the reform of the tax system proposed by the OECD in the form of Pillar One is radical since, inter alia, it deviates from international tax principles. It is difficult to state at the time of writing that Pillar One will not be able to achieve its goal as the MLC is still under development. However, it is safe to say that deviation from certain principles will provoke many discussions between the signatories, which in turn will delay the implementation of the new reform. According to this, in order to develop a truly effective and lasting solution, it is necessary to rely primarily on the principles and try not to deviate from them without motivated and justified reasons.

It is also worthwhile, in this case, to understand whether there is other "less painful" (less radical) ways to overcome tax challenges arising from the digitalization of the economy.

According to the above, the problem of avoiding a permanent establishment in a foreign country existed long before the emergence of large digital corporations. Therefore, the receipt of large profits in a particular territory became one of the critical impetuses for the new tax reform. Such

[169] Schön, *supra* note 165: 8.

reforms can be successful and effective only if they follow and are based on the existing international tax regime.

4.2. Another way to reform the international tax system

One of the proposals of the Public Consultation of the Inclusive Framework "Addressing the Tax Challenges of the Digital Economy" was to change the definition of permanent establishment. The idea of a 'significant economic presence' constituting a permanent establishment has already been discussed in some detail and was part of the Final Report on Action One "Addressing the tax challenges of the digital economy"[170].

This proposal focuses on "broadening" the concept of what constitutes a taxable presence in a jurisdiction, which is different from a traditional permanent establishment, to include features which developed during the prosses of the digitalisation of the economy.

The current definition of a permanent establishment focuses on physical factors, as outlined in Chapter 2, especially in part "*2.4.2. Traditional PE concept*". Instead, this proposal focuses on "factors that indicate a purposeful and continuous interaction with the jurisdiction through digital technology and other automated means", which may constitute a significant economic presence in combination with income generated on a continuous basis[171].

Professors Peter Hongler and Pasquale Pistone published a draft modified concept of a permanent establishment in which they proposed some of these digital factors in 2015[172]. They drew attention to 2 critical issues in this case. The first issue is the question of nexus: what nexus is necessary to establish the threshold of the taxable presence or permanent establishment? The second question concerns the attribution of income to that taxable presence and the establishment of tax rights to facilitate taxation. Professors stated that they "*focus on how the PE concept can be changed in a way that adapts its boundaries to the new scenario of the digital economy without losing the traditional function that such concept has played in international taxation over several decades*"[173].

---

[170] OECD/G20 Base Erosion and Profit Shifting Project, *supra note*, 4:107; *see also* "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy," OECD/G20 Inclusive Framework on BEPS, assessed 29 October 2022, www.oecd.org/tax/beps/programme-of-work-to-develop-a- consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm.
[171] Ibid.
[172] Peter Hongler and Pasquale Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy," *WU International Taxation Research Paper Series* No. 2015 - 15, (January 20, 2015) : 11, available at SSRN: https://ssrn.com/abstract=2591829 or http://dx.doi.org/10.2139/ssrn.2591829
[173] Ibid. 11.

Regarding the first, Hongler and Pistone proposed that this new nexus between digital PEs should consist of four main elements or requirements[174]:

(i) digital services.

(ii) a user threshold.

(iii) a certain time threshold; and

(iv) a de minimis revenue threshold.

When these requirements were met, a new permanent establishment threshold was reached, justified by the idea of "digital presence".

From a theoretical point of view, this new link is rooted in "a revised theoretical framework for the traditional sourcing theory, reflects the benefit theory and reduces the existing bias in the tax treatment of cross-border digital and physical business activities in order to achieve greater consistency between the two categories"[175].

The envisaged changes to the current PE definition by expanding the new PE definition to include the four elements discussed above (i.e. digital services, etc.) indicate that the changes will only affect certain e-commerce businesses that are part of the digital economy. According to Elliffe, C., as a consequence, non-digital businesses will be treated under the existing rules, which will create quite a lot of pressure on the definition of "what is digital?" [176]. However, on the other hand, such a definition and compromise seem to be much more realistic and reasonable from a practical point of view, as it is based on the historical concept of the source.

