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Whether nexus rules under EU Commission proposal of Significant digital presence rules is compatible with separate provisions of international tax law

by

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Summary

Growing digitalisation of the global economy is brining irreversible changes in business models and structure of economic relationships. External factors, such as pandemic, only facilitate the process of remote participation in economic life and performing economic functions. International system of allocation of taxing rights between resident and source states faces new challenges because of mentioned above global tendencies and events. Permanent establishment concept developed for "brick and mortar" economic business models seems to be outdated and fail task of fair taxation of digital economy. The matter of sufficient and genuine link ("nexus") between states and taxable matters is necessary. Nexus calls for extraterritorial taxation missing in digital service taxes, doing nothing with international tax law.

The EU Commission has developed the proposal for a directive establishing the PE rules on the basis of significant digital presence. The research focuses on an assessment of proposed rules from the perspective of general international law and answers the question whether the proposed PE nexus is in line with requirements of international law.

Further, the present work aims to assess proposed rules from the perspective of economic allegiance theory to find whether the allocation of taxing rights under the proposed PE nexus may be justified.

Aknowlegment

I would like to thank my supervisor Cécile Brokelind for guidance and endless patience while I was writing this thesis.

My studies would not have been possible without being honored to become a Visby (Swedish Institute) Scholar.

Abbreviation list

ATAD	Anti-Tax Avoidance Directive
SDP	Significant digital presence
BEPS	Base Erosion and Profit Shifting
ECJ	European Court of Justice
EU	European Union
DTT	Double Taxation Treaty
Model Convention	Model Tax Convention on Income and on Capital

1 Introduction

1.1 Background

As written in "Broader tax challenges raised by the digital economy" by OECD[1], from the perspective of direct taxation, digitalized economy triggered a range of challenges which may be summarized in three main categories (nexus, data, characterization).

The adequacy of the existence of the international tax framework is under discussion because of the challenges arising from digitalizing of modern economy and new patterns in business. Such discussions relate to the allocation of taxing rights within the dichotomy of source and residence jurisdictions.

Regardless the different nature nexus data and character may trigger issues simultaneously. As an example, it is relevant to refer potential issue of double taxation or double non-taxation arising from non-traditional treatment of payments and taxation of the payor in state of its residence considered from the perspective of nexus. In the same way the data collection and processing may lead to the debates regarding its attribution to taxable nexus. The tax treatment of income arising from "digitalized" transaction need to be scrutinized. There is a discussion in literature regarding the acceptability of physical presence as a single ground to impose taxes for the reason of lacking a legal basis[2].

Desire of states to extent its sovereignty as much as possible results in clashes in the form of double taxation and complicate the legal framework in the field of taxation of international business. The states execute their taxing rights with regard to international business transactions within legal order confirmed by the concept of the doctrine of state sovereignty[3]. The power of state to regulate its tax jurisdiction is unlimited within mentioned legal framework. It is implemented in domestic provision in unilateral way or by joining bilateral or multilateral international agreements[4].

EU Commission in its communication papers on Business Taxation for the 21st Century underlines the old-fashioned nature of tax residence and source principles from perspective of modern business practices existing without maintaining a physical presence. It seems that current rules fail to manage challenges arising from transformation of tax base resulting from digitalised

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[1] OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264218789-en. Chapter 7

[2] E. Kemmeren, Principle of Origin in Tax Conventions: A Rethinking of Models p. 18 (Pijnenburg Vormgevers/Uitgevers 2001). https://research.tilburguniversity.edu/en/publications/principle-of-origin-in-tax-conventions-a-rethinking-of-models

[3] S. Gadžo, Acknowledgements in Nexus Requirements for Taxation of Non-Residents' Business Income – A Normative Evaluation in the Context of the Global Economy (**hereinafter - Gadžo**) (IBFD 2018), Books IBFD (accessed 20 May 2021) Chapter 2.

[4] *Ibid* Chapter. 2

economy allowing to manipulate current tax principles and apply tax planning schemes[5].

According to modern international tax the states' taxing rights with regard to cross-border situation are limited for a few reasons. Initially, genuine and substantial connection between state and subject matter is required to justify the taxation of respective income. If all Member states introduce digital taxes simultaneously, nothing prevents from double taxation except genuine link introduced in international law. Thus, being introduced unilaterally at the level of Member States tax measure regarding digitalized income may jeopardize double taxation situations which are beyond the scope of primary law area of concern. The only way seems to be relevant to prevent it is making general conclusion and introducing a directive (as in case of Parent-subsidiary Directive or Interest-Royalty Directive) explaining the genuine link which allows to tax digitalized income. In the context of mentioned problem of potential double taxation nexus concept was considered to be a remedy at the level of EU proposals[6]. However, Juridical double taxation is not subject to concern of EU primary law[7] because of it does not concern freedoms.

The taxation of income arising from cross-border transactions resulted in situation when the legitimate tax claim was limited to cases when the state has connection to person (i.e. "personal attachment") or to a territory (territorial principle)[8].

Nevertheless, politically convenient solutions need to be backed by sound legal principles. In other words, the solutions used to reconsider allocation of taxing rights need to better align economic activities within the state with proxies used to tax it. In this context a single standard or nexus are an issue[9].

In the beginning of 20 century due to the initiative of League of Nations there was fulfilled the research regarding the economic allegiance between state and income subject to tax. It is a corn stone of all global tax system designed in 20th century underpinning the residence and source principles of direct taxation[10].

In respect of all those classes of activities, the group came to the conclusion that the place where income was produced is "of preponderant weight" and

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[5] COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL Business Taxation for the 21st Century https://ec.europa.eu/taxation_customs/communication-business-taxation-21st-century_en

[6] Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence COM/2018/0147 final - 2018/072 (CNS) (**hereinafter – SDP proposal**)

[7] Opinion Case C-375/12 Bouanich v Directeur des services fiscaux de la Drôme, ECLI:EU:C:2014:138 para 36

[8] Schön, W. Persons and Territories: on the International Allocation of Taxing Rights. (British tax review, 2010) (6), 554-562.

[9] A.J. Martín Jiménez, Value Creation: A Guiding Light for the Interpretation of Tax Treaties?, 74 Bull. Intl. Taxn. 4/5 (2020), Journal Articles & Opinion Pieces IBFD (accessed 21 May 2021) Chapter 1.

[10] Report on Double Taxation submitted to the Financial Committee — Economic and Financial Commission Report by the Experts on Double Taxation — Document E.F.S.73. F.19 (April 5th 1923) — Volume 4 Section 1: League of Nations (hereinafter – **the Report**) accessed 21 May 2021, https://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;collection=;database=;query=;brand=default

"in an ideal division a preponderant share should be assigned to the place of origin"[11]. In other words, in allocating jurisdiction to tax on business profits, greatest importance was attached to the connection between business income and the various physical places contributing to the production of the income. Common efforts and initiatives brought the result in the form of system of bilateral treaties eliminating double taxation. OECD and UN supported development of the treaty system by creating models of the treaty as well as commentaries with regard to the provisions of the treaty.

Overall, treaties establish rules that business profits of a business are subject only to taxation in the state of residence unless the business is carried out in the other state through a PE situated in that state (source principle). The PE concept is core element in taxation of business profits by state where such profits generated by non-resident enterprises. It should be noted that PE concept cover only the taxation of business profits.

Being the measurement of economic presence of foreign entity and its integration in local economy PE concept justifies the taxation of profits arising from such presence. The economic allegiance factors discussed above are linked with the requirements of sufficient economic presence through the PE concept[12].

According to OECD commentaries and some scholars PE thresholds reflect economic presence of foreign enterprise at source state's market is a result of political consensus and allow states to exercise its own jurisdictions in respect of such non-resident entity [13].

As stated above tax treaties aim is to tackle double taxation issues. Double taxation is a situation when both tax principles (residence and source) apply to the same income. In other words when the juridical double taxation exists. Opposite side of the coin is the existence of double non-taxation[14].

Referring to the OECD double non-taxation or low taxation may be understood as shifting profits away from the jurisdiction where the commercial activities generated such profit[15]. Comparing the effect from the avoidance of physical presence by digitalized business model and understanding of double non-taxation provided by the OECD it is possible to conclude that digitalized business models may trigger unintended double non-taxation due to the nature of the business.

As stated in BEPS action plan OECD was called to develop actions against gaps in allocation of taxable profit arising from application to digitalized economy residence and source tax principles[16]. It is possible to refer the

[11] OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, (hereinafter - **Addressing the Tax Challenges of the Digital Economy**) OECD Publishing, Paris, https://doi.org/10.1787/9789264218789-en. 37

[12] Addressing The Tax Challenges Of The Digital Economy pg. 39

[13] ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY pg. 40

[14] Erdős Dr. PhD, Eva & Kiss, Lilla. (2019). Double Taxation and Double Non-Taxation as the New Tendencies of EU e-Tax Law. https://www.researchgate.net/publication/337654968_Double_Taxation_and_Double_Non-Taxation_as_the_New_Tendencies_of_EU_e-Tax_Law

[15] OECD, Action Plan on Base Erosion and Profit Shifting (OECD, 2013), at p.10

[16] Ibid. pg. 9

political argument that the position of EU Commission regarding the double non-taxation. To illustrate it is relevant to refer ATAD and in particular hybrid mismatches rule implemented by the EU targeting double non-taxation[17]. Moreover, it is necessary to refer that some scholars see risks or distortion of free movement freedoms in form of double non-taxation or state aid [18].

Avoiding taxable presence in market state was identified by the OECD as an area of BEPS opportunity. For instance, cross-border online transactions do not usually require physical presence. Generally, domestic law provisions establish taxing rules for such kind of transactions. In situation when residence state does not apply taxing rights there is a risk that respective income is taxed with effective rate around zero[19].

A physical presence was considered to be a sufficient enough proxy identifying the participation in economic life of a state. Therefore, the PE concept was developed focusing on this. In present economic reality digitalized business model allows enterprises to exclude physical presence in country where they participate in economic life. It may be performed remotely. It brings the society to discussion regarding the reconsideration of nexus thresholds developed on physical presence.[20].

Considering above mentioned, development of new concepts or significant changes of existing PE concept seems to be relevant and appropriate. Current residence taxation principle seems not to be fully capable to tax changed digitalized international business in correct way for mostly economic and political reasons as described above.

In 2018 EU Commission represented Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence[21]. The Proposal set new rules allowing to tax companies without any physical presence at the territory of Member States where the income is earned. According to the EU Commission the concept of significant digital presence is built on the basis of value creation. As was stated above all existing rules regarding allocation of taxing rights is built in light of economic allegiance concept. It seems to be relevant to consider proposed rules from the perspective of economic allegiance.

Nevertheless, it is not answered whether the proposed rules are reconciled with the economic allegiance criteria with respect to relationships between source state and taxable income? Initially, PE concept represents economic

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[17] REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL on the implementation of Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market as amended by Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries pg. 6

[18] Double Taxation and Double Non-Taxation as the New Tendencies of EU e-Tax Law.

[19] Marcel Olbert and Christoph Spengel International Taxation in the Digital Economy: Challenge Accepted? pg.41.

[20] R.R. Das, The Concept of Value Creation: Is It Relevant for the Allocation of Taxing Rights?, 74 Bull. Intl. Taxn. 3 (2020), Journal Articles & Opinion Pieces IBFD (accessed 24 May 2021) Ch 4.3.

[21] Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence COM/2018/0147 final - 2018/072

allegiances in the source states[22] and as a result source states were justified to impose income tax regarding respective income. Otherwise, if the extending PE definition proposed concept of significant digital presence fails to be in line with economic allegiance there is a risk that it fails to achieve its main goal.

Research question

This thesis will try to answer the following questions: what boundaries and requirements are imposed by the existing system of international public law to connection between a state and taxable income, and examine, in particular, nexus concept under the proposals of EU Directives in digital taxation compared to requirements of international law and normative standards in particular economic allegiance.

1.2 Aim

The connection established by the proposed rules considers the matter of tax sovereignty and its boundaries: when the taxing rights of one state exhaust and limited by sovereignty and rights of another.

Additionally, as mentioned above at current stage, proposed rules under EU proposal to tax digitalized business models seem to establish loose nexus between taxed income and states. Moreover, it is not obvious what taxing rights belongs to states under the significant digital presence in light of economic allegiance.

Generally, the first legal issue is related to the fact that substantive tax jurisdiction is delimited by a public international law requirement for a "reasonable connection" between the state and taxable income. The research is going to examine the required boundaries and requirements of such connection from the perspective of the public international law for the purpose of taxation and normative standards.

Considering that the main function of international law is the delimitation of boundaries of state sovereignty[23] it will be focused on the research of the regulation of international law with regard to the state jurisdiction in particular tax jurisdiction. The research will be limited to generally recognized sources of international law: 1) international treaty conventions, 2) international customs, 3) general principles of international law, 4) judicial practice of international judicial bodies and generally recognized scholars[24].

The second one arises from the fact that existing permanent establishment concept represents economic allegiance theory and from this perspective it is required to research whether taxing rights should be referred to states under the significant digital presence.

[22] Skaar Arvid A., Permanent Establishment: Erosion of a Tax Treaty Principle, 1991 Edition, Boston Kluwer Law and Taxation Publishers, 559

[23] Ibid Chapter 2

[24] Statute of the ICJ, 39 AJIL Supp. 215 (1945).

1.3 Method and material

The aim and objective of the research fully delimitate the methodology. As written above the research concerns the issue regarding the international law requirements to the law of nexus. To answer this question starting part of the research is descriptive to prepare evaluation existing legal framework. At the same time, to understand international law environment the classical dogmatic method applies[25]. Within the study, scholars' publications in international law are referred to understand basic concepts delimitating state's taxing rights such as state sovereignty and state jurisdiction. By assessing the proposed nexus rules against international law requirements (protection of state sovereignty, equity, neutrality and simplicity) the normative approach applies[26]. The approach at present research with respect to evaluation of proposed nexus norms stipulated on the international level.

For the purpose of this research the academic literature and literature provided by tax practitioners are referred. The proposed (drafted) legislations and guidance provided by global multinational organisations (for instance, the OECD) will be considered and analysed within the research. Taking into account the close connection to economic issues of economic allegiance theory relevant non-tax law literature was considered, for example, literature concerning value creation definition.

1.4 Delimitation

Considering the complex nature of digital economy and how hard are challenges arising therefrom the thesis is limited to the issues concerning the tax nexus for digital economic activities. This research does not intend to consider the matters of nexus in international law and is limited to tax nexus for the taxation of digital activity because of the scope of the current research.

Regardless the fact that the problematic of value creation concept in digitalized business models is related to the topic the matter will not be subject to comprehensive analysis because of the thesis is concentrated on boundaries and nature of nexus concept from the perspective of international law. Value creation will be analysed from the perspective of "sufficiency" as a feature of taxable nexus. Moreover, the distribution profit rules are not subject to research because as well as matter of implementation of such rules by Member States.

The research does not focus on the details of value creation as a justification to allocate taxing rights.

The matter of relevance of value creation as a criterion of allocation of taxing rights is out of scope of the research. The compatibility of proposed allocation of taxing rights is not considered within the present research.

The paper is limited to the date when it is submitted (26 of May 2021) and it does not cover legislative proposals or changes happening after this date.

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[25] S. Douma, Legal Research in International and EU Tax Law (**hereinafter – Douma**) pg. 35 (Kluwer 2014).

[26] *Ibid* pg.33

1.5 Outline

Chapter is devoted to the boundaries and origination of the term of “nexus” and what requirements are set in international law to “genuine link” to allow a state to tax income. However, the first subparagraph considers the question whether EU has to shape its own legislation to international law requirements. The relationship between these two legal systems (EU legal order and international public law) in this particular matter is subject to first subparagraph. Further, the genuine link under international law is scrutinized from the origination to its place in international tax law. The concept of sovereignty and jurisdiction will be researched to understand the boundaries of extraterritoriality taxation in context of nexus application.

In the second Chapter the significant digital presence concept will be analysed from the perspective of economic allegiance theory. The fact that the proposal declares the value creation as a core stone of SDP requires to reconcile proposed rules with the economic allegiance and its definition. After this the question needs to be answered whether states have taxing rights under the significant digital presence from the perspective of economic allegiance.

2 International law requirements to genuine link between states and an enterprise.

2.1 Whether EU has to follow international law provision in respect of tax sovereignty?

As stated above the EU primary law put beyond the question of double taxation and the competition of tax claims. The matter of nexus in taxation is closely link to the state’s sovereignty regulating with international law. From this perspective it is necessary to find whether the EU legislation has to be in line with the provision of international law. It was mentioned that new concept of digital presence implemented in unilateral manner potentially may jeopardize double taxation risk for income arising from cross-border transactions. From the perspective of EU primary legislation risk of double taxation is not subject to concern[27]. Thus, the international law regulating the matter of extraterritoriality sovereignty (in particular, extraterritorial taxation) seems to be the only source relevant in the case of genuine link.

Nevertheless, the EU primary law mission (to achieve single market principle) does not exclude the obligation of Member states to obey international law provisions as a participant of global legal order. Considering from previous chapter that there is an empirical evidence that a Directive may be possible instrument to set in legal terms political decision regarding allocation of taxing rights and the fact that international public law is a relevant source of regulation with regard to the matter of extraterritoriality (in particular, matter of taxation), it flows to substantial research of nexus.

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[27] Opinion of Mr Advocate General Geelhoed delivered on 6 April 2006. Case C-513/04 Mark Kerckhaert and Bernadette Morres v Belgische Staat. European Court Reports 2006 I-10967 ECLI:EU:C:2006:242 para 30

2.1.1 The origination of nexus as a definition and legal terms.

Nexus concept was developed and originated from US legal system, in particular sales tax field. The degree of connection between a state and entity subject to sales tax. Beyond this level the state is not in position to impose sales tax[28].

According to provisions of the US Constitution (Due Process and Commerce Clauses) require pre-condition to tax income generating in cross-border activities - in the form of minimal connection or "nexus" (definite link between state and entity).

The US court practice established the approach that a sufficient physical presence in the state is a factor determining connection between state and entity subject to imposed tax[29]. However, the *South Dakota v. Wayfair case* revisited the approach and concluded that physical realm is not strictly required to recognize the nexus in a jurisdiction. The domination of physical presence proxy was reconsidered because of its narrow view inadequate for modern economic realities[30].

2.1.2 International law approach to determine nexus.

For the purpose of this research it is needed to identify the requirements set under the international public law in respect of nexus definition. To answer this question, it is considered the definition of jurisdiction and sovereignty from the perspective of international public law and international tax law. Further, the study will be performed in respect of a normative benchmark for examination of nexus norms proposed by EU Commission's proposal whether having implemented the concept the Member States may lawfully exercise their jurisdictions in terms of international public law.

2.1.3 International public law regulation of nexus approach.

The sovereignty concept is a core element of international law. A state jurisdiction is a side of sovereignty concept, which includes nexus as an element describing jurisdiction execution.

As stated by Brownlie the genuine link is a mandatory element of the state jurisdictional claim and may be admitted as the core limiting factor of its exercising under general international law[31]. It seems to be reasonable the opinion that above mentioned treatment emphasizes flexibility of general international law regulation regarding the jurisdictional matters.

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[28] Sam Brotman, JD, LLM, MBA The History of Nexus Rules and Case Law https://www.multistate.us/insider/2018/4/16/a-brief-history-of-the-biggest-state-tax-case-in-a-generation

[29] *Quill Corp v. North Dakota*, 504 U.S. 298 (1992) 504 U.S. 298 (more) 112 S. Ct. 1904; 119 L. Ed. 2d 91; 1992 U.S. LEXIS 3123; 60 U.S.L.W. 4423; 92 Cal. Daily Op. Service 4458; 92 Daily Journal DAR 7142; 6 Fla. L. Weekly Fed. S 269

[30] *South Dakota v. Wayfair,* __ U.S. __ (No. 17-494, 2018) 585 U.S. ___ (more) 138 S. Ct. 2080; 201 L. Ed. 2d 403

[31] Part VII State jurisdiction, 21 Jurisdictional competence James Crawford SC, FBA From: Brownlie's Principles of Public International Law (9th Edition) James Crawford **(hereinafter - Brownlie**) p. 301.

The sovereignty of states usually is understood as a representation of the core constitutional doctrine of the law of nations managing a state's society having common legal personality[32]. Sovereignty sometimes is understood as discretionary power within the specified territory bound by law[33].

The scope of "sovereignty" includes general legal competence of state, particular functions within such competence and how the competence should be exercised[34]. Generally, this term may use to explain capacity to exercise control (for instance over the territory) and ability to take action in international plane as a representator of territory or community[35].

It seems reasonable that taking into account above mentioned tendencies of states exercising of jurisdiction the position what constitutes the sufficient connection to justify exercise of jurisdiction depends on the specified circumstances. That means that each situation and field of law requires individual solution[36]. According to Ryngaert specific set of jurisdictional rules applies to each field of law[37].

The reciprocity of the state sovereignty concept and the system of international law is boiled down to the fact that being set by the states the system of international law set a range of limitation regarding the edges of state's sovereignty[38].

The correlation between state sovereignty and state's jurisdiction is based on the fact that jurisdiction is one of the sovereignty aspects.

Scholars in international law usually have treated concept of jurisdiction as a discussion regarding rights and powers of states. The importance of jurisdiction's rules role is highlighted by their goal – to delimitate state regulatory authority, particularly, the fact whether the person of event may be treated under national legislation.

Generally, for the purpose of international public law, the "sovereignty" of states is understood (excluding Lotus case) as a ramification of rules of jurisdiction arranging the limitations of the authorities of a one state with other states exercising their power in the international legal environment as well as, regulatory authority of the state in international law.

In terms of international public law provisions regulating competence of states distinguish three kinds of jurisdiction is discerned: (i) prescribed or legislate jurisdiction It means how far the application of state domestic legislation may be extend, (ii) Adjudicate jurisdiction of state, (iii) Adjudicate jurisdiction is also known as prescriptive (when judicial bodies are engaged in law-making procedures). The third one jurisdiction is about how the

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[32] US, see *Restatement Third* §401.
[33] Brownlie supra 37 pg.440
[34] Brownlie supra 37 pg. 442
[35] Glanville, Sovereignty and the Responsibility to Protect (2014) 7–9.
[36] Gadžo supra 3 Chapter 2
[37] C. Ryngaert, Jurisdiction in International Law: United States and European Perspectives (**hereinafter - Ryngaert**) (Katholieke Universiteit Leuven, 2007) p. 787
[38] Gadžo supra 3 Chapter 2

executive body of government is limited in their power to implement domestic law as well as domestic provision on taxation[39].

The jurisdiction is treated as a power and right of a state. In terms of international public law rules the state is exclusively authorized to exercise the jurisdiction according to territorial or personal criteria 'Jurisdiction involves a State's right to exercise certain of its powers'[40]. Existing framework of various grounds of jurisdiction allow situations when different states overlap regulation due to different grounds apply to the same objects. There is an opinion that it reflects collective policy decision by states and its just a simply part of reality existing in International public law[41]. Considering this the core goal of international law is complete elimination of cases when the states exercise their jurisdictions simultaneously. Further such rules will be considered.

2.1.3.1 The Lotus case

In the beginning of last century PCIJ issued an opinion which creates the core range of references for the matters of jurisdiction for the purpose of international law. It was the first time when the doctrine of extraterritorial jurisdiction was evoked by PCIJ in terms of international law at global level.

Regardless the fact that the case is subject to discussion from the perspective of representativeness of jurisdictional conflicts it became a standard of reference in the field of such kind of conflicts[42].

Moreover, the Court stated that the States are authorized to establish rules for persons, property and acts beyond their territory provided that actions are line with prohibition on extraterritorial enforcement jurisdiction. The lack of prohibitive rule allows State to exercise law-making jurisdiction extraterritorially.

To sum up, territorially limited enforcement jurisdiction could force persons to fulfil the rules prescribed extraterritorially. At the same time person with no or limited connection with jurisdiction (no assets, permanent residency on the territory of state etc.) will be out of effective exercise of extraterritorial jurisdiction.

In the opinion of scholars Lotus case may be recognized as the high watermark of the concept of unbridled sovereignty of the State under the international law[43]. It is obvious from analysis of the case that Lotus predicted decrease of physical borders importance in an era of global mobility of persons and businesses.

Currently, genuine sovereign equality of States cannot require from States to limit extraterritoriality of their legislation and exercising of jurisdiction and it demand to keep people protected by such sovereignty beyond the internal acts issued under the sovereignty of other states[44]. However, the nature of

[39] Ryngaert supra 43 pg. 63
[40] Ryngaert. Supra 43 pg 65
[41] Third Restatement (Foreign Relations) (1986) p 403.
[42] P.C.I.J., S.S. Lotus, P.C.I.J. Reports, Series A, No. 10 (1927).
[43] Ryngaert supra 43 pg 33
[50] Ryngaert supra 43 pg 36

consensual legal system excludes any possibility to ban sovereign state from regulation against activities outside physical borders (i.e. exercising jurisdiction beyond the borders)[45].

Further, Lotus concept was cautiously amended regarding emphasizing jurisdictional limits (in particular regarding substantial jurisdiction) and restraint under international law. Nevertheless, it was underlined that no particular international law rules exist[46].

2.1.3.2 Customary international law regulation of a state jurisdiction boundaries.

As stated about Lotus case set wide capability of states to set their legislation jurisdiction which was not fully used by states. However, it results in opinion among scholars that such Lotus doctrine is narrowed by the customary international law to situation when the state and subject matters are linked with specific kind of connection.[47] As noted by Gadžo usually such kind of connection is referred as "sufficient" "genuine" or "close"[48]. Such link is usually arising from connection between set of facts and territory of states and specific relationships with its population (elements objectivating core principles of jurisdiction – territoriality and nationality)[49].

However, the principles of jurisdiction are not limited to territoriality and nationality. State practice confirm emergence of other principles of jurisdiction due to rapidly-changing economic and political reasons50. It confirms the outstanding feature of the international law – its flexibility[51].

As Brownlie stated genuine link between matter subject to regulation and state is a core constrain of jurisdiction under general international law[52]. In this situation malleability of international law illustrates both existence of such link as well as dedication to changes in political and economic environment[53]. The flexible approach allows to reconsider the Lotus case doctrine as step aside from strict territorial doctrine to fit variable conditions of international environment[54].

On the basis of the malleability of international law there is an opinion in literature that sufficient connection with jurisdiction is determined on case-by-case approach which depends on the specific jurisdictional rules[55]. Currently, only principles of general international law of non-intervention applies without any discussions in literature[56].

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[45] Ryngaert supra 43 pg 37
[46] Case concerning Barcelona Traction, Light and Power Co. Ltd., ICJ Reports 1970, at 105
[47] Ryngaert, supra 43 38-39
[48] Gadžo supra 3 Chapter 2.1.5
[49] Brownlie, p. 301.
[50] B.H. Oxman, Jurisdiction of States, Max Planck Encyclopedia of Public International Law, p. 11 available at: http://opil.ouplaw.com/view/10.1093/law:epil/9780199231690/law-9780199231690-e1436?rskey=f3gol9&result=2&prd=EPIL;
[51] Gadžo supra 3 Chapter 2.1.4
[52] Gadžo supra 3 Chapter 2.1.5
[53] Gadžo supra 3 Chapter 2.1.5
[54] Gadžo supra 3 Chapter 2.1.5
[55] Ryngaert supra 43 pg. 787.
[56] Gadžo supra 3 Chapter 2.1.4

Another important feature of general international law noted in literature is the fact that the norms do not provide clear and straight forward regulation of the requirements to the genuine link[57] which confirm the importance of the flexibility of general international law[58].

To sum up it is necessary to emphasize that genuine link between state and subject matter is not clearly regulated by general international law, traditionally generally recognized are connections on the basis of the territory and personality. Customary international law applies malleable case-by-case approach to boundaries of such connection due to rapidly changing economic and political environment. Such boundaries depend on specific facts and circumstances of particular field of law. The definition of "genuine link" is a matter of assertion of jurisdictional claims, in particular, tax claims.

2.1.4 Regulation of tax jurisdiction in international law.

As defined above exercising of states tax jurisdiction is an expression of tax sovereignty[59]. State is in position to impose tax to claim tax on the basis of relationship between a state and: 1) taxable person, 2) taxable event.

On the one hand, a personal nexus between the individual and the state (e.g. residence) would imply the taxation of worldwide income (full tax liability). On the other hand, an objective link between the person and the state (e.g. a transaction) would imply only the taxation of the income earned in that state (limited tax liability).

As stated above the main opinion dominating in literature is an opinion that substantive income tax jurisdiction is subject to limitations arising from general international law. General international law is understood as a range of international law provisions binding for all relationships regulated under international law.

To examine income tax jurisdiction, it is assumed that there is the less debatable understanding on what is that an income tax – is a tax imposed on income of both individuals and legal entity[60].

Therefore, the concept of sovereignty – providing a theoretical explanation for the evolution of pure factual force (might) into force qualified by law (power) – is an inevitable starting point for the examination of a state's power to impose and collect taxes.

For the purpose of this thesis tax jurisdiction is an element of state jurisdiction and consequently is an aspect of state sovereignty[61].

It seems reasonable that substantive tax jurisdiction is subject to limitation arising from international law requirements regarding "reasonable

[57] Brownlie, supra 37 p. 313.
[58] Gadžo supra 3 Chapter 2.1.5
[59] F.D. Martínez Laguna, Abuse and Aggressive Tax Planning: Between OECD and EU Initiatives – The Dividing Line between Intended and Unintended Double Non-Taxation, 9 World Tax J. 2, p. 194 (2017), Journal Articles & Papers IBFD.
[60] International Monetary Fund and Statistics Department, Government Finance Statistics Manual 2014, pp. 91-92 (IMFund 2014).
[61] M. Lang, *Introduction to the Law of Double Taxation Conventions* p. 23 (Linde 2010)

connection" between the state and taxable persons or taxable event due to its consistency with general international law expressed in different opinions[62].

Doctrinal approach to tax nexus definition.

It is commonly agreed among tax scholars that being an element of tax jurisdiction from the perspective of general international law, the qualifying connection between state and subjective or objective elements of taxation limits state's power to claim and collect taxes. Such connection is often labelled as "tax nexus"[63].

Different scholars provide wide range of income tax nexus definition. Vogel limits the definition of nexus to sufficient connection between the taxpayer and the taxing State[64]. At the same time Lang provides broad and comprehensive definition of the tax nexus.

He defines nexus as a personal or objective connection between a state and person subject to tax and taxable event[65].

Some tax scholars assume that customary international law requires some form of the nexus, in particular personal and territorial connection, to limit substantive tax jurisdiction[66].

Connecting factors are usually grouped on the basis of whether of political or economic "allegiance" of the taxpayer to the respective state[67]. Gadžo emphasizes that fiscal residence or nationality are treated as political allegiance when the location of the income generating activity or source is a typical feature of economic allegiance[68].

Doctrinal approach to distribution of connecting factors under the international law slightly differs. It applies criteria of personal or territorial element of state sovereignty. Moreover, from the perspective of the principles of both nationality and territoriality, income tax nexus may be treated as core reasons to exercise substantive jurisdiction according to customary international law[69].

In conclusion, for the purpose of the research, it is referred to the understanding of the substantive tax jurisdiction, expressed in literature, which means the jurisdiction of state to claim income tax as one of the kinds of state jurisdiction to issue regulative acts.

Justification to tax

In his research Gadžo pays attention to the perspective of justification to tax as another perspective to assess connection between state and a taxpayer or a taxable event. This emphasizes the role of taxes as a source of public finance

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[62] Gadžo supra 3 Chapter 2.1.5
[63] Gadžo supra 3 Ch. 2.2.4
[64] K. Vogel, Klaus Vogel on Double Taxation Conventions p. 11
[65] M. Lang, Introduction to the Law of Double Taxation Conventions pp. 23-24 (Linde 2010).
[66] A. Rust, Double Taxation, in: Double taxation within the European Union p. 3 (A. Rust ed., Kluwer Law International 2011). R.S. Avi-Yonah, International Tax as International Law: An Analysis of the International Tax Regime p. 5 (Cambridge University Press 2007).
[67] W. Schön, International Tax Coordination for a Second-Best World (Part I), 1 World Tax J. 1, p. 67 (2009), Journals IBFD (**hereinafter – Schon**).
[68] Gadžo supra 3 Chapter 5
[69] Gadžo supra 3 Chapter 5

which used on public needs. It seems to be relevant that this is a natural economic effect of income tax which should be analysed from the perspective of the doctrine of economic allegiance (considered below). At the same time political loyalty is also a factor connecting state and some category of individuals creating substantial ground for a state to exercise tax claim. The theory of allegiance justifies differentiation between resident taxpayers (taxed on their worldwide income) and non-resident taxpayers (taxed on their sourced income in the respective state). Explanation for taxation of global income of a resident arises from the assumption that physical presence of fiscal residence consists with the deep engagement of an individual in the economic and social activity of the community[70].

Income tax nexus criteria

As was mentioned above that according to customary international law income tax nexus is required and it is represented as a qualifying connection between with personal and sovereign sides of a state. The connection is a result of certain engagement of a taxpayer in the political and economic fields of state's life. The following opinion in literature seems to be correct that the degree of the taxpayer's engagement in state's life determining the state's power to tax[71].

The example of implementation of personal nexus and a political allegiance of a taxpayer in legal basis is a concept of nationality (or citizenship). An implementation of territorial nexus and economic allegiance is represented by a concept of fiscal residence, for instance. Considering that significant digital presence concept is focused on the economic allegiance it is considered only residence and source criteria of connection between a state and a taxpayer. In this research it is ignored that the nationality criteria as irrelevant because it is an expression of political allegiance between taxpayer and a state.

Conclusions: there are two kinds of nexus: personal and territorial. The nexus is in the form of allegiance: personal (nationality or citizenship) and economic (residence, location of economic activity). Economic allegiance is based on the distribution of economic activity depends on the fact where the value is created.

The territorial type of connection is a prerequisite to the types of income tax nexus: 1) fiscal residence and 2) source, as the most used in practice[72].

Fiscal residence and source are two broad criteria embodying territorial income tax nexus, generally recognized in a literature. The criteria are stipulated by the type of territorial connection between a state and a taxpayer which allow to exercise tax claim in lawful manner.

First of all, it is necessary to establish doctrinal and international treaty positions to the criteria of fiscal residence. On the example of fiscal residence of individuals which described as a substantial and intimate[73] the tax scholars

[70] Gadžo supra 3 Chapter 5
[71] Gadžo supra 3 Chapter 3
[72] Gadžo supra 3 Chapter 3
[73] A. Nikolakakis, Civil Law and Common Law Perspectives: A View from the Left, in: Residence of Individuals under Tax Treaties and EC Law p. 76 (G. Maisto ed., IBFD 2010).

agreed that such type of link between a resident state and a taxpayer is strong enough to justify the tax claim in respect of taxpayer's global worldwide income and apply so-called "unlimited tax liability"[74]. Domestic tax law approaches to definition of tax residence varies and consider different criteria from the range of relevant facts and circumstances proving the presence of an individual and the concept of domicile to the temporal criteria which sets specific time limits of individual's presence on the state's territory to determine the residence[75]. From the perspective of the DTT there is only reference to the domestic tax provisions defining "resident" as "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature"[76]. It seems to be Considering that the provided definition contains some non-defined references there is an opinion that this definition in light of general DDT's goal set limits of the concept of residence according to general international law[77]. The common feature for different definitions of fiscal residence seems to be physical presence on the territory of resident state or at least reasonably deemed presence[78].

The residence concept applied to legal entities has some differences from the residence criteria applied to individuals. The main reason for that distinguishes is based on the legal nature of legal entities as a fiction concept stipulated by private law. Due to its artificial nature, legal entity is not in position to be a final payer of income tax.

It was noted in literature that the majority of states considers the resident concept as a primary tax nexus between a legal entity and a state.

There are two main approaches to determine the residence of legal entities: formal including so-called identification place of incorporation of registration (legal seat) of legal entity and the second one is factual including determination of effective management place[79].

The main difference of legal entities from the individuals is a lack of physical characteristics. Thus, it requires parameters to be measure for determination the fiscal residence of a legal entity which differ from described above for individuals.

The common denominator for different kinds of the place-of-management tests for fiscal residence of legal entities seems to be the idea that doing business place is a place where that business is managed. It also brings to conclusion that place of doing business or operational activity is fully

[74] J. Monsenego, Taxation of Foreign Business Income within the European Internal Market: An Analysis of the Conflict between the Objective of Achievement of the European Internal Market and the Principles of Territoriality and Worldwide Taxation, (**hereinafter - Monsenego**) pg. 76 https://ex.hhs.se/dissertations/419437-FULLTEXT01.pdf
[75] Gadžo supra 3 Chapter 5
[76] Commentary on Article 4 of the OECD Model 2017 para. 4.
[77] Gadžo supra 3 Chapter 2.2.7.2.1.
[78] Gadžo supra 3 Chapter 5
[79] Zornoza Perez distinguishes formal tests of legal entities' residence from the "substantial" tests; *see* J. Zornoza Perez, *Changing Residence as Tax Planning* (2013), available at http://hdl.handle.net/10016/18175.

irrelevant from the perspective of determination of fiscal residence[80]. The same approach seems to apply in legal seat test. From the perspective of tax treaty provision, the "place of management: may be treated as a criterion under the category of "any other criteria of a similar nature" as stated in article 4(1) of the OECD Model.

Overall, fiscal residence is commonly accepted base of income tax jurisdiction assertion. The concept demonstrates primary nexus for the purpose of income taxation which based on sufficient connection between subjective element of taxable matters and a state. territoriality principle of general international law is embodied in fiscal residence concept. States are in position to exercise their tax jurisdiction in respect of individuals or legal entities on the basis of territorial link. Under the international law the link is limited. The limitation for individuals is set from temporal element (not a short time of being present on the state's territory) and substantial (physical presence of an individual on the territory of a state). The same logic to the limitation of connection is set for determination of place of economic interest (i.e place of management) for determination of legal entity fiscal residence[81].

Source criterion

Under the general international law, persons may be subject to income tax jurisdiction even they are outside the personal sphere of sovereignty and fail to have fiscal residence. The case require connection between state and objective element of taxable object (income)[82]. Subjective element of taxable matter is ignored for the purpose of this kind of territorial income tax nexus[83]. This form of tax nexus does not concern a personal sphere of tax sovereignty and represents only economic interest of the taxpayer localized in state's territory. That kind of nexus unlike fiscal residence nexus and nationality is referred as "secondary nexus". The definition of "source of income" refers the form of territorial tax nexus.

In literature the concept of source is debatable. However, it seems to be persuasive that the general feature is that the location of value creation determines the right of state to tax that income. For sure, the ambiguity of source concept was identified in literature. However, represented by that concept the territorial principle seemed to set some wage boundaries. Some authors state that the right of states to tax income earned on its territory is so natural as right to dispose over natural resources within their territory[84].

There was found only one option when the source rules are definitely described under the international law which also confirmed by some scholars. The income arising from immovable property is fully regulated and such regulations under the OECD and UN Models are explicit. Gadžo notes that the consistency of state's practice with the provision of DTT is enough to prove the required factor of source taxation (generally agreed among states

[80] M.J. McIntyre, Determining the Residence of Members of a Corporate Group, 51 Canadian Tax Journal 4, p. 1568 (2003)
[81] Gadžo supra 3 Chapter 2.2.7.2
[82] Monsenego, supra 83 p. 46.
[83] Gadžo supra 3 Chapter 2.2.7.3
[84] M.J. Graetz, The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, 54 Tax Law Review 3, p. 299

and international community) – physical existence of immovable property on the territory of a source state[85]. It seems that a lack of this fact makes the taxation of immovable property income of non-residents lawful from the perspective of state sovereignty and technically hard.

The determination of source of income is treated as more complicated than the identification of fiscal residence[86].

The specific kind of income is a predominant determining income tax source rules. Usually, the income is treated as active (earned from doing business) and as a passive (income generated mostly from investment or e.g. rental income)[87]. The core consequences of different kind on income is the fact that source of income arising from business activity is a place income's production and the source of passive income is usually identified as a place of location of asset generating income or the place of residence of payer of the income[88].

With regard to the provisions of DTT's regulating income source rules it is necessary to say a few words regarding its status as a norm of customary international law. There are debates regarding its status in literature. Monsenego and Gadžo seek the status of the provisions of Model Conventions and their commentaries as doubtful because of arguable subjective element of the DTT provisions application. In other words, being a provision of bilateral treaty the specific provisions of DTT is binding only to states participating in such treaty[89]. However, there is an opposite opinion in doctrinal literature stating that model tax treaties (or their commentaries) may be treated as source of customary international law due to the fact of general practice arising from their legal relevance in the international tax framework.

Regardless the non-binding nature of models of international treaty many states refer the OECD model, for instance, as a basis for the own tax treaties. The existing of general practice may allow to consider model's provisions as a norm of customary international law but with arguable subjective element[90].

Scholars performed research regarding the source rules at domestic level and made a conclusion that there is a lack of consensus between domestic provisions and provisions of OECD Model.

Another important feature which is mandatory to be mentioned is the nature of income. Being an abstract concept, an income does not belong to physical world[91]. At the same time the source concept of income taxation represents territorial sphere of tax sovereignty. To merge these two opposite spheres the certain proxies are used which also affect the strength of the connection

[85] Gadžo supra 3 Chapter 2.2.7.3.1
[86] Prebble, Ectopia, Tax Law and International Taxation, British Tax Review 5, p. 385 (1997), p. 386
[87] Passive Income in International Tax Glossary, Glossary IBFD
[88] Gadžo supra 3 Chapter 2.2.7.3
[89] Monsenego supra 83, pg. 90
[90] Elizabeth Gil García The Single Tax Principle: Fiction or Reality in a Non-Comprehensive International Tax Regime? World Tax Journal August 2019 pg. 331
[91] J. Prebble, Ectopia, Tax Law and International Taxation, British Tax Review 5, p. 386-387 (1997)

subject to tax type of economic activity is a predominant for proxy of a source[92].

The substance and form of assets engaged in economic activity affect the proxy used in determination of source. For instance, rental income arising from tangible property has only one logical proxy – the location of the property[93]. Thus, territorial location of assets may be used to determine source of income. However, the appropriateness of such possible proxies is subject to discussion. As stated in literature there are no limitations in international law on using of any kinds of proxies to determine source of income for income tax purposes[94].

To sum up, source of income as a ground of substantive income jurisdiction applies to the income earned by non-residents with certain degree of economic interests in the state's territory. The connection between the territory and earned income justifies the right of state to tax. Such justification is born from the understanding that income's "drivers" are localized within state's territory. Legal act is required to localize growth of wealth subject to tax[95]. The role of source rules established in OECD and UN Models are subject of discussion from the international law perspective. The legality of any source rules is stipulated by the reasonable connection between a state's territory and economic activity resulting in taxable tax[96].

Generally, qualifying connection (nexus) between subjective or objective elements of taxable matter and territorial side of state sovereignty is a core boundary for income tax jurisdiction.

At present moment all qualifying connections are considered from the perspective from the following three criteria demonstrating income tax nexus: nationality, fiscal residence and source of income[97].

From the perspective of international law fiscal residence and source of income concepts reflects of the principle of territoriality for the purpose of income tax. Territoriality connection under fiscal residence and source of income concepts relate to subjective and objective elements of taxable matter, respectively[98]. The only requirements set under the general international law is a reasonable territorial connection to execute fiscal residence and income source concepts. General international law regulation of substantive income tax jurisdiction is limited, and state's imposition of income tax claim is mostly a matter of tax policy[99].

[92] Gadžo supra 3 Chapter 2.2.7.3
[93] K. Vogel, "State of Residence" May as Well Be "State of Source" - There Is No Contradiction, 59 Bull. Intl. Taxn. 10, p. 420 (2005).
[94] Gadžo supra 3 chapter 2.2.7.3
[95] K. Vogel, "State of Residence" May as Well Be "State of Source" - There Is No Contradiction, 59 Bull. Intl. Taxn. 10, p. 420 (2005).
[96] Gadžo supra 3 Chapter 2.2.7.3
[97] M.F. de Wilde, "Sharing the Pie": Taxing Multinationals in a Global Market (Erasmus University Rotterdam 2015)
[98] Vogel, p. 422.
[99] Gadžo supra 3 Chapter 2.3

3 Whether the Significant digital presence concept justify allocation of state's taxing rights from the perspective of economic allegiance.

The chapter will discuss the matter of justification of allocation of taxing rights within the Proposed rules of significant digital presence under the traditional concept born simultaneously with the global income system – economic allegiance concept.

3.1 The relevance of value creation concept as a basis to allocate taxing rights.

Before starting the main discussion, it is necessary dive into the declared by the EU documents[100] idea of value creation principle underpinning the significant digital presence according to the EU Commission documents. The main question required to be answered is whether the value creation principle is a relevant justification of allocation of taxing rights?

On the basis of OECD Base Erosion and Profit Shifting (BEPS) Project the concept of value creation was widely represented for the international tax discussions. It is a concept in economics which has been discussed among the international tax community for some period. The Interim OECD Report pay attention to the value creation issues in its few chapters[101]. Regardless of different versions of a concept[102] value creation is considered mostly from the perspective of an entity rather than customers[103].

It is expressed in literature that value creation is a source principle from the perspective of taxing rights allocation[104]. There is a range of arguments regarding the doubtfulness to apply value creation principle for allocation of taxing rights.

First of all, it is necessary to note the discussable status of the concept meaning. The value creation concept is subject to discussion among modern scholars and there is no single approach regarding its meaning[105]. The chances to rich generally agreed definition of valued creation are doubtful. Therefore, the controversy of the concept seems to be its drawback.

Another one arguable feature is the ability to justify wide range of taxing rights allocation proxies. It may be simultaneously used to justify destination-based taxation, considering customers role in value creation;

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[100] Proposal SDP preface

[101] OECD/G20, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, ch. 2 pp. 23-82 (OECD 2018)

[102] It means the following versions: (i) value chain; (ii) value network; and (iii) value shop. See. M. Porter, Competitive Advantage Creating and Sustaining Superior Performance, The Free Press, New York (1985), S. Greil & L. Wargowske, Pillar 1 of the Inclusive Framework's Work Programme: The Effect on the Taxation of the Digital Economy and Reallocation of Taxing Rights, 73 Bull. Intl. Taxn. 10 (2019), Journal Articles & Opinion Pieces IBFD (accessed 24 May 2021), OECD/G20, Interim Report 2018

[103] R.R. Das, The Concept of Value Creation: Is It Relevant for the Allocation of Taxing Rights?, 74 Bull. Intl. Taxn. 3 (2020) (**hereinafter – R.R, Das**), Journal Articles & Opinion Pieces IBFD (accessed 24 May 2021). Chapter 2.1

[104] J. Hey, "Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative, 72 Bull. Intl. Taxn. 4/5, sec. 2.4. (2018), Journal Articles & Papers IBFD.

[105] R.R. Das supra 112 Chapter 2.2

residence-based taxation, on the basis of control of business risks by parent company[106]. Such approach may lead to uncertainty and chaos in assertion of tax claims in cross-border transactions.

Complexity and ambiguity of measurement and determination of value creation seems to be one more negative feature of the principle. Being a multi-jurisdictional MNE contribute various input in final product delivered to end users. At present moment it is arguable that there is clear and precise method to distinguish the share of value of each contributor arising from synergy and surplus of MNE supply chain. It is hard to allocate such surplus and trace the various stages of a final product of service[107].

3.2 Current situation with allocation of taxing rights of a source from the perspective of economic allegiance.

As was mentioned earlier the rules of domicile and origin (sources) are considered to be a basis for allocation of taxing rights at the convention and domestic level[108]. As it demonstrated from the analysis of Model Conventions taxation of royalties or interests is not based on value creation principle and the taxing rights are mostly allocated to residence states according to OECD Model Convention and justification to allocate taxing rights is not based on value creation principle[109].

With regard to the business income "sharing pie" fiscal domicile and source (PEs) principle govern allocation of taxing rights in international cases according to UN and OECD Model Conventions. Thus, not a value creation principle, but an economic allegiance principle applies to allocate taxing rights in interstate situations[110].

3.3 Proxies in present PE concepts reflecting economic allegiance.

Generally, cross-border cases regarding taxing rights of business income is subject to regulation of double tax treaties mostly based on Model Conventions. OECD Model is one of the most popular. Due to this it is reasonable to refer its relevant provisions representing PE concept. Overall, existence of a PE arranges taxing rights in respect of business profits earned by non-residents. Being out of scope of PE business income is not subject to tax at source state.

The initial idea of PE concept represents political compromise regarding allocation of taxing rights. PE thresholds have to reflect the proper degree of an engagement in economic life and allegiance of non-resident taxpayer to

[106] S.C. Morse, Value Creation: A Standard in Search of a Process, 72 Bull. Intl. Taxn. 4/5, sec. 2. (2018), Journal Articles & Papers IBFD

[107] IMF, Policy Paper, Corporate taxation in the global economy p. 18 available at www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650.

[108] OECD Model Tax Convention on Income and on Capital (21 Nov. 2017), UN Model Double Taxation Convention between Developed and Developing Countries (1 Jan. 2017

[109] R.R. Das supra 112 Chapter 4

[110] R.R. Das supra 112 Chapter 4

the state where the PE located physically, and it indicates the sufficiency of taxpayer's engagement in economy to justify taxing rights of a source state[111].

The figure of PE, the scope of which is described in Article 5 OECD MC and in the Commentaries on the same, represents an exception to the provisions of Article 7.1 OECD MC, which states that the profits of an enterprise of a Contracting State shall be taxable only in that State.

In particular, PE provisions according to article 5 OECD Model is an exemption to general rule set under article 7 OECD Model which delimit that income of entity shall be taxed only at residence State. Let see below the conditions required for such exemption.

"Place of business" is a feature required to recognise PE and it includes any facilities or premises needed for business purposes according to Article 5 OECD Model[112].

The following feature required for PE is a characteristic of the place of business. The place of business needs to have some territorial and temporal features, in particular, temporary stable geographical link with a territory of a state[113].

Finally, the activity of such establishment has to be productive. Any preparatory or auxiliary activity do not fit for the definition of establishments. Otherwise, the presence of a company may have form of representative office, for instance[114].

Overall, from the perspective of tax treaty there is the understanding of the PE concept as a general proxy for source state[115].

Described elements generalize the PE concept from the tax treaties perspective. Generally, mentioned above features are basic and do not cover further developing of a PE concept such as "building sites or construction projects" or "dependent agent PE".

3.4 Economic allegiance as justification of taxing rights.

Within the starting point of research, it is relevant to look at the principle of economic allegiance described in the Report.

3.4.1 Economic allegiance criterion

To research this question, it is required to refer to the one of the core documents which underlined principles of elimination of double taxation - Report on Double Taxation submitted to the Financial Committee — Economic and Financial Commission Report by the Experts on Double Taxation, also broadly known as "Report of four economists".

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[111] José Ángel Gómez Requena, 'Adapting the Concept of Permanent Establishment to the Context of Digital Commerce: From Fixity to Significant Digital Economic Presence', (2017), 45, Intertax, Issue 11, pp. 732-741, p.734 https://kluwerlawonline.com/journalarticle/Intertax/45.11/TAXI2017063
[112] OECD MC Commentary Art. 5 (1), para. 4.
[113] OECD MC Commentary Art. 5 (1), para. 5.
[114] OECD MC Commentary Art. 5 (1), para. 3.
[115] Gadžo supra 3 Chapter 4.8

Practically, the Report recognized the mandatory role of source-based taxation and furthermore tried to provide arguments for system of source and residence taxation in a benefit-based concept also known as "economic allegiance". Benefit-based concept of taxation justifies so-called "production of wealth" and "disposition of wealth"[116].

The Report distinguishes three fundamental considerations of economic allegiance:

(1) production of wealth;

(2) possession of wealth;

(3) disposition of wealth and

(4) acquisition of wealth.

On the basis of these considerations four criteria apply to consider proper place of taxation: (1) origin of wealth; (2) the situs of the wealth; the principle of legal rights to the place; (3) enforcement of the rights to wealth; the principle of consumption or appropriation or disposition to the place of (4) residence or domicile[117].

The criteria meaning is explained within the Report. With regard to the situs of the wealth and the principle of legal rights to the place the Report stresses that it is necessary do distinguish taxes on income and capital gain. To determine the right place of taxation of income it is necessary to identify place or income's origin i.e. where the earnings are created. The authors of the Report distinguish the physical location of situs from the place of real economic location. The physical situs should be considered for the purpose of economic allegiance to extend it is in line with true economic location[118]. Economic location is more valuable compared to the factor of physical situs from the perspective of determination of right place of taxation.

The following four main questions are required to determine the economic obligations under considerations:

> "(1) Where is the yield physically or economically produced?
>
> (2) Where are the final results of the process as a complete production of wealth actually to be found?
>
> (3) Where can the rights to the handing-over of these results be enforced?
>
> (4) Where is the wealth spent or consumed or otherwise disposed of?"

Moreover, the Report underlines the importance of the origin of income and the domicile of the ultimate owners compared to the location of final products

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[116] All of a Piece Throughout: The Four Ages of U.S. International Taxation Reuven S. Avi-Yonah

[117] League of Nations, Double Taxation and Tax Evasion – Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, Publications of the League of Nations – Economic and Financial, C.216 M.85, April 1927.

[118] League of Nations, Double Taxation and Tax Evasion – Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, Publications of the League of Nations – Economic and Financial, C.216 M.85, April 1927.

and the place of enforcement of such rights. At the same time case-by-case approach is suggested to assess the importance of above-mentioned factors simultaneously.

It may be concluded the following that economic allegiance is a core connection between a state and subject matter. Income generation is treated as an important element determining the right to tax within source-based paradigm. There is a great difference between so-called "physical situs" and place where the income is earned.

3.4.2 Economic allegiance as an element of inter-nation equity

It is necessary to note regarding the nature of equity in context of economic allegiance because of its connection[119]. Equity requirements usually are assessed from the perspective of the benefit principle and ability to pay principle. Benefit principle determines equity in taxation as correlation between amount of tax and the scope of consumed public benefits. Ability to pay principle linked of tax liability with economic capacity of taxpayer regardless the level of public good's consumption.

At international level equity concepts may rise a range of difficult questions, in particular, within the case when source and resident states may be entitled to tax income. Application of single tax principle at international level require careful and through approach. It is noted in literature that ability to tax principle obliges states to allocate tax burden among their residents[120]. There is an opinion that in case of cross-border taxation comprehensive applicability of "ability to pay principle" seems to be doubtful[121]. From the perspective of international taxation assessment only economic capacity seems to be not enough for resolving core issue of international taxation – sharing taxing rights[122]. Though, a separate application of "ability to pay principle" may ignore the taxing rights of source states under international law[123]. In terms of tax sovereignty paradigm, it is possible to identify two sides of tax equity: inter-taxpayer equity and inter-nation equity[124]. Inter-nation equity considers the matter of allocation of taxing rights among sovereign states. Thus, it is more reasonable to focus on this concept.

It was submitted in literature that certain degree of inter-state mutual recognition to prevent double taxation and non-taxation from the perspective of tax justice. Most generally accepted tax principles require the income should be taxed only once[125]. This principle was formalized and developed by Avi-Yonah. He calls it as "single tax principle" of international tax[126]. Due

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[119] N.H. Kaufman, *Fairness and the Taxation of International Income*, 29 Law and Policy in International Business 2, p. 194 (1998)
[120] Gadžo supra 3 Chapter 5.1.2.
[121] W. Schön, International Tax Coordination for a Second-Best World (Part I), 1 World Tax J. 1, p. 67 (2009), Journals IBFD.
[122] Gadžo supra 3 Chapter 5.1.2
[123] Gadžo supra 3 Chapter 2.2
[124] M.F. de Wilde, "Sharing the Pie": Taxing Multinationals in a Global Market (Erasmus University Rotterdam 2015). P.44
[125] R.S. Avi-Yonah, Who Invented the Single Tax Principle? An Essay on the History of US Treaty Policy, 59 New York Law School Law Review (2014)
[126] R.S. Avi-Yonah, International Tax as International Law: An Analysis of the International Tax Regime p. 5 (Cambridge University Press 2007) p.10;

to wide interest to this principle in literature underline the importance of its for the tax policy purposes. The role of benefit principles is quite important due to its ability to justify taxation of non-residents aliens, consuming public goods. Thus, it is usually used by source states to justify cross-border income taxation[127].

Another side of inter-nation equity is economic allegiance principle. The inter-nation equity theory was developed by Peggy Musgrave to discover the source states justification of tax. The following justification criteria were evoked: (ii) principle of territorial sovereignty; (iii) derivation of economic rents from the source country; and (iv) distributional concerns on an international level[128].

The relevance of inter-equity concept is proved by an interest among recent research of tax writers[129]. There is a lack of recommendations in favor of precise metrics and standards of inter-nation equity. The ability to pay and benefit principles seem to be out of inter-nation equity concepts and no substitutes of that principles are suggested[130]. Fairly it is recognized in literature that inter-nation equity concept has a lack of certainty and practical recommendations[131]. However, it is admitted its widely acceptance and undervaluation as tax policy criteria[132].

It was pointed out in literature that there are some connections between the doctrine of economic allegiance (which grounds existing system of tax rights allocation) and inter-nation equity concept. The modified form of economic allegiance concept is used in League of nations famous 1923 repot. Some authors see parallels between the reference to the level of taxpayer's economic engagement under the economic allegiance doctrine and the ideas of inter-nation equity concept[133]. The requirement to consider degree of economic engagement of a taxpayer to determine taxing rights seems to be in line with inter-nation equity idea[134]. There are substantial research regarding benefit principles to justify to tax. Overall, public goods and benefits provided by the state and consumed by a non-resident which has economic activity may be considered as a factor justifying taxation by such "source country". Logically, such provided public goods should be consumed by taxed non-resident within its activity.

To sum up, from an inter-taxpayer equity perspective, nexus rules should take into account the benefits provided by the taxing state, since these benefits justify a taxing claim. Accordingly, whenever a non-resident alien enjoys

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[127] W. Schön, International Tax Coordination for a Second-Best World (Part I), 1 World Tax J. 1, p. 67 (2009), Journals IBFD.

[128] Gadžo supra 3 Chapter 5

[129] Gadžo supra 3 Chapter 5

[130] Gadžo Chapter 5.1.3

[131] Brooks, Kim. (2008). Inter-Nation Equity: The Development of an Important but Underappreciated International Tax Value.

[132] R.S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harvard Law Review 7, p. 1648

[133] Gadžo supra 3 Chapter 5.1.3

[134] E. Kemmeren, Principle of Origin in Tax Conventions: A Rethinking of Models p. 18 (Pijnenburg Vormgevers/Uitgevers 2001) (**hereinafter - E. Kemmeren**).

benefits from the public sector of the taxing state, the taxing claim may be deemed justified.

It is submitted in literature that do determine tax equity the ability to pay principle, the benefit principle and the economic allegiance doctrine apply[135]. In literature, the nexus provisions are assessed in terms of "legitimation" or "justification" aspects of tax equity[136]. Considering the principles applied withing inter-nation equity concept beneficial theory seems the most relevant to the problem of justification to tax. Economic allegiance doctrine needs to be mentioned as a normative standard to assess allocation of taxing rights which may be boiling down to the rule: no restrictions should arise regarding taxing rights if taxpayer has strong economic interest under tax nexus provisions[137]. Following this standard there is a problem how to determine state with more economic allegiance (source of income) fairly. Comprