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EU VAT CATEGORIES AND THE DIGITAL ECONOMY

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CHAPTER I
INTRODUCTION

SECTION I: SETTING THE SCENE

1. *Research Question, Methodology and Structure of this Study*

The revolution resulting from to the progressive digitization of the economy is challenging legal and tax systems. This is because these systems are designed for another era, i.e., for past times. They were framed when technology was much more underdeveloped and there were no expectations of such enormous changes.[1] The main issue is that the very nature of several products, production chains, and jobs is changing. New concepts are emerg-

[1] K. SCHWAB, *The Fourth Industrial Revolution*, Geneva, 2016, p. 18. The scholar identifies the "*Digital*" as one of the drivers and megatrends of what he names the fourth industrial revolution. He explains that «*In its simplest form, it can be described as a relationship between things (product, services, places, etc.) and people that is made possible by connected technologies and various platforms*».

ing that go beyond the confines of the categories on which the current tax systems are shaped.

To give an example, on 20 December 2017 the CJEU decided the case *Asociación Profesional Elite Taxi*,[2] which very effectively demonstrates this new phenomenon of "change of nature" and how difficult it can be to classify these new business models.

The case originates from a preliminary ruling submitted by a Spanish Court with regard to Article 2(2)(d) of Directive 2006/123/EC on services in the internal market which excludes transport activities from the scope of this legislation. The issue was whether the activity of an online platform through which private car drivers can "offer a ride" (*Uber Systems Spain*) concerns of an activity of intermediation between the owner of a vehicle and a person who needs to make a journey within a city; an activity of IT management that enables the offeror and the customer to contact one other; a mere transport service; or an information society service provider as defined by Article 1(2) of Directive 98/34/EC.[3] To state it very simply, the (referred) questions may be summarised as follows: What is "Uber"? Is it a taxi services provider, an IT company, or an intermediary?[4] This demonstrates very well how the actual legal categories are challenged by the new concepts created by the digital economy.[5]

For the sake of completeness, it is opportune to mention that, in this specific case, the identification of the legal nature of this service was aimed at

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[2] C-434/15 *Asociación Profesional Elite Taxi* [2017] ECLI:EU:C:2017:981. For a comment, see G.O. TEIJEIRO-J.M. VÁZQUEZ, *Taxation of the Ride-Sharing Economy: Source Taxation through Service Permanent Establishment Provisions Revisited – The Case under the Argentine Treaty Network*, in *Bulletin for International Taxation*, 2019, p. 667.

[3] Directive 98/34/EC of the European Parliament and of the Council of 22 June 1998 laying down a procedure for the provision of information in the field of technical standards and regulations. Article 1(2) reads as follows: «'*technical specification' a specification contained in a document which lays down the characteristics required of a product such as levels of quality, performance, safety or dimensions, including the requirements applicable to the product as regards the name under which the product is sold, terminology, symbols, testing and test methods, packaging, marking or labelling and conformity assessment procedures. The term 'technical specification' also covers production methods and processes used in respect of agricultural products as referred to Article 38(1) of the Treaty, products intended for human and animal consumption, and medicinal products as defined in Article 1 of Directive 65/65/EEC (1), as well as production methods and processes relating to other products, where these have an effect on their characteristics*».

[4] See also L. ZECHNER, *How to Treat the Ride-Hailing Company Uber for VAT Purposes*, in *International VAT Monitor*, 2019, p. 261 ss.

[5] For a non-EU perspective, R. MILLAR, *Uber Drivers Supply Taxi Travel and so Must be Registered for GST*, in *World Journal of VAT/GST Law*, 2017, p. 47 ss.

defining whether or not it falls within the scope of the principle of freedom to provide services as guaranteed under EU legislation – specifically, Article 56 TFEU and Directives 2006/123/EC and 2000/31/EC. The Court ruled that the service provided by such a platform is more than an intermediation service involving the connection of a non-professional driver using his or her own vehicle with a person who wishes to make an urban journey by means of a smartphone application. Therefore, this service has to be considered a transportation service according to EU law.

The purpose of this study is to assess whether the current VAT categories and constituent elements are currently appropriate for the digital economy and how they can be reshaped. Its findings are intended as guidelines that should be an element for a new approach to the digital economy for VAT purposes. More precisely, the research questions of this study are the following: How are recent internet developments impacting current VAT categories? Are current VAT categories suitable for the digital era? How could they be reshaped?

As to the methodology, this study is based on the "method of evaluation" or "legal assessment" that is conducted by means of an extensive "desktop research". It assesses whether current VAT rules are in line with the founding principle of the VAT system and work in practice. It includes both wide-ranging descriptive sections and a legal analysis of the present framework, all of which are clearly oriented toward the answering of the research question(s).

In particular, the current VAT categories of "goods and services", "taxable person", and "place of taxable transactions" are assessed in light of recent developments of the digital economy. The research is conducted using one or more technological innovations and new business models to test the suitability of these tax building blocks to cope with the innovations in the digital economy. At the end of each assessment, a number of proposals for a partial reshaping are elaborated.

The assessment that is carried out takes into special consideration the principle of neutrality. This is true in particular with regard to the first two of the listed categories, specifically, those of "goods and services" and of a taxable person. Concerning these two assessments, the "sub-research question" is whether the current VAT categories at issue are acceptable for ensuring the neutrality on which VAT is based.

With regard to the third category, the same is done in respect of the destination principle which is strongly endorsed by both the EU and OECD and is becoming one of the main pillars of the EU VAT system.