The next key issue raised by scholars is the solution of income distribution. Large multinational corporations that do not have a traditional physical presence in the jurisdiction where they conduct distance sales should not allocate income to the market jurisdiction under the current OECD transfer pricing guidelines[177]. Since an enterprise's traditional risks and functions are not associated with a permanent digital establishment, profits cannot be attributed to a permanent foreign establishment without further amendments. Hongler and Pistone propose the prospective implementation of a modified profit-split approach with an upfront income allocation of a portion of the profit to the market jurisdiction in order to determine the taxable income to be allocated to the PE jurisdiction after analysing numerous alternatives. Their reasoning thinks that the state of origin provides value, so "a certain income should be taxed" alongside the market jurisdiction because "the

[174] Ibid. 12.
[175] Hongler and Pistone, supra note,172: 24-25.
[176] Elliffe, *supra note*, 21:286
[177] Hongler and Pistone, op. cit., 28.

demand side also creates value"[178]. As a result, Hongler and Pistone believe that the market jurisdiction should have the authority to tax at least a portion of an enterprise's profits and that the cross-border income allocation should rely in part on a destination-based key[179]. They further propose that income should be allocated such that one-third of total profits are allocated to market jurisdictions (which is the allocation of global profits allocated on a sales basis to all jurisdictions that fall under the new digital permanent establishment requirements) and two-thirds are allocated according to existing transfer pricing concepts (to the country(s) of origin). They acknowledge that this issue is subject to negotiation and that further economic studies may yield different results[180].

Thus, the digital permanent establishment theory focuses on redefining the link established between a non-resident company and a particular jurisdiction based on a significant digital presence. This idea could potentially be an answer to the problem of non-residents' economic nexus with a country's economy without meeting the requirements of a fixed place of business or any other form of a permanent establishment, which allows profits to be taxed under Article 7 of the MTC.

4.3. Significant economic presence

On 21 March 2018, the European Commission published a new package of proposals to ensure the fair taxation of digital business activities within the EU. In its communication, "Time to establish a modern, fair and efficient taxation standard for the digital economy"[181]. The Commission notes that the EU's Digital Single Market needs a stable tax framework in line with modern digital business models. To this end, the Commission proposes a comprehensive solution, which includes three key elements:

1. A new Directive on corporate taxation of a significant digital presence;
2. Integrating the principles within a Common Consolidated Corporate Tax Base (CCCTB) proposal;
3. Extending the solution to a global level (non-EU jurisdictions) through Member States' tax treaties[182].

The proposal has two main approaches. Firstly, to establish new rules for determining the taxable nexus of non-resident digital businesses - a significant digital presence. Secondly, value

[178] Ibid., 31.
[179] Ibid., 33.
[180] Hongler and Pistone, supra note,172: 5.
[181] “COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL: Time to establish a modern, fair and efficient taxation standard for the digital economy,” European Commission, accessed 1 December 2022, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52018DC0146
[182] Ibid.

creation mainly relies on intangible assets to establish profit allocation guidelines for Member States[183].

So, the idea of the professors Hongler and Pistone about digital presence eventually became the basis of the proposal of the EU Commission Directive on the introduction of a digital presence in the tax legislation of the European Union. The proposal is based on three criteria to determine whether multinational companies have a significant digital presence in a Member State[184]:

- Revenue: more than 7,000,000 euros of turnover in the Member State during one financial year;
- Number of users: more than 100,000 in the same period;
- Contracts: more than 3,000[185].

According to the proposed EU Council Directive, if one of these conditions is met, it is considered that there is a significant digital presence. It also contains several definitions necessary to ensure straightforward application[186].

Also, the proposed document states that the digital permanent establishment provision will coexist with the current permanent establishment threshold in tax treaties and national rules. Specifically, Article 4(2) of the proposed Directive provides that it "shall be in addition to, and shall not affect or limit the application of, any other test under Union or national law for determining the existence of a permanent establishment in a Member State for corporate tax, whether specifically concerning the supply of digital services or otherwise"[187].

It should be noted that in terms of implementation, there is also an important feature. The EU Commission proposes to adopt a Directive of the Council of the EU and its further transposition into the domestic law of each Member State[188]. Therefore, this choice of implementation tool is potentially the most effective.

---

[183] Georg Kofler and Julia Sinnig, "Equalisation Taxes and the EU's 'Digital Services Tax,'' *Intertax*, 42, Issue 2, (2019): pp. 176-200, https://www.researchgate.net/publication/332540731_Equalization_taxes_and_the_EU%27s_%27digital_services_tax%27

[184] "Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence," European Commission, accessed 1 December 2022, https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A52018PC0147

[185] Ibid.

[186] Ibid., Art 5.

[187] Ibid.

[188] Ibid., EXPLANATORY MEMORANDUM para 2: "Distortions in the internal market, as identified earlier, may only be tackled through binding legal rules and approximation of tax legislations through a common legislative framework. Soft law would be a suboptimal choice, as Member States would be free to not to implement it at all or it could lead to a piecemeal approach. Such an outcome would be highly undesirable".

Thus, the EU is decisively moving towards tax reforms. Such actions demonstrate the desire to improve the perception of fairness for EU citizens by ensuring that large companies with significant digital activities do not avoid taxation in the EU. In any case, this decision will contribute to the long-term stability of the corporate tax system and a fairer distribution of tax revenues.

4.4. Pros and contras of the expanded PE concept in comparison with Pillar One

After analysing the main elements of the proposed new permanent establishment concept, it is possible to compare this approach with the proposed Pillar One. In this part, the proposed permanent establishment concept will be compared through the prism of the main shortcomings of Pillar One, namely: general orientation to solve the problem of tax law related to the digitalisation of the economy, compliance with the fundamental principles of tax law and complexity.

Regarding the *general orientation of the problem*, Pillar One and the idea of expanding the concept of PE pursue the common goal of adapting the international income tax system to new business models due to the digitisation of previously known services and services. One of the advantages of the extended PE method is that it addresses the fundamental problem of avoiding a permanent establishment by large, digitalised companies. Instead, it seems that Pillar One only declares this in its name because if you look at the scope of application, which was analysed in part "3.4. Problems on the way of international tax reform through Pillar One Proposal approach" of Chapter 3, the main taxation factor is consolidated income exceeding specific indicators. In this case, we are talking about something other than business models that will take advantage of digitalisation but, in general, about all MNEs. It seems that the key goal of Pillar One is not to solve the problems declared in it, but to create a new model of the international tax system. Therefore, the idea of expanding the CP looks quite reasonable from the point of view of the goal that policymakers initially pursued. Since one of the main problems posed by the digital economy can be directly solved by expanding the definition of a PE, however, it can also be attributed to the disadvantages that the idea of developing the PE is very focused only on the digital economy. The OECD has already expressed the view that addressing the challenges of the digital economy cannot be limited to the digital economy itself[189].

Regarding *compliance with the fundamental principles of tax law.* The use of the modified definition of permanent establishment proposed by Hongler and Pistone to establish the nexus is also attractive, as it is a continuation of a familiar concept, namely the taxation of business profits when

[189] OECD Directorate for Science, Technology and Innovation and Statistics and Data Directorate, *supra note,* 39:34.

the permanent establishment threshold is set, which has been in place for a century. However, maintaining the old paradigm should not be done in such a way as to ignore the latest developments in the business world, a revised and updated application of some of the old theories, such as the source of supply theory and the benefit theory, if properly adapted to the newly developed digital economy, can serve as a rather solid theoretical basis in the field of international taxation, which can help in developing a new and better functioning permanent establishment concept based on the updated requirement of a nexus with the business. This may help in the development of a new theoretical framework in the field of international taxation, which may help in the development of a new theoretical framework in the area.

This change is a more gradual but still direct response to the digital challenge. In contrast, Pillar One proposes entirely new rules, which may challenge compliance as identified in the previous chapter.

In terms of *complexity*, the digital economy is a very complex and highly integrated industry, and it is undeniable that a new solution will lead to uncertainty and grey areas. However, if there is consensus on the redistribution of income in the digital economy, it should also be acknowledged that the potential new connection will lead to certain uncertainties[190]. It was noted in Chapter 3, part 3.4 that one of the most difficult challenges of the Pillar One proposal is to find a global international consensus among 140 jurisdictions. This challenge is very serious as the future life of Pillar One depends on it. Therefore, this part will consider a possible way to solve the tax problems.

However, at the same time, it is necessary to realise that the expansion of one point in the concept is more pragmatic and more straightforward than the large-scale implementation of unreasonable reforms. In addition, for example, at the moment, only a physical computer server can be considered a permanent establishment for the enterprise that owns it under the current system, provided that it meets the conditions of Article 5 (1) of the OECD Model Convention (MC). Because of this, web pages stored on the server are still inaccessible.

The somewhat outdated set of prerequisites that must be met to establish a PE does not correspond to the way of doing business in the modern era. Introducing a so-called digital PoE, which will require a modification of the generally accepted concept, is one of the methods that can work in this particular scenario. An electronic substitute for a physical place of business, known as a permanent virtual establishment, would be created to achieve this goal. However, for this concept to

[190] Hongler and Pistone, *supra* note, 168: 42

offer a workable alternative to the method currently used, an economically fair threshold must be used to determine under what circumstances taxes should be paid in the source state.

Accordingly, Pillar One is an important, valuable, comprehensive work. However, after a general comparative analysis of the proposed approach, there are faster, more effective, and more reasonable methods that will work here and now. This is not to say that Pillar One is a "panacea". This concept may be the tax "medicine" for the digitalised economy. However, this new economy will require more careful supervision and an additional factor (international consensus), without which it will not "be absorbed" into the "body of the digitalised economy". Therefore, there are doubts about the effectiveness of such a "course of treatment".

CONCLUSIONS:

Given the conducted research and its underlying objectives, the following conclusions have been developed:

1) Industrialisation and better transport connections in the early 19th century were essential factors in improving the conduct of business on a cross-border level. Accordingly, the problem of double taxation arose, as most jurisdictions continued to tax based on worldwide income. The Compromise of the 1920s managed to lay the foundation of the modern international tax system by proposing that the right to tax income should be allocated between the source and residence states, as they were considered to be one of the main components of the concept of "economic allegiance". Therefore, this concept has confirmed its value for the world with time and a wide range of applications in practice, which is currently manifested in about 3000 bilateral international double tax treaties. Also, there are generally accepted and fundamental principles that are the guidelines for the formation of tax policy. These principles include neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility, and equity.

2) There is no universally recognised and unified definition of the “digital economy”, as it has been transformed over time. The first scientific works noted that this definition includes two types of economic activities related to information and communication. However, over time, it became increasingly clear that the phenomenon of digitalisation fills all economic activity and becomes the economy itself. Therefore, it is important not to separate the digital economy as a phenomenon from all economic activity but to treat it as an element of particular technical progress worldwide. This process has provided many positive elements, such as creating new business models that are faster, more convenient, have better contact with the end users, and can operate with minimal maintenance costs. However, on the other hand, such mobility allows bypassing the concept of "permanent establishment" formed in the 1920s as a threshold indicating the right of the source country to tax income generated on its territory. Large digital multinational enterprises are exploiting this "gap" as they do not need a local infrastructure to provide their services. For example, they do not need a specific factory in a market jurisdiction (as an element of permanent establishment) to sell the content of movies and TV shows on an internet-connected device.

3) The Pillar One Proposal implementation process carries many challenges that can significantly hinder the performance of the new international tax regime reform. An essential aspect of the success of Pillar One is its support by all jurisdictions of the BEPS project members, which may be a difficult political step for many jurisdictions, particularly the United States of America. Moreover, the signing of the multilateral convention is only the first step which must be followed by implementation, which may take a long time, depending on different jurisdictions. Among other problems, it is also worth emphasising that as of December 2022, no expected international mechanism has yet been developed and introduced to the public. Also, from the supported and signed Statement, it is clear that Pillar One aims not to solve the challenges arising from the digitalisation of the economy but to tax companies that exceed a certain level of income regardless of whether they use digital elements or not. Among other equally essential problems are complex and unclear rules of profit distribution between market jurisdictions, sometimes contradiction to generally accepted fundamental tax principles, lack of theoretical basis, a contradiction to modern tax rules, and undeveloped dispute resolution mechanisms.

4) The main problem driving the tax reforms is that the concept of permanent establishment is not adapted to modern digital business models, which can easily be avoided in the market jurisdiction. According to this, a possible solution to the tax challenges arising from the digitalisation of the economy could be to expand the concept of permanent establishment. This idea has a theoretical basis in numerous scientific publications. Also, after the failure of the BEPS 1 project, the European Commission proposed the concept of significant digital presence, which can be called the so-called digital PE. Pillar One is an important, complex work that aims to change the international tax system. Considering that the planned scope of application in the first years of implementation of Pillar One is approximately up to 80 large international companies, the problems that may arise with the implementation of it are disproportionate to the task and purpose of the reform. Therefore, considering all the above, Pillar One lacks the capacity to change the international tax system, and the goal set by the OECD can be achieved differently and less radically.

