



## The challenges and proposed solutions of the taxation of digital economy

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### Abstract

The revolutionary progress of the information and communication technology offers a window of opportunities to development new products and services that were not needed before, and contributes to the change of business model. More and more enterprises, especially multinational enterprises, are widely applying the Internet and digital technology in all aspects of their business. In the digital economy, the unique characteristics of the new business model poses challenges to the existing rules of international taxation, and aggravate the base erosion and profit shifting (BEPS). In October 2015, the Organization for Economic Cooperation and Development (OECD) published a series of reports on this issue, among which the Final Report on BEPS Action 1 was widely concerned for proposing countermeasures to the problems caused by the digital economy. The digital economy poses challenges to the existing rule of permanent establishments, it is undeniable that the impact of digital economy on the international taxation cannot be fully solved by simply changing the exemptions of permanent establishments.

**Keywords:** digital economy, permanent establishments, BEPS

### Introduction

The revolutionary progress of the information and communication technology offers a window of opportunities to development new products and services that were not needed before, and contributes to the change of business model. More and more enterprises, especially multinational enterprises, are widely applying the Internet and digital technology in all aspects of their business. In the digital economy, the unique characteristics of the new business model poses challenges to the existing rules of international taxation, and aggravate the base erosion and profit shifting (BEPS). In October 2015, the Organization for Economic Cooperation and Development (OECD) published a series of reports on this issue, among which the Final Report on BEPS Action 1 was widely concerned for proposing countermeasures to the problems caused by the digital economy. The challenge brought by the digital economy is prominently reflected in the rule of permanent establishments which is the basis for the source country to exercise its taxing rights with respect to the business profits of a non-resident taxpayer. However, with the development of internet, correlation between the size of business and extent of physical presence in the source country has virtually vanished. In addition, activities that are regarded as preparatory and auxiliary in the traditional economy, such as collecting data and storing goods, have become an integral part of the core business activities in the digital economy. Therefore, it is critical to modify the definition of permanent establishments in order to maintain the effectiveness and fairness of international taxation in the era of digital economy.

### Definition and Main Features of Digital Economy

Digital economy has quickly become a new economic form with the development of information and communication technology. It refers to a series of commercial activities with data and digital information as key factors of production.

The representative business types in the digital economy include app stores, participative networked platforms, and online payment services, etc. Due to the constantly update and application of the technology, the digital economy has shown some features that are not available in the traditional business pattern.

### Mobility

In the digital economy, the intangibles, users and business functions of enterprises will become more flexible and have a high degree of mobility due to the continuous progress of information and communication technology. First, the transaction activities in the digital economy environment are usually carried out on the virtual network platforms, and the products related to the trading are no longer in the physical form. Similarly, the main assets of enterprises are gradually changing from fixed assets such as machines and equipment to intangibles which create more and more value. The rights to those intangible assets can be easily distributed and transferred among affiliated companies. In addition, when an enterprise uses digital platforms for cross-border transactions, the location of the consumer and the place where the ultimate sale took place could be in different countries. Multinational enterprises have a lot in common with it since they can realize the integrated monitoring and organizing of complex business activities at any place through the improved telecommunication networks and efficient information management software in the digital economy. Therefore, virtual presence through internet is as effective as physical presence for carrying on businesses in certain respects due to the mobility of the digital economy.

### Reliance on Data

In the context of the digital economy, as the improvement of computing power and the decrease in data storage costs, the threshold for enterprises to collect, store and analyze data at a greater distance and in greater quantities has been

significantly reduced. This promotes the massive use of data to become as a new way for enterprises to create economic value. In other words, the progress of information technology makes enterprises more dependent on the tremendous value created by the massive use of data. Correspondingly, as a new asset form, data constitutes the core resource of digital economy. Therefore, in the digital economy, the collection and processing of data have become the main business activities, which are crucial for the revenue of the non-resident enterprises. Unlike the traditional economic model, the establishment of a physical presence in the source country is no longer necessary for multinational enterprises for carrying on businesses in digital economy. However, the rule of permanent establishment has been impacted considerably for the reason that the enterprises are more likely to provide goods and services through online platforms.

### **Challenges of Digital Economy to the Rule of Permanent Establishment**

The development of the digital economy has led to changes in business model that are challenging existing rule of permanent establishment. This has two main influences. On the one hand, the high mobility of the digital economy has extended the definition of the rule of permanent establishments, and the physical presence under the traditional economic model has lost its original significance. On the other hand, the intangible assets represented by data play an increasingly important role. In the digital economy, the core activities of enterprise are composed of collection, storage and analysis of data. Between them, the former leads to the failure of the nexus in the form of a physical presence, and the latter causes the change in the nature of preparatory and auxiliary activities in the exceptions clauses of the permanent establishment.

### **Issue of Nexus for the Taxation of Non-resident Enterprise**

The rule of permanent establishments is generally used in bilateral tax treaties to coordinate the tax jurisdiction of the residence and source countries. Under normal conditions, when the non-resident enterprise constitutes a permanent establishment, the source country can exercise the taxing rights. The existing rule of permanent establishments requires multinational enterprises to have a fixed place of business, which emphasizes the physical presence. In other words, in allocating jurisdiction to tax on business profits, greatest importance was attached to the nexus between business income and the physical places for carrying on businesses in the source country. However, in the e-commerce environment, a large number of digital transactions are more dependent on the virtual platform, and enterprises do not need to set up a physical presence for business. Instead, enterprises can conduct remote transactions with customers in different countries through new business activities such as online sales, online payment, cloud services, etc. Take *Apple Music* as an example. As a type of digital distribution platform for online music, its users can search, purchase and download music composed by different artists through a personal computer or mobile phone. In this instance, *Apple Inc.* can operate business activities in different countries simply by its websites and servers for data transmission, rather than establishing physical place of business in the source countries. As a

result, it is difficult for the source country to determine the nexus for corporate income tax purposes according to the existing rule of permanent establishments.

In practice, it is common for multinational enterprises to use the requirement of physical presence in the existing rule of permanent establishment to avoid tax. In *Right florist*, the court held that the concept of permanent establishment has evolved, and it was not sufficient to fully protect the taxing rights of the source country in digital economy. With the development of the Internet, the correlation between the size of business and the extent of physical presence in the source country has virtually vanished. Nowadays, it is as effective as physical presence to conduct business through online platform in certain respects. The virtual presence based on the Internet can function the same as the physical business places, with the result that the existing nexus of permanent establishment is also facing challenges in digital economy.

### **Difficulties in Identifying Preparatory and Auxiliary Activities**

According to the Article 5 (4) of the OECD Model Convention, non-resident enterprises would be exempted from being deemed to constitute a permanent establishment for carrying out preparatory or auxiliary activities in the source country. In the traditional economy, the preparatory or auxiliary activities such as collecting information and storing goods have a limited contribution to the profits of the enterprise, with the result that the OECD provided these activities as exceptions of the permanent establishment rules. This aims to address the problem of high tax burden for taxpayers who only conduct preparatory or auxiliary activities in the source country. However, activities that are regarded as preparatory or auxiliary in the traditional economy, such as data collection and transmission, have become an integral part of the core business activities in the digital economy. In response to the change resulting from the digital economy, the Final Report on BEPS Action 7 specifically analyzed the issue of the artificial avoidance of permanent establishment status. This is particularly evident in *MasterCard Asia Pacific*, in which the applicant argued that their each transaction went through a interface processor located in the Indian bank branch itself, and these interface processors for the encryption and communication of data shall fell within the exceptions for preparatory or auxiliary functions in the treaty. In this regard, the Indian Authority for Advance Rulings did not accept the argument and noted that the interface processor played a vital role in relation to data transfer between two banks. In other words, the interface processor is indeed used for data transmission as stated by the applicant, however, due to the great economic value of data in the digital economy, its transmission should be regarded as the basic process of the economic activities. For example, the high-frequency traders attach great importance to the transaction speed, and generally set the server near the location where the ultimate sale took place in order to make the trading more efficient than other competitors. In this situation, the information processing undertaken by the server cannot be regarded as an auxiliary or preparatory activity. Therefore, in the digital economy, the activities represented by the collection and processing of data have become the core part of the process and should not be regarded as exceptions of the permanent establishments. In addition, the rapid development of information and communication technology pose challenges

for determining the preparatory or auxiliary activities in the digital economy. Taking a Japanese court case discussed in the Final Report on OECD Action 7 (BEPS) as an example, an American citizen engaged in the online sales to Japanese consumers through virtual platform, and he rented an apartment in Japan to store goods for the business. In this way, once the order is received, the employee he recruited in Japan can immediately send the goods out of the warehouse. According to the Article 5(4) of the OECD Model Convention, as the function of this apartment is for the storage of goods, which is a kind of auxiliary activity, this warehouse should not be regarded as a permanent establishment. However, the Tokyo District Court upheld the existence of a permanent establishment in Japan, and the court held that the activities mentioned in Article 5(4) of the OECD Model Convention are not automatically deemed to be preparatory or auxiliary. The court noted in particular that a warehouse located in Japan for quick delivery to local customers and the ability to handle returned products were significant elements of the online retail business. In other words, for the cross-border online sales in the digital economy, the speed of transport and logistics is crucial, and the establishment of warehouses in the source country is an important measure to maintain competitiveness. As a result, it is unreasonable to identify the warehouse as an exception to the permanent establishment, which would present substantial risks of base erosion in the source country. In digital economy, the new technology and business model pose challenges to determine the nature of preparatory and auxiliary activities, with the result that the content and scope of the exceptions clauses of the permanent establishments need to be redefined.

### Proposed Solutions to the New Challenges

Facing the challenges posed by the digital economy to the international taxation, especially the rule of permanent establishments, the OECD and the European Union have proposed solutions at different levels.

### New Nexus in the Form of a Significant Economic Presence

In the Final Report on BEPS Action 1, OECD proposes a solution to the challenges arise regarding the issue of nexus for tax purposes mentioned above, that is, the concept of significant economic presence. A common scenario is that a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international tax rules. However, in the digital economy, the remote collection, transmission and processing of data should give rise to another nexus for tax purposes even in the absence of a physical presence. The significant economic presence is a new nexus, with the intent to reflect situations where a company use digital technology to engage in the economy of a country in a regular and sustained manner without having a fixed business place in the source country. In other words, this would create a nexus for tax purposes in the source country when a non-resident enterprise has a significant economic presence on the basis of factors that evidence a purposeful and sustained interaction with the economy of that country via virtual platforms. Compared with the concept of significant digital presence proposed in the Public Discussion Draft on BEPS Action 1, the factors considered in this new concept are more comprehensive,

which emphasizes the connection among corporate revenue, digital technology and user relationships in the digital economy.

### Revenue-based Factor

The BEPS Action 1 presents that when an enterprise generates revenue on a sustained basis from a country, it could be considered to be one of the potential indicators of the existence of a significant economic presence in the source country. In defining revenue factor, it should be noted that due to the high mobility of the digital economy, the two strongly interrelated markets are likely to be situated in the same country. For example, an enterprise operates both social media platform and remote transactions, it could analyse the data of user information collected from the social platform, and then introduces products to the potential targeted user groups, so as to improve the profits. In this case, if the two forms of business activities are targeted at the market in the same country, the value generated by the data of these users should be reflected in the revenue of the enterprise in the source country, and with the result that become a potential factor for the nexus in the form of a significant economic presence. In addition, the advanced digital means for supervision and management, such as the artificial intelligence and the blockchain, could be used to monitor and analyze the essence of enterprise transactions. This would effectively overcome the technical limitations in the determination of income and other factors.

### Digital Factors

In traditional economy, physical presence was required in the source country if any significant level of business was to be carried on by the multinational enterprises. While in the digital economy, enterprises can use improved telecommunications software to interact with customers on the networked platforms continuously. Consequently, the OECD points out that a variety of digital factors of the digital economy shall be used as part of a test for significant economic presence. Firstly, a non-resident enterprise targeting customers or users in a country will generally set up a website with a localized or specialized domain name of the source country. Secondly, due to the differences in languages, cultures and regulations between countries, enterprises that want to facilitate interaction with local users or customers through digital platforms have to integrate their goods and services with the commercial and legal context of the local environment. For instance, *Google map* provides multiple languages for users to choose from, which is essential to attract meaningful numbers of local users. It is necessary to fully consider whether the specific digital platform of the non-resident enterprise offers localized services for users, including adjustments to local languages, cultural norms and legal policies, so as to determine the nexus in the form of a significant economic presence. Thirdly, in digital economy, a non-resident enterprise that maintains a sustained interaction with the economy of a country will ensure that local customers have access to convenient payment methods. Take *Amazon* as an example, it has provided a direct payment service via *Alipay* for users in China. Since providing local payment options is related to attracting consumers and generating profits, it should be included in the digital factors.

### User-based Factors

The user and the associated data play a significant role in the digital economy, which should be used as a factor that reflects the purposeful and sustained interaction between the non-resident companies and the source country. The main indicators to be considered include monthly active users and online contract conclusion, etc. On the one hand, the former reflects the number of registered users who logged in and visited the digital platform of an enterprise every 30 days. This could present both in terms of size and level of engagement between non-resident enterprises and local users. Besides, the regular conclusion of contracts is a necessary part of the test for user-based factors of the significant economic presence, which is also deemed to an important indicator reflecting the participation of an enterprise in the economy of the source country.

The concept of significant economic presence creates a new nexus for the source country to exercise the tax jurisdictions. Compared with the traditional concept of the permanent establishments, significant economic presence emphasizes on internal connection of various factors of the new business model in the digital economy, and could reflect the tax principle of neutrality and fairness. Meanwhile, this solution could present the purposeful and sustained interaction of the non-resident enterprises with the economy of the source country via information technology, which is more in line with the economic allegiance principle. In other words, this option can better embody the economic connection for tax purposes between enterprises and the source country in the digital economy.

It should be noted that as the development of information and communication technology, a large number of transactions and interaction with users or customers are more dependent on the virtual platform, and enterprises do not need to set up a physical presence for business. This has a substantive impact on the nexus between business income and the various physical places contributing to the production of the income. Therefore, the existing rule of permanent establishment is not enough to cope with such a huge change, this solution could better deal with the challenges posed by the digital economy.

In order to make this solution more effective and feasible, the certainty and flexibility of relevant factors should be balanced. The indicators of the existence of a significant economic presence are quantitative, such as the number of online contract conclusion and registered user. In addition to the quantitative criteria, other substantive indicators reflecting the purposeful interaction between the non-resident companies and the source country should be concerned, such as the economic influence, so that have the flexibility to meet the challenges brought by the further development of digital economy.

### Withholding Tax on Digital Transactions

The Public Discussion Draft on BEPS Action 1 issued by OECD in 2014, points out that residents of the source country should pay withholding tax when they purchase certain goods or services online from non-resident providers. Then the Final Report on BEPS Action 1 in 2015 analyze the feasibility of this mechanism. The purpose of setting up withholding tax in online transactions is to address the problem that enterprises with substantive economic activities in the source country without being liable to taxation due to the lack of nexus under current

international tax rules. In order to avoid leading to different treatment for tax purpose between economically equivalent transactions depending on their form in the digital economy, the report tends to be a more general definition in terms of the covered transactions for goods or services via the virtual platform, such as the online sales of products to customers. A general scope of transactions covered by the withholding tax is more flexible, and more in line with the value pursuit of tax neutrality between similar types of business activities in digital economy.

The collection of withholding tax is mainly aimed at two types of subjects, including resident enterprises and individual consumers of the source country, rather than the non-resident enterprises. For the consumers, requiring withholding from the payor would be more difficult as they have little experience nor incentive to declare and pay the tax due, which would involve considerable cost and administrative challenges. At the same time, if the intermediaries processing the payment are required to withhold the tax, it is obviously beyond the abilities and responsibilities of these financial intermediaries. For example, an intermediary would generally not have access to transaction information enabling it to determine its character and hence the amount of tax due. In addition, due to uncertainty about the gross-basis or net-basis taxation between domestic and foreign suppliers of same products, the national treatment obligations which provided in the General Agreement on Tariffs and Trade and the General Agreement on Trade in Services is likely to be violated. As a result, it would raise substantial conflicts with trade obligations if a standalone final withholding is applied. Furthermore, if the online transactions for goods or services via the virtual platform be covered in the collection of withholding tax, the current bilateral or multilateral agreements should be revised first. However, at present, most of the withholding tax in digital economy are only implemented at the domestic law, which has not yet been transformed into corresponding amendments of the enforceable double taxation treaties. Due to the limitations of withholding tax, a more feasible and appropriate approach could regarding this solution as a back-up mechanism on the basis of a significant economic presence nexus, rather than as the primary option.

### Equalisation Levy

The OECD also introduced the concept of equalisation levy in the Final Report on BEPS Action 1. The purpose of this approach is to avoid the unfair tax burden aroused by the new profit attribution rules based on the nexus of significant economic presence. In other words, if the corporate income tax paid by non-resident enterprises is lower than that of domestic companies in the same tax environment, the equalisation levy would be imposed on the former additionally to ensure the equal treatment of foreign and domestic suppliers. In order to avoid double taxation, and to provide certainty and equity, the equalisation levy would be applied only in a non-resident enterprise with significant economic presence in the source country.

One of the potential issues of this solution is that if the equalisation levy only applicable to non-resident enterprises, it would be likely to violate the tax principle of fairness. As a result, the OECD has not yet formally proposed the equalisation levy. In addition, the equalisation levy may lead to a situation where the provider of services and goods



to transfer part of the tax burden to the user, due to the undue burden on the non-resident enterprises. On one hand, the equalisation levy is unable to deduct the output tax from the input tax since it does not in the scope of the value-added tax; and on the other hand, it cannot claim a credit in the source country as it is not the income tax. Therefore, imposing this levy may raise risks of double taxation and cause a significant tax burden on the non-resident enterprises.

### Modifications of the Specific Activity Exemptions

According to the exceptions of the permanent establishment in the OECD Model Tax Convention, the non-resident enterprise would be exempted from being deemed to constitute a permanent establishment in the source country if the business activities of it are considered to be of a preparatory or auxiliary nature. However, activities that were previously regarded as merely preparatory or auxiliary in nature may nowadays have become an integral part of the core business activities in the digital economy, such as collecting data and storing goods. In order to prevent the adverse effects led by the non-resident enterprises from artificial avoidance of permanent establishment status in the source country through these exemptions, the OECD modified the specific exemptions in the Final Report on BEPS Action 7, which effectively expands the scope of the permanent establishments. It means that the OECD has recognized that nexus for tax purposes should not be restricted in the form of a physical presence but focus more on the substantial interaction with the economy of the source country. For example, in *Warehouse* discussed above, the apartments rented by the US citizen for cross-border online sales should be considered as the permanent establishment within the source country based on these modifications of the specific exemptions. In addition, this report introduces the anti-fragmentation rule in order to prevent non-resident enterprises from abusing the exemptions to avoid constituting permanent establishments in the source country. To be specific, multinational enterprises would split up a cohesive business into several operations in order to argue that each part of it is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Article 5(4) in the OECD Model Tax Convention. In response to this issue, the OECD indicates that other complementary activities that are part of a cohesive business operation carried on by the same enterprise or affiliated enterprise at the same place must be taken into consideration in determining whether the activities shall be regarded as preparatory or auxiliary in nature. These modifications have not substantially changed the definition of permanent establishment, nor proposed a new nexus for tax purposes to address the challenges posed by the digital economy. It can eliminate the loopholes caused by some typical strategies for the artificial avoidance of permanent establishment status, however, this solution also has its inherent limitations. The main reason is that in the digital economy, the new business model of enterprises, such as e-commerce and participative networked platforms, are quite different from those in the traditional economy. Consequently, this solution, which still applies the physical presence as the nexus for tax purposes between enterprises and the source country, cannot fundamentally deal with the challenges brought by the digital economy to the international taxation. In other words, the impact of the

digital economy on the current tax rules cannot be fully addressed by simply changing the specific exemptions of permanent establishments.

### Digital Services Tax

In March 2018, the European Commission proposed new rules to ensure that digital business activities are taxed in a fair and growth-friendly way in the EU, as the current tax rules fail to recognise the new ways in which profits are created in the digital world. In the Directive, the Commission has made proposal for an interim tax which covers the main digital activities that currently evade tax altogether in the EU. This proposal would enable Member States to tax profits that are generated in their territory, even if a non-resident enterprise does not have a physical presence there. On April 1, 2020, the new Digital Services Tax came into force in the UK. Under this tax, search engines, social media platforms and online marketplaces that make revenue from users in the UK will be subject to a 2% tax. The problem of the digital service tax mainly manifested in that the separation of digital services from the traditional economy may result in unfair tax burden. In fact, the digital economy is closely related to the other parts of the global economy, so it is difficult to calculate them separately. In addition, the basis of digital service tax is still the principle of economic allegiance, that is, the specific digital service activities of an enterprise are closely linked to Member State. However, the factors considered in the nexus of digital services tax are still controversial, for example, Member States have not yet reached an agreement on whether or to what extent data and user participation represent the contribution to the value creation.

### Conclusion

The digital economy is characterized by its high mobility and reliance on data, which poses challenges to the existing rule of permanent establishments mainly in two aspects: the failure of the nexus in the form of a physical presence and the change in the nature of preparatory and auxiliary activities. The proposed solutions, represented by the modifications of the specific activity exemptions, which still applies the physical presence as the nexus for tax purposes between enterprises and the source country, cannot essentially address the issue brought by the digital economy. Although the implementation of programs such as the withholding tax and significant economic presence requires to make structural adjustments to the existing rules, it is undeniable that the impact of digital economy on the international taxation cannot be fully solved by simply changing the exemptions of permanent establishments.

Among these solutions, the significant economic presence creates a new nexus, with the intent to reflect a purposeful and sustained interaction with the economy of the source country via digital technology. It provides an important model for countries around the world to prevent non-resident enterprises from artificial avoidance of permanent establishment status. Compared with other solutions, the concept of the significant economic presence emphasizes on internal connection of various factors of the new business model, which is more suitable for the digital economy, and more in line with the tax principle of neutrality and fairness.

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