The literature on "VAT and the digital economy" is already quite extensive, and this has been a controversial topic of discussion for some time.

Nevertheless, all of the solutions proposed thus far tend to "preserve" the current VAT categories. This study focuses on the categories themselves.

The assessment carried out with regard to the categories of "goods and services" and "taxable person" highlights some weaknesses and inconsistencies. For this reason, a number of proposals are made at the end of the respective chapters. More precisely, the innovative concepts of re-materialization and hybridization are elaborated.

On the contrary, the assessment regarding the category of place of taxable transactions is conducted with regard to the destination principle. The outcome is very different because it clearly emerges that the current legal framework is sufficient to face the challenges posed by the digital economy. Nevertheless, this does not mean there are no problems, but that they are of a practical nature. In fact, at the end of the dedicated chapter it is emphasized how the taxation at destination raises issues, especially with regard to the "identification" of the customer.

Before providing some details on the structure of the study, it is appropriate to make a number of clarifications with regard to the scope of the research. Indeed, it is very important for the reader to understand from the very outset how wide it is. In particular, it is important to note that the word "digital" is intended in its widest possible meaning. In this contribution, it has to be recognised as something "that can be significantly affected by internet or technologies". In order to understand this statement, it may be useful to take the example of the sharing economy. From a legal (and VAT) standpoint, offering a room on an online platform is exactly equal to offering it in a newspaper. Moreover, to rent out a room itself is not a digital business. Therefore, can the sharing economy still be considered a digital economy?

The answer to this question is "yes", or, at least, it is "yes" for the purposes of the present study. The reason is that, without the Internet, the sharing economy would not have grown to this extent. Indeed, although the possibility of offering rooms using newspaper advertisements has existed for decades, it is only with the Internet that the sharing economy has been able to grow exponentially. This economy is deeply rooted in the digital world and, therefore, it can "doubtlessly" be considered as digital economy. As a consequence, for the purposes of this contribution, the wording "digital economy" is relevant for Uber, Airbnb, e-commerce, bitcoin, etc. [6]

From a methodological standpoint, there would be no reason to cut out

[6] For a general definition, G. MELIS, *Commercio Elettronico nel Diritto Tributario*, in *Digesto delle Discipline Privatistiche, Sezione Commerciale*, Aggiornamento, 2008, Torino, pp. 63-85.

phenomena like the sharing economy or e-commerce from the analysis solely because they have a significant physical component. This would just reduce the scope of the research without any relevant positive consequence. If the investigator wants to understand the complex phenomena characterizing the present-day world, it is necessary to examine the entire picture, and it would be arbitrary to exclude some of the consequences of the growth of the Internet and would lead to unsatisfactory answers.

As regards other phenomena that are strongly influencing the economy and often developing in tandem with digitization, such as globalisation or internationalization, these are outside the field of this research.

This having been stated, the structure of the study is briefly presented hereinafter. The first two chapters, specifically, the present one and Chapter 2, propose a review of the work accomplished by the OECD and the EU in the field of "indirect taxation of digital economy". They are aimed at giving a clear idea to the reader of "where we are" in order to be able to determine "where we want to go". They provide the reader with all of the "tools" to read the following chapters.

In particular, the second section of Chapter 1 focuses on the OECD work in this field. After defining briefly and by no means exhaustively what digitization is, how it can be approached and what challenges it is posing to contemporary tax systems, the relevant components of the VAT/GST guidelines and of BEPS Action 1 are described. Special attention is paid to the principles of neutrality and destination elaborated by the OECD.

It is important to emphasise that this section serves as a very general overview of what lies behind of the issues addressed. The phenomenon of digitization is actually extremely complex and closely intertwined in reality with others, such as globalisation. This study focuses only on digitization and a specific section is dedicated in the following chapters to each of the technologies and business models used to verify the suitability of VAT categories for dealing with this new reality. Therefore, reference is made to these sections for technical aspects of interest for this study.

Chapter 2 focuses on the work of the EU in this field. An analysis of the relevant legislation is proposed with a special focus on the sub-category of electronically supplied services. Additionally, in this case, a distinct emphasis is placed on the neutrality principle which is used in the following chapters to assess the current legal framework. Following that, a review is made of the main policy documents delivered at the European level in recent times.

The following three chapters, specifically, Chapters 3, 4, and 5, are the core of this research project. In these three chapters, the aforesaid legal evaluation is carried out. The structure of the different chapters is kept as

consistent as possible but, due to the unavoidable differences in the evaluation process, some differences emerge.

Despite this, the first part of each of the three Chapters always consists of a comprehensive description of the pieces of legislation and of the category "under assessment", followed by a description of the innovation of the digital economy used for the evaluation.

Chapter 3 is dedicated to the assessment of the actual borderline between the VAT categories of "goods" and "services". This evaluation is performed using the challenges raised by the VAT treatment of bitcoin and e-books (in particular with regard to reduced rates). The outcome is that the borderline at issue is outdated and not entirely appropriate for the digital economy. At the end of the chapter, an innovative solution to redraw this borderline is proposed. It is labelled 're-materialization'.

In Chapter 4, an evaluation of the current VAT category of taxable person is performed using the issues raised by the VAT treatment of the sharing economy. Once again, in this case too, the outcome is that the current category is not suitable for the digital economy and, at the end of the chapter, a solution is proposed. It is labelled 'hybridization'.

Chapter 5 is dedicated to the evaluation of the rules aimed at deciding where a transaction has to be taxed. As explained hereinafter, the scope of the assessment is wider than the category (or, better, of the group of rules) usually called the place of taxable transaction. Unlike the previous two chapters, the result of the evaluation is that the current legal framework is acceptable for the challenges posed by the digital economy. Nevertheless, the existing rules have several weaknesses when it comes to their implementation. The final part of the chapter proposes an analysis of the practical issues raised by the implementation of the destination principle.

Finally, Chapter 6 proposes a brief summary of the two innovative solutions suggested in the previous chapters and the potential impact that their implementation would have on the neutrality principle at the European level. Moreover, a number of changes are suggested, and some hypothetical provisions are drafted.

It is worth mentioning from the very beginning that all of the hypothetical legislation amendments elaborated in this contribution must be understood as "conceptual" and not as "prescriptive". Indeed, it has to be considered that amendments would have to be made at the European level and then transposed into domestic legislations. Therefore, the hypothetical amendments proposed here are not be understood as final from a technical standpoint but rather as conceptual guidelines.

2. *A Brief (and non-exhaustive) Introduction to the Digital Economy*

When it comes to the digital economy, it is now commonly perceived to be changing the world and is omnipresent in our lives. However, great difficulty is encountered when faced with the need to define the concept. In very general terms, for example, the Treccani Dictionary defines the digital economy as the economic model based on the exploitation of information technology as the ideal infrastructure for economic and commercial exchanges. [7]

In its BEPS Action 1, which is one of the milestones of the digital economy studies applied to the tax area, the OECD underlines how the digital economy is the result of a transformative process brought about by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardized, improving business processes and bolstering innovation across all sectors of the economy. [8]

This is an extremely broad phenomenon, to the extent that it is virtually impossible to separate the digital economy from the material one. In a sense, the whole of the economy is becoming digital, and this goes far beyond the field of information and communication, as it is affecting virtually all sectors: financial services, tourism, retail, healthcare, etc.

While it is possible to characterize the concept of digital economy through a set of key features like mobility, network effects and the use of data, it is impossible to give a clear definition of what the digital economy is as opposed to the traditional economy.

The OECD expresses this concept by stating that, because the digital economy is increasingly becoming the economy itself, it is difficult, if not impossible, to ring-fence it from the rest of the economy for tax purposes. This conclusion is also taken as valid for the purposes of this study. While there are sectors that have developed almost entirely on the web, many of the more traditional sectors of the economy are also affected by a massive entry of technology that is causing a radical reorganization (for instance, the so-called food-delivery, whose applications on mobile phones are partly changing the world of catering).

Legal and tax systems are struggling to keep up with these extensive changes and react to them. Digitalization is undermining the foundations of "traditional" taxes that are grounded on material activities and "paper doc-

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[7] The definition proposed in the text is translated from the Vocabolario Treccani, which is written in Italian: «*Modello economico basato sulla valorizzazione delle tecnologie informatiche come infrastruttura ideale per gli scambi economici e commerciali*».

[8] OECD Report '*Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report*', p. 11.

uments". The main innovations are due to the fact that markets are becoming wider, dematerialized, and international which is putting pressure on the "traditional" tax systems based on territorial sovereignty. [9]

Indeed, although some positive progress is undeniable, it is evident that this context requires new solutions. This is particularly evident in the work of the OECD that places the digital economy among the top priorities of the BEPS Project. A significant number of jurisdictions all over the world are also prioritizing the attention on this topic.

This study focuses on a specific issue arising from the digitalization of the economy, i.e. the suitability of current legal categories to address the new digital dimension of business. But this is not the only issue, as there are many others of both a practical and theoretical nature which are caused, for example, by the increasing level of globalization and internationalization of the economy.

As previously mentioned, present legal and tax systems use categories that were conceived in a period during which the digital revolution currently witnessed was inconceivable. [10] The result is that many of the innovations of the digital economy are hardly referable to the present legal categories. [11] Even if this is an issue that, from a purely legal standpoint, must be dealt with at the national level, at least for non-harmonized taxes, a certain degree of coordination is necessary to implement effective solutions. The digital economy should be addressed in relation to the issues to be dealt with

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[9] G. TREMONTI-G. VITALETTI, *La fiera delle tasse*, Bologna, 1991, p. 12; see also I. ROXAN, *The Nature of VAT Supplies of Services in the Twenty-First Century*, in *British Tax Review*, 2000, p. 603 ss., who analyses the uncertainties attached to the traditional VAT categories and explains that: «*The same cannot be said of supplies of services. Here there is no obvious complete meaning that jumps to mind. Initially we will think of services performed by individuals--work done (although we know that work done as an employee is excluded since employees are not acting as taxable persons). This includes the work of professionals, consultants, artisans and artists: from lawyers to lobbyists to plumbers to sculptors. Other things described as services will come to mind, such as financial services. Then we must also consider other things that do not sound like a supply of goods, such as supplies of intangibles (e.g. copyright) or of the use of physical things (hirings and lettings). The link between these items that would justify calling all of them supplies of services is starting to look tenuous*».

[10] For a historical perspective, see, among others, E. MARELLO, *Le categorie tradizionali del diritto tributario ed il commercio elettronico*, in *Rivista di Diritto Tributario*, 1999, p. 595 ss.

[11] On this point, see also I. CUGUSI, *Prospects for Taxation of the Digital Economy between "Tax Law and New Economy" and "Tax Law of the New Economy"*, in *World Tax Journal*, 2020, p. 763 ss. The scholar explains that: «*for some time now, the virtual nature of the internet has led commentators to regard the so-called cyberspace as a "non-place", an "online wild west", since it has no territorial basis, and is "a space without sovereignty or rules", outside the domain of the law*».

individually by each jurisdiction with a global vision. To discuss these global solutions and seek such coordination, international organizations and academia are among the most suitable forums.

In general, legal systems can approach the digital economy in three different ways: (1) by attempting to preserve present categories, thus underevaluating as much as possible the peculiarities of information technology; (2) by elaborating a dedicated set of rules thereby keeping digital and 'real' worlds separate for the purpose of achieving the greatest level of efficiency possible; and (3) by deregulating it on the basis that the digital world is something 'parallel' and beyond the traditional dimensions of time and space and in which 'traditional' legal systems shall have no jurisdiction. [12]

These possible approaches are also theoretically adoptable by tax systems. In this context, for instance, the attempts to introduce 'Google taxes' a number of years ago [13] and the recently introduced digital service taxes are noteworthy and seem to fall into the second of the approaches described. [14]

With more specific regard to tax theory, as from the 1990s tax scholars

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[12] For an exhaustive and comprehensive analysis of this aspect, see F. DELFINI-G. FINOCCHIARO, *Diritto dell'informatica*, Torino, 2014. In the field of tax law, this is recalled by L. DEL FEDERICO, *La Digital Economy ed il sistema tributario: considerazioni introduttive*, in L. DEL FEDERICO-C. RICCI (eds.), *La Digital Economy nel Sistema Tributario Italiano ed Europeo*, Milano, 2015, p. 4 ss.

[13] See, among others, C. TRENTA, *La "Google Tax" Italiana. Il regime fiscale italiano e la e-company europea*, in *Rivista Trimestrale di Diritto Tributario*, 2014, p. 889 ss. For a more general overview of what happened in different jurisdictions, see M. PISENTE, *Reazioni internazionali e nazionali in tema di web e digital tax*, in L. CARPENTIERI (ed.), *Profili Fiscali dell'Economia Digitale*, Torino, 2020, p. 25 ss.; S. ARIATTI-R. GARCIA ANTON, *La nuova e variegata frontiera della "Google Tax": profili comparatistici*, in L. DEL FEDERICO-C. RICCI (eds.), *La Digital Economy nel Sistema Tributario Italiano ed Europeo*, cit., p. 247 ss.; J.A. ROZAS, *El Impuesto Catalan Sobre la Provision de Servicios de Communicaciones Electronicas*, *ivi*, p. 211 ss.

[14] For a general perspective on this topic, see, among others, D. STEVANATO, *A Critical Review of Italy's Digital Services Tax*, in *Bulletin for International Taxation*, 2020, p. 413 ss. «*There is a widespread belief that large digital undertakings, due to their business models based on intangibles that are relatively easy to place in low or no-tax jurisdictions, are avoiding both source and residence country taxation. The result has been unilateral action and the enacting of new types of taxes that are reminiscent of those experienced in the distant past*». For the experience of other jurisdictions, see, among others, M. NIEMINEN, *The Scope of the Commission's Digital Tax Proposals*, in *Bulletin for International Taxation*, 2018, p. 664 ss.; N. CORREA, *The Spanish Digital Services Tax: A Paradigm for the Base Enlargement & Profit Attraction (BEPA) Plan for the Digitalized Economy*, in *European Taxation*, 2019, p. 341 ss.; B. MICHEL, *The French Crusade to Tax the Online Advertisement Business: Reflections on the French Google Case and the Newly Introduced Digital Services Tax*, in *European Taxation*, 2019, p. 523 ss.; X. YEROSHENKO, *Introducing a Digital Services Tax in the Czech Republic*, in *International Transfer Pricing Journal*, 2020, p. 199 ss.

focused on two of the possible approaches to the digital economy: [15] the one known as "revolutionary approach", which aims to elaborate "new rules for a new reality" thus establishing a dedicated body of rules for cyberspace. This also includes extreme solutions, from the non-taxation of the digital economy to the creation of new taxes to be imposed only in this realm [16] and corresponds to the set of second and third general approaches mentioned above.

One common factor links all of these sub-groups, which can be referred to the "revolutionary approach", and that is the belief that cyberspace and the activities performed therein are something "separate" and "independent". As such, they cannot be subject to the same rules embodied for the "real" world.

Whoever advocates for the non-taxation of the digital world adopts various arguments such as the idea that e-commerce is in its early stages and therefore deserves some types of special treatment. [17]

The second approach is known as the "status quo approach". This is a conservative approach and is supported by the vast majority of scholars and international institutions. For example, as explained hereinafter in this contribution, the OECD openly endorses the extension of the rules, to which the "real world" is subject, to cyberspace. [18]

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[15] See, in particular, S. CIPOLLINA, *I confini giuridici del tempo presente. Il caso fiscale*, Milano, 2003, p. 277 ss.

[16] More in general, see also A. CARINCI, *La fiscalità dell'economia digitale: dalla Web Tax alla (auspicabile) presa d'atto di nuovi valori da tassare*, in *Il Fisco*, 2019, p. 4513 ss., who proposes the value of the data collected by businesses through a wealth-type tax and defines the digital economy as "*non-territorial*" (*a-territoriale*).

[17] See S. CIPOLLINA, *op. ult. cit.,* p. 288, who in turn cites W.F. FOX-M.N. MURRAY, *The Sales Tax and Electronic Commerce: So, What's New?*, in *National Tax Journal*, 1997, p. 573 ss. She also cites a US legislative initiative of 21 October 1998 when a bill known as the 'Internet Freedom Act' was passed. This is part of a wider law known as 'Omnibus Appropriations Act of 1998' of which Title IX is designated the 'Moratorium on Certain Taxes'. More precisely, the non-taxation prescribed by this law is a three-year moratorium that began on 1 October 1998. Sections 1101 and 1201 clarify that no state or political subdivision shall impose any new tax in this lapse of time. It is therefore a 'pro-tempore' non-taxation because it does not involve existing taxes. On 28 November 2001, the so-called "Internet Tax Nondiscrimination Act" was passed that extended the moratorium until 1 November 2003. See also K. KISSKA-SCHULZE, *The Future of E-mail Taxation in the Wake of the Expiration of the Internet Tax Freedom Act*, in *American Business Law Journal*, 2014, p. 315 ss.

[18] See, for example, the OECD Report '*Electronic Commerce: A Discussion Paper on Taxation Issues*', (1998) 7, point 16: «*The Committee on Fiscal Affairs* […] *also accepts that any taxation arrangements put in place must be capable of developing as the technological and commercial environment changes* […]»; and BEPS Action 1, p. 54, in which it is upheld that

Under the "status quo approach", cyberspace is considered an offshoot of the real world and, therefore, the same rules must be applied after suitable adaptations. The same body of fundamental principles is relevant for both of the realities, although some minor adaptations of the rules are not excluded *a priori.*

It should be emphasized from the very outset that the author is fully aligned to this second approach. This study is grounded on the premise that the digital economy has to be treated, as far as possible, in the same way as the "material economy". This does not mean that adaptations have to be ruled out. On the contrary, the effort of scholars and lawmakers must proceed exactly in this direction to achieve the widest reconciliation possible of these two worlds from a legal standpoint.

In the meantime, the current challenge is to draft the rules in a way that makes them suitable for both the actual and the digital worlds. This may be "easier" in the cases in which the digital economy business models have a "counterpart" in the real economy. However, it should always be borne in mind that our legal and tax systems have to be prepared to draft rules that are suitable for new future concepts that will exist only in the digital world.

3. *How the Digital Economy is Challenging Tax Systems*

A significant amount has been written recently by scholars on how deeply digitalization is changing the way of conducting business, especially with regard to activities, companies, and groups who work in multiple jurisdictions. Nearly all of them agree that businesses have adapted to the new economic environment much faster than both the tax systems and the rules of international tax law.[19] Taxpayers have learned very quickly how to render their

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the digital economy shall not be ring-fenced. Both of these documents are analysed in detail hereinafter and are available on the official website *www.oecd.org*. These approaches are extensively explained with regard to VAT in G. BEVERS, *Value Added Tax And Electronic Commerce*, in *British Tax Review*, 2001, pp. 449-481.

[19] As stated in the first page of the introduction of the Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence {SWD(2018) 81 final} – {SWD(2018) 82 final}: «*However, digitalisation is also putting pressure on the international taxation system, as business models change. Policy makers are currently struggling to find solutions which can ensure a fair and effective taxation as the digital transformation of the economy accelerates, and the existing corporate taxation rules are outdated to catch such evolution. The application of the current corporate tax rules to the digital economy has led to a misalignment between the place where the profits are taxed and the place where value is created. In particular, the current rules no longer fit the present context where online trading across borders with no physical presence has been facilitated, where businesses largely*

profits "stateless" while tax systems have, for a long time, "stood by and watched" and, when they have sought to take action, they have done so late and in a widely uncoordinated manner.

Generally speaking, from a legal perspective, the development of the Internet as well as IT relationships and contracts are creating new tax issues since legal and tax systems are very rigid and based on formality. [20]

In spite of the general tendency towards particularism, tax legislation remains substantially anchored to civil law categories and to contractual schemes conceived in an historical period in which the current structure of the digital economy was not conceivable. It is, therefore, becoming increasingly difficult to relate the models of the digital world to the traditional legal categories. As a result, this is having considerable repercussions on the tax system. [21]

One of the most significant problems emerging from this framework is the allocation of taxing rights. The current principles governing the tax treatment of cross-border income both at domestic and international levels are primarily those developed decades ago on the basis of a political compromise reached in the 1920s – 1930s between states that had an interest in distributing their taxing powers, generally by avoiding double taxation. [22]

For many decades, this set of rules was effective, and concepts such as permanent establishment or transfer pricing led to results that were widely accepted by all stakeholders and parties involved. [23] This remained true as

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rely on hard-to-value intangible assets, and where user generated content and data collection have become core activities for the value creation of digital businesses». For a non-exhaustive view of how Italian scholars dealt with these apsects of digitalization, see among others F. GALLO, *Il futuro non è un vicolo cieco. Lo Stato tra globalizzazione, decentramento ed economia digitale*, Palermo, 2019; A.F. URICCHIO, *La fiscalità dell'innovazione nel modello Industria 4.0*, in *Rassegna tributaria*, 2017, p. 1041 ss.; S. CIPOLLINA, *I redditi "nomadi" delle società multinazionali nell'economia globalizzata*, in *Rivista di Diritto Finanziario e Scienza delle Finanze*, 2014, p. 21 ss.; P. PISTONE-D. WEBER (eds.), *Taxing the Digital Economy*, Amsterdam, 2019; G. CORASANITI, *La tassazione della digital economy: evoluzione del dibattito internazionale e prospettive nazionali*, in *Diritto e Pratica Tributaria Internazionale*, 2020, p. 1397 ss.; C. BUCCICO, *Problematiche e prospettive della tassazione dell'economia digitale*, in *Diritto e Processo Tributario*, 2019, p. 255 ss.

[20] L. DEL FEDERICO, *Introduzione al dibattito sulla tassazione della digital economy*, in L. DEL FEDERICO-C. RICCI (eds.), *Le nuove forme di tassazione della digital economy – analisi, proposte e materiali per il dibattito politico e istituzionale*, Canterano, 2018, p. 15.

[21] *Ibidem.*

[22] L. CARPENTIERI, *La tassazione delle imprese al tempo dell'economia digitale*, in L. CARPENTIERI (ed.), *Profili Fiscali dell'Economia Digitale*, Torino, 2020, p. 3.

[23] See also S. DORIGO, *Il superamento dei criteri di collegamento "tradizionali" nell'epoca dell'economia digitale: le conclusioni dell'AG Kokott nella causa Google e la problematica loca-*

long as the economy was predominantly based on the manufacturing sector since the creation of profits was, unlike today, tangible and locatable in a territory.[24] However, the current legal framework is still the one developed many years ago with the result that tax systems are proving to be partly inadequate.[25]

In other words, the rationale behind contemporary tax systems is to tax business income in the state where the economic activity takes place and production facilities are situated.

In a report dating back to 1923, commissioned by the League of Nations, with respect to business establishments several economists came to the conclusion that such income should be taxed in the state where an enterprise has its origin factors, which, in the context of the material economy existing then is typically intended to refer to the place where *earnings are created* by human agency.[26]

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lizzazione del reddito d'impresa, in *Rivista di Diritto Tributario Online*, 6 December 2019; and, from the same author, *Il problematico adattamento della nozione di stabile organizzazione all'economia digitale*, in *Corriere Tributario*, 2019, p. 759 ss.

[24] L. CARPENTIERI, *La crisi del binomio diritto-territorio e la tassazione delle imprese multinazionali*, in *Rivista di Diritto Tributario*, 2018, p. 351 ss.; more in general, U. VINCENTI, *Diritto senza identità, La crisi delle categorie giuridiche tradizionali*, Bari, 2007, p. 14, according to whom, the law is increasingly "borderless" due to the crisis of the connection between border and law produced by globalization and by the new virtual reality of the Internet.

[25] For an overview of what happens in the field of direct taxation, see also G. FRANSONI, *La proposta estone di una web tax basata sul numero dei clienti: stabile organizzazione virtuale o reale?*, in *Rivista di Diritto Tributario Online*, 22 September 2017.

[26] G. BRUINS ET AL., *Report on Double Taxation: Submitted to the Financial Committee*. Document E.F.S.73.F.19 (League of Nations 1923), pp. 39-40. This was also reiterated two years later, in League of Nations, *Double Taxation and Tax Evasion Report and Resolutions Submitted by the Technical Experts to the Financial Committee*, Document F.212 31 (1925) and in several other reports, among which *League of Nations, Draft of a Bilateral Convention for the Prevention of Double Taxation and Tax Evasion, Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, Document C.216.M.85.1927.II 10–11 & 15 (1927); League of Nations, *Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, Document C.562.M.178.1928.II 8–9 & 12–13 (1928); League of Nations, *Fiscal Committee, Report to the Council on the Work of the First Session of the Committee*, Document C.516.M.175.1929 4 (1929); League of Nations, *Fiscal Committee, Report to the Council on the Work of the Second Session of the Committee*, Document C.340.M.140 8 (1930); League of Nations, *Fiscal Committee, Report to the Council on the Fifth Session of the Committee, Purposes of Taxation*, Document C.252.M.124 5, (1935); League of Nations, *Fiscal Committee, London and Mexico Model Tax Conventions, Commentary and Text*, Document C.88.M.88.1846.II.A 13–21 & 60 (1946). For a detailed analysis of these reports, see the first chapter of R.COLLIER-J. ANDRUS, *Transfer Pricing and the Arm's Length Principle After BEPS*, Oxford, 2017.

For a state other than the one of residence to tax income produced within its territory, the general rule remains that a permanent establishment must be situated there. On the contrary, the mere presence and availability of warehouses and depots as well as the use (under certain conditions) of agents do not constitute a permanent establishment. The consequence is that it is often very easy for digital businesses working "remotely" to escape taxation. [27]

The BEPS Project promoted an approach based on the concept that profits shall be taxed where *economic activities take place and value is created*. [28] In this regard, several actions of the BEPS have reinforced the application of activity-based concepts. For example, Actions 8-10 provide detailed guidance on the concept of control over risk, Action 5 introduces the substantial activities test, and Action 6 provides that treaty benefits will only be granted to taxpayer structures that are linked to core commercial activity. [29] The intended consequence of the concept of *value creation* is the allocation of taxing rights in the country where the *supply* or *production* facilities are present.

This led various jurisdictions to develop solutions, such as the concept of *digital permanent establishment*, which marked a step forward compared to the previous situation but were not conclusive. [30]

Even then, the debate arose as to whether the concepts of *supply* and *production*, used in the definition of the theory of taxing rights allocation, could be interpreted broadly to include *demand* or *market* factors. [31]

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[27] For an Italian perspective, see C. RICCI, *La digital economy ed il problema della stabile organizzazione nell'esperienza italiana*, in L. DEL FEDERICO-C. RICCI (eds.), *La Digital Economy nel Sistema Tributario Italiano ed Europeo*, cit., p. 57 ss. More in general, L. SHEPPARD, *Digital permanent establishment and digital equalisation taxes*, in *Bulletin for International Taxation*, 2018, available in the IBFD online research platform. For an historical perspective, C. GALLI, *Primi orientamenti dell'OCSE in materia di attributzione degli utili ad una stabile organizzazione nel contesto del commercio elettronico*, in *Rivista di Diritto Tributario*, 2001, p. 79 ss.

[28] OECD, *BEPS Project Explanatory Statement – 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project*, OECD Publishing Oct. 2015, para. 1.

[29] V. CHAND, *Allocation of Taxing Rights in the Digitalized Economy: Assessment of Potential Policy Solutions and Recommendation for a Simplified Residual Profit Split Method*, in *Intertax*, 2019, p. 1023.

[30] For an in-depth analysis of the development of the notion of permanent establishments and the application of territorial connections, see G. BIZIOLI, *L'applicazione dei criteri di territorialità. Le piattaforme come stabili organizzazioni o come semplici strutture di supporto in sede nazionale*, in A. DI PIETRO-P. SANTIN (eds.), *La fiscalità dell'economia digitale tra Italia e Spagna*, Padova, 2021, p. 241; P. PISTONE, *Permanent Establishment and the Digital Economy*, in G. MAISTO (ed.), *New Trends in the Definition of Permanent Establishment*, Amsterdam, 2019, p. 199.

[31] M. DEVEREUX-J. VELLA, *Value Creation as the Fundamental Principle of the Interna-*

The fact that in a comprehensive view of modern tax systems, consumption taxes also play a major role should not be overlooked. In a hypothetically perfectly co-ordinated tax system, income tax revenues are allocated between the jurisdictions where the value was created, using transfer pricing rules as a toolkit, and the *market* jurisdiction collects the consumption taxes.

Nevertheless, the basic problem remains that this structure and the categories on which it is based are somewhat outdated. The world based on the material economy in which they were conceived no longer exists, and digital platforms have become the new markets. Businesses, for their part, sometimes exploit this new reality to their advantage by engaging in tax misconduct while, at other times, they simply no longer need to resort to outdated concepts such as permanent establishments with the result that it may even be difficult to detect avoidance and evasion. [32]

This phenomenon has also been dubbed "the disappearing taxpayer" [33] and its causes lie in the increased digitalization of the economy. In fact, digitalized businesses can centralize operations and sell their products (either digitalised or not) on a remote basis, as well as managing these activities from virtually anywhere in the world without any physical presence of personnel or with minimal presence in most of the jurisdictions involved.

Moreover, these new business structures make it very difficult to ascertain with certainty where value has been created, thus exposing tax systems to major inefficiencies, as well as the risk of being exposed to avoidance and evasion schemes.

Much more recently, in 2021, the OECD gave further impetus to its work in this area by working on what is commonly referred to as the *Two-Pillars Solution*. [34] Despite the progress made, the basic problem continues to be the

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tional Corporate Tax system (July 31, 2018), *European Tax Policy Forum Policy Paper*, 2018; S.C. MORSE, *Value Creation: A Standard in Search of a Process*, in *Bulletin for International Taxation*, 2018; J. HEY, *"Taxation Where Value Is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative*, in *Bulletin for International Taxation*, 2018. With regard to the ambiguity of some of the concepts on which the BEPS project is based, the last contribution mentioned states: «*As unclear as the concept is the nature of the value creation standard. Criticism has rightly been made that the OECD has invented a guiding principle without conducting any thorough analysis of its effects and without any clear theoretical foundation*».

[32] See also F. GALLO, *Fisco ed economia digitale*, in *Diritto e Pratica Tributaria*, 2015, p. 600 ss. The published text is the transcript of a speech by the scholar to the Italian parliament. He explains that it is by "taking advantage" of the characteristics of the digital economy that many companies have found it very easy to reduce their tax burden.

[33] This definition was used by the economist in the title of an article published on 29 May 1997. It was later taken up by J. OWENS, *What Chance for the Virtual Taxman*, in *The OECD Observer*, 1997, p. 16.

[34] OECD, *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisa-*

clear identification of suitable criteria for linking income to states' territory (the so-called "nexus"), so as to allocate taxing rights according to the value creation. [35]

In its paper presenting this project, the OECD acknowledges that it has made a significant contribution to a more coherent international tax system overall, but identifies two persistent major problems: [36] (i) the first is that the old rules provide that the profits of a foreign company can only be taxed in another country where the foreign company has a physical presence; (ii) the second is that most countries only tax domestic business income of their multinational businesses, but not foreign income, on the assumption that foreign business profits will be taxed where they are earned.

More precisely, under Pillar One a new special rule is introduced, the purpose of which is to establish a new nexus allocating taxing rights to the market jurisdiction, when the in-scope multinational business [37] derives at least 1 million euros in revenue from that jurisdiction. [38]

Two types of activities are covered: (i) automated digital services (ADS), such as online advertising services, social media platforms and online intermediation platforms; and (ii) consumer-facing businesses (CFB), i.e., businesses that sell goods and services primarily targeted at consumers.

When all conditions are met, a three-step process should be applied for the allocation of rights. First, the deemed residual profit is calculated by deducting from the global profit an amount representing the "deemed routine

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tion of the Economy, October 2021. This is the outcome of a long work, started in 2019 with the following note: OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note As approved by the Inclusive Framework on BEPS on 23 January 2019*.

[35] For a comprehensive analysis of this project and its implications, see in particular W. SCHÖN, *Is There Finally an International Tax System?*, in *World Tax Journal*, 2021, p. 357. The scholar concludes his analysis by stating that «*The question of whether we are finally witnessing the emergence of an international tax system worth its name cannot be answered from a scholarly perspective alone. But it seems sensible to assume that we have reached an intermediate stage: The traditional institutional framework of international taxation has morphed into a dense network of multilateral cooperation involving new instruments and organizations. Meanwhile, the substance matter of international tax law, in particular the allocation rules under tax treaties, has not reached a stable outcome in so far as traditional tax principles have been abandoned without new and solid principles taking their place*». In a previous publication, he had investigated why the international tax regime needs changes in the light of the disruption caused by the digital economy: W. SCHÖN, *Ten Questions about Why and How to Tax the Digitalized Economy*, in *Bulletin for International Taxation*, 2018, p. 278.

[36] See p. 12 of the document.

[37] The proposal would apply only to multinational businesses with a global turnover above EUR 20 billion and profitability above 10%.

[38] See p. 6 of the document.

profit", which is computed on the basis of a fixed percentage. Second, the tax due is calculated as a fraction of the remaining deemed residual profit. Lastly, the relevant portion of tax is allocated to each market jurisdiction using an agreed allocation key (e.g., sales). If an amount of residual profit of a business has already been sufficiently allocated to a market jurisdiction under the existing profit allocation rules using the arm's length principle (e.g., because of the presence of a resident entity or a permanent establishment), a mechanism is proposed to prevent double taxation.

As to the so-called Pillar Two, also known as Global Anti-Base Erosion (or "GloBE") proposal, it primarily deals with the issue of tax competition and aims to reduce its negative consequences. It is a two-fold proposal formed by: (i) an income inclusion rule; and (ii) a tax on base eroding payments.

The first provides that the income of a foreign branch or a controlled entity would be taxed if that income were subject to tax at an effective rate that was below a minimum rate. Where the taxation in the source jurisdiction is lower than the minimum, the income inclusion rule is activated and acts as a top-up to achieve the minimum tax rate. The intended result is to ensure that an international business is subject to tax on its global income at the minimum rate, regardless of where it was incorporated.

The second proposal is intended to complement the income inclusion rule, for the purpose of enabling the source jurisdiction to protect itself from tax base erosion. It would also in turn be formed by two rules, namely (i) an under-taxed payment rule, according to which a tax deduction would be denied or taxation at source (including withholding tax) would be imposed on payments made to a related party, unless the payments were subject to tax at or above a minimum rate; and (ii) a subject-to-tax rule, according to which eligibility for certain treaty benefits could be denied in situations in which the payment was not subject to tax at a minimum rate.

Although an in-depth analysis of the technical aspects of this proposal is beyond the scope of this study, it can be seen that this initiative, after the BEPS, is certainly a step forward in the construction of a more coherent international tax system. However, it also seems reasonable to expect that the solution proposed by the OECD will not be definitive this time either, in the sense that some of the problems affecting contemporary tax systems will not be solved definitively. To give just one example, the way in which the concepts on which this solution is based, such as market jurisdiction, are interpreted will also have consequences for its effectiveness in the future.

4. *How the Digital Economy is Challenging the EU VAT System*

Value added tax is one of the most advanced forms of consumption taxation, and the items on which it is levied have changed radically due to the afore-mentioned reality of the recent decades.[39] With specific regard to EU VAT, it is no exaggeration to say that the progressive dematerialization of the economy has challenged many of its founding principles.

Although VAT has very different characteristics from income tax, and is based on very different nexuses which in most cases lead to taxation of the destination jurisdiction, this tax has also proved vulnerable to a certain extent to innovations brought about by digitalization.

The basic features of EU VAT were also conceived when the economy was predominantly material and most transactions consisted of material supplies between parties who met in person in a well-defined place, who were often based in the same Member State, and who acted within the framework of stable commercial relations and economic activities.

The progressive advent of the internet has changed all this, making it increasingly common to carry out transactions that are not bound by geographical distance or national borders, that do not require any physical contact, and that may involve new types of services and goods that are completely dematerialized. The items on which VAT is levied, namely the supply of goods and services, have undergone a radical transformation over the last two decades: goods were first dematerialized and then, in many cases, transformed into services which, as is well known, create many more difficulties in terms of tax management and collection.[40] A new concept of goods is

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[39] See, among others, K.A. JAMES, *The Rise of the Value-Added Tax*, in *Cambridge Tax Law Series*, Cambridge, 2015; F. ZAWODSKY, *Value Added Taxation in the Digital Economy*, in *British Tax Review*, 2018, p. 606 ss., according to whom «*Although the debate on the digital economy still focuses mostly on direct taxation, value added taxation (VAT) is also included in the debate as far as the fight for fair taxation and the fight for allocation of tax revenue are concerned. The most common way in the world of taxing consumption by individuals is put to a test. A thorough analysis of the consumption process in the digital economy is so far missing from the literature. Insights derived from such an analysis would provide the necessary background from which to draw conclusions. The fact that the digital economy is omnipresent in daily life does not mean that there is any understanding of the changes that have occurred since the pre-internet era. In a rapidly changing economy, it is prone to debate if the way in which people consume is also subject to changes. Accordingly, whether or not the traditional VAT model is appropriate for new modes of consumption in the internet era is a question which calls for an answer*».

[40] As regards the realm of direct taxes, see in particular the in-depth analysis of G. BIZIOLI, *I nuovi prodotti tra beni immateriali e servizi*, in A. DI PIETRO-P. SANTIN (eds.), *La fiscalità dell'economia digitale tra Italia e Spagna*, Padova, 2021, p. 225. On page 226, the author