LIST OF BIBLIOGRAPHY:

BOOKS AND DISSERTATIONS

1. Cockfield, Arthur J., Walter Hellerstein, Rebecca Millar, and Christophe Waerzeggers. *Taxing global digital commerce*. Alphen aan den Rijn: Wolters Kluwer Law & Business, 2013.
2. Elliffe, C. *In Taxing the Digital Economy: Theory, Policy and Practice*. Cambridge: Cambridge University Press, 2021.
3. Hentschel, Sven. "The Taxation of Permanent Establishments a Critical Analysis of the Authorised OECD Approach and Its Implementation in German Tax Law under Specific Consideration of the Challenges Imposed to the PE Concept by the Digitalisation of the Economy". Doctoral dissertation, the Martin-Luther-University Halle-Wittenberg, 2021.
4. Reimer, Ekkehart, Stefan Schmid, and Marianne Orell. *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective.* Alphen aan den Rijn: Wolters Kluwer, 2018.
5. Schwab, Klaus. *The Fourth Industrial Revolution*. New York: Crown Business, 2017. https://law.unimelb.edu.au/__data/assets/pdf_file/0005/3385454/Schwab-The_Fourth_Industrial_Revolution_Klaus_S.pdf
6. Shome, Parthasarathi. *Taxation History, Theory, Law and Administration.* London: Springer Nature, 2022.

LEGAL DOCUMENTS

7. "A Borderless World: Realising the Potential of Electronic Commerce." The OECD Committee on Fiscal Affairs. Accessed October 3, 2022. https://www.oecd.org/ctp/consumption/1923256.pdf
8. "A Fair and Efficient Tax System in the European Union for the Digital Single Market." European Commission. Accessed October 15, 2022. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017DC0547&from=RO
9. "A Roadmap toward a Common Framework for Measuring the Digital Economy." OECD Directorate for Science, Technology and Innovation and Statistics and Data Directorate. Assessed 26 October 2022. https://www.oecd.org/sti/roadmap-toward-a-common-framework-for-measuring-the-digital-economy.pdf

10. “Addressing the tax challenges arising from the digitalisation of the economy.” OECD/G20 Base Erosion and Profit Shifting Project. Accessed October 17, 2022. https://www.oecd.org/tax/beps/brochure-addressing-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf?utm_
11. “Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report.” OECD/G20 Base Erosion and Profit Shifting Project. Accessed 7th of October 2022. http://dx.doi.org/10.1787/9789264241046-en
12. “Base Erosion and Profit Shifting Project: Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note.” OECD/G20 Base Erosion and Profit Shifting Project. Assessed 15 November 2022. https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf
13. “Commentaries on the Articles of the Model Tax Convention”. OECD. Accessed October 15, 2022. https://www.oecd.org/berlin/publikationen/43324465.pdf
14. “COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL: Time to establish a modern, fair and efficient taxation standard for the digital economy.” European Commission. Accessed 1 December 2022. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52018DC0146
15. “COMPOSITION OF THE STEERING GROUP OF THE OECD/G20 INCLUSIVE FRAMEWORK ON BEPS”. OECD. Accessed October 17, 2022. https://www.oecd.org/berlin/publikationen/43324465.pdf
16. “Composition of the Steering Group of the OECD/G20 Inclusive Framework on BEPS.” OECD. Accessed 15 November 2022. https://www.oecd.org/tax/beps/steering-group-of-the-inclusive-framework-on-beps.pdf
17. “Corporate Taxation In The Global Economy”. International Monetary Fund. Accessed October 17, 2022. https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650
18. “Cover Note by the Inclusive Framework to the Progress Report on Amount A of Pillar One”. OECD/G20 Inclusive Framework on BEPS. Accessed October 21, 2022. https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-on-beps-cover-note-to-the-progress-report-on-amount-a-of-pillar-one.pdf

19. "Digital Economy – Facts and Figures". European Commission Expert Group on Taxation of the Digital Economy. Accessed October 15, 2022. https://taxation-customs.ec.europa.eu/system/files/2016-09/2014-03-13_fact_figures.pdf

20. "Digital Economy Report 2019. Value Creation and Capture: Implications For Developing Countries." United Nations. Accessed 11 November 2022. https://unctad.org/system/files/official-document/der2019_en.pdf

21. "FACT SHEET AMOUNT A: Progress Report on Amount A of Pillar One". OECD. Accessed November 1, 2022. https://www.oecd.org/tax/beps/pillar-one-amount-a-fact-sheet.pdf

22. "Measuring the Digital Economy". International Monetary Fund. Accessed October 6, 2022.https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/04/03/022818-measuring-the-digital-economy

23. "Model Double Taxation Convention between Developed and Developing Countries". United Nations. Accessed October 15, 2022. https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf

24. "Model Tax Convention on Income and on Capital: Condensed Version 2017". OECD. Accessed 7th of October 2022. https://doi.org/10.1787/mtc_cond-2017-en

25. "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy." OECD/G20 Inclusive Framework on BEPS. Assessed 29 October 2022. www.oecd.org/tax/beps/programme-of-work-to-develop-a- consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm.

26. "Progress Report on Amount A of Pillar One Two-Pillar Solution to the Tax Challenges of the Digitalisation of the Economy". OECD/G20 Base Erosion and Profit Shifting Project. Accessed October 22, 2022. https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf

27. "Progress Report on Amount A of Pillar One: TWO-PILLAR SOLUTION TO THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY," OECD/G20 Base Erosion and Profit Shifting Project, accessed 1 December 2022, https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf

28. "Progress Report on Amount A of Pillar One. TWO-PILLAR SOLUTION TO THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY. Public consultation 11 July – 19 August 2022." OECD/G20 Base Erosion and Profit Shifting Project. Accessed 2

December 2022. https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf .

29. "Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence," European Commission, accessed 1 December 2022, https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A52018PC0147
30. "Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy". OECD/G20 Base Erosion and Profit Shifting Project. Accessed October 22, 2022. https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf
31. "Report on Double Taxation. Document EFS73 F19". Financial Committee, League of Nations Economic and Financial Commission. Accessed October 6, 2022. https://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;chunk.id=item-1;toc.depth=1;toc.id=item-1;database=;collection=;brand=default
32. "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy – 8 October 2021." OECD. Accessed October 7, 2022. https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm.
33. "Tax and Superannuation Laws Amendment (2016 Measures No. 1) Act 2016 (Austl.)" Federal Register of Legislation. Accessed 2 December 2022. https://www.legislation.gov.au/Details/C2016A00052
34. "Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on". Inclusive Framework on BEPS. Accessed October 15, 2022. https://www.oecd-ilibrary.org/docserver/9789264293083-en.pdf?expires=1668510817&id=id&accname=guest&checksum=783EDE3088AE4565CF9B2DB2710F2277
35. "Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS". OECD/G20 Base Erosion and Profit Shifting Project. Accessed 7th of October 2022. https://doi.org/10.1787/beba0634-en.
36. "Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS." OECD/G20 Base Erosion and Profit Shifting Project. Accessed 7th of October 2022. https://doi.org/10.1787/abb4c3d1-en

37. “Taxing the digital economy: New developments and the way forward.” European Parliament. Assessed 15 October 2022, https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698761/EPRS_BRI(2021)698761_EN.pdf
38. “The Digital Economy”. OECD. Accessed October 15, 2022. http://www.oecd.org/daf/competition/The-Digital- Economy-2012.pdf
39. “The Finance Act No.28 of 2016.” Ministry of Law and Justice. Accessed 15 November 2022. https://www.cbic.gov.in/resources/htdocs-cbec/fin-act2016.pdf
40. “The Finance Act No.28 of 2016.” Ministry of Law and Justice. Accessed 15 November 2022. https://www.cbic.gov.in/resources/htdocs-cbec/fin-act2016.pdf
41. Tax and Superannuation Laws Amendment (2016 Measures No. 1) Act 2016,” Federal Register of Legislation, accessed 15 November 2022, https://www.legislation.gov.au/Details/C2016A00052

JOURNAL ARTICLES

42. Abrams, Howard E, and Doernberg, Richard L. "How Electronic Commerce Works." *Tax Notes International* 14, no. 19 (1997): 1573-1589.
43. Avi-Yonah, Reuven S., Kim, Young Ran (Christine) and Sam, Karen. “A New Framework for Digital Taxation.” *Harvard International Law Journal (2022 Forthcoming)* Vol. 72, No. 63 (2022): 1-72, available at SSRN: https://ssrn.com/abstract=4068928
44. Brauner, Yariv. “Editorial: Agreement? What Agreement? the 8 October 2021, OECD Statement in Perspective.” *Intertax* 50, no. Issue 1 (2022): 2–6. https://doi.org/10.54648/taxi2022001.
45. Bukht, Rumana, and Richard Heeks. “Defining, Conceptualising and Measuring the Digital Economy.” *SSRN Electronic Journal*, Vol.26 (2017): 1-26. https://doi.org/10.2139/ssrn.3431732.
46. Cockfield, Arthur. “BEPS and Global Digital Taxation.” *Tax Notes International*, Vol. 75, No. 11. (September 15, 2014): 933 – 940. https://ssrn.com/abstract=2507872
47. Cooper, Graeme S. “Building on the Rubble of Pillar One”. The Bulletin for International Taxation. (November/December 2021): 533-542.
48. Devereux, Michael P. and Simmler, Marti. “Who will pay amount A?”. *EconPol Policy Brief*, No. 36, ifo Institute - Leibniz Institute for Economic Research at the University of Munich, Munich. (2021):1-10. https://www.econstor.eu/bitstream/10419/236737/1/176520884X.pdf

49. Dourado, Ana Paula. “Editorial: The OECD Report on Pillar One Blueprint and Article 12B in the UN Report.” *Intertax* 49, no. Issue 1 (2021): 3–6. https://doi.org/10.54648/taxi2021001.
50. Eden, Lorraine. “Pillar One Tax Games”. *Tax Management International Journal*, Vol. 50, No.1. January 2021: 1-4. https://ssrn.com/abstract=3758671
51. Eden, Lorraine. “Taxing the Top 100: U.S. Estimates of Winners and Losers from Pillar One Amount A.” *Tax Management International Journal*, 50, 6, (June 7, 2021): 1-17. https://ssrn.com/abstract=3862062
52. Elliffe, Craig, "Justifying Source Taxation in the Digital Age," *Victoria University of Wellington Law Review* 52, no. 4 (December 2021): 743-768 https://heinonline.org/HOL/Page?handle=hein.journals/vuwlr52&collection=journals&id=748&startid=&endid=773
53. Hongler, Peter and Pistone, Pasquale. “Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy” January 20, 2015. *WU International Taxation Research Paper Series* No. 2015, 15, Available at SSRN: https://ssrn.com/abstract=2591829 or http://dx.doi.org/10.2139/ssrn.2591829
54. Hongler, Peter, and Pasquale Pistone. “Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy.” SSRN Electronic Journal, 2015. https://doi.org/10.2139/ssrn.2591829.
55. J. (Jinyan) Li. “The Legal Challenges of Creating a Global Tax Regime with the OECD Pillar One Blueprint.” *Journal Articles & Opinion Pieces IBFD* 75, 2 (2021): 25-50. https://research-ibfd-org.kuleuven.e-bronnen.be/#/doc?url=/document/bit_2021_02_o2_1
56. Kiggins, Robert J. "OECD PILLARS ONE AND TWO: A NEW PARADIGM FOR INCOME TAXATION OF INTERNATIONAL BUSINESS?" *Corporate Taxation* 48, no. 5 (Sep, 2021): 31-43, https://www.proquest.com/trade-journals/oecd-pillars-one-two-new-paradigm-income-taxation/docview/2585991375/se-2 .
57. Kofler, Georg and Sinnig, Julia, “Equalisation Taxes and the EU’s ‘Digital Services Tax,'' *Intertax*, 42, Issue 2, (2019): 176-200, https://www.researchgate.net/publication/332540731_Equalization_taxes_and_the_EU%27s_%27digital_services_tax%27
58. Mason, Ruth. “The Transformation of International Tax.” *American Journal of International Law*114 (2020): 353 - 402.
59. Navarro, Aitor. “The Allocation of Taxing Rights under Pillar One of the OECD Proposal.” *SSRN Electronic Journal*, 19 (2021): 1-19. https://doi.org/10.2139/ssrn.3825612.

60. Schön, Wolfgang. "Ten Questions About Why and How to Tax the Digitalized Economy". Working Paper of the Max Planck Institute for Tax Law and Public Finance No. 2017-11. (December 21, 2017): 1-29. https://ssrn.com/abstract=3091496 or http://dx.doi.org/10.2139/ssrn.3091496
61. Szczepański, Marcin. "Digital taxation: State of play and way forward*". Paper presented to the Members and staff of the European Parliament*, Brussels, May 2020. https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698761/EPRS_BRI(2021)698761_EN.pdf
62. Tillinghast, David. "The Impact of the Internet on the Taxation of International Transactions." *Bull. Int'l Fiscal Documentation* 524, 50 (1996)
63. Wilcox, Gary B. and Payne, Warren. "*Hitching Biden's Corporate Tax Proposals to the Global Tax Bandwagon." TAX NOTES* (2021). https://www.taxnotes.com/tax-notes- today-federal/corporate-taxation/hitching-bidens-corporate-tax-proposals-global-tax-bandwagon/2021/06/21/76lr5?highlight=ratification%20challenges%20multilateral%20treaties#76lr5-0000040
64. Young Ran Kim, Digital Services Tax: A Cross-Border Variation of the Consumption Tax Debate, 72 Alabama Law Review 131 (2020).

WEBSITES

65. "A fair & competitive digital economy – digital levy." European Commission. Accessed October 7, 2022. https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12836-Digital-Levy/public-consultation_uk
66. "Digital Taxes May Linger After Global Deal, Panelists Say." LAW 360. Assessed 4 December 2022. https://www.law360.com/tax-authority/articles/1407499/digital-taxes-may-take-on-permanence-despite-global-accord
67. "Diverted Profits Tax: Navigating your way," KPMG, assessed 1 November 2022, https://assets.kpmg/content/dam/kpmg/pdf/2015/09/diverted-profits-tax-navigating-your-way.pdf
68. "European businesses could unlock €622 billion growth with digital transformation." Richon Europe. Accessed 8 December 2022. https://www.ricoh-europe.com/news-events/news/european-businesses-could-unlock-eur622-billion-growth-with-digital-transformation/

69. "Four Ways Digital Leaders are Accelerating Their Innovation Strategy." Harvard Business Review. Accessed 10 October 2022. https://hbr.org/sponsored/2022/06/four-ways-digital-leaders-are-accelerating-their-innovation-strategy
70. "The Price of Tax Reform: Pillar 1 Reduced To The Back Of A Napkin." Forbes. Accessed November 12, 2022. https://www.forbes.com/sites/taxnotes/2021/07/06/the-price-of-tax-reform-pillar-1-reduced-to-the-back-of-a-napkin/?sh=ec3ea546868c
71. "Trade and Globalization." Our World in Data. Accessed September 28, 2022. https://ourworldindata.org/trade-and-globalization#trade-has-changed-the-world-economy

ABSTRACT

This master's thesis defines the nature of the modern international tax system and the generally accepted fundamental principles of the current tax regime. It also investigates the impact and consequences of the digitisation of the economy on current international tax regulation and explores the challenges facing the international community to overcome them. The main elements of the revolutionary Pillar One proposal are revealed, and the main problems that may arise in its implementation are identified. Other possible ways of solving tax challenges are also analysed. This paper raises the question of the ability of the proposed BEPS/G20 Inclusive Framework Pillar One reform to solve the problem of tax avoidance in the jurisdiction of the market where large digital corporations carry out their business activities, bypassing the establishment of a permanent establishment.

The study concludes that although Pillar One is an essential and comprehensive work with important aspects, in particular, global support is needed for such large-scale reform. However, there are other, more effective ways to address the tax challenges arising from the digitalisation of the economy. In addition, the implementation of Pillar One depends on overcoming the problems identified in this paper and finding a comprehensive international agreement, which is called into question, and, accordingly, the possibility of the proposal to change the international tax system.

Keywords: *Tax law, OECD, Pillar One, Amount A, permanent establishment, digitalisation.*

SUMMARY

The title of this master's thesis is "OECD/G20 Pillar One Proposal to Address Tax Challenges". This research aims to identify the main problems that may arise during the implementation of the proposed OECD/G20 Inclusive Framework international tax reform through Pillar One proposal and to explore the possibility of solving the challenges arising from the digitalisation of the economy in another way.

This paper is divided into four Chapters and includes the following:

1. The first Chapter explores cross-border taxation and the development and impact of the 1920s Compromise on the modern international tax system. This Chapter also analyses the generally accepted and fundamental principles that guide international tax policymaking.
2. The second Chapter analyses the "digital economy" concept and identifies the main features that are more pronounced in economic activities based on digital products and services. Furthermore, the positive and negative consequences for the tax system that the digitalisation process provides to the world are revealed.
3. A possible response to these tax challenges in the form of the Pillar One proposal is explored, and the reasons for its radical nature are revealed in the third Chapter. It also assesses the key elements of this proposal and identifies possible problems on the way to its implementation.
4. The last Chapter investigates the feasibility of reforming the international tax system through Pillar One and analyses other ways to overcome the challenges. Also, a comparative analysis of Pillar One with the proposed idea of expanding the concept of permanent establishment is made.

The objectives that were set for this paper are the following: (1) to explore the existing international tax regime and its fundamental principles; (2) to determine the concept of a "digital economy" and the legal challenges it creates for the current international tax system; (3) to evaluate legal problems arising from the implementation of Pillar One; (4) to assess other ways to deal with current tax challenges.

After a comprehensive scientific analysis, it can be concluded that the Pillar One proposal to address tax challenges arising from the digitalisation of the economy has many problems, which potentially threaten to overcome the challenges posed and, therefore, to change the international tax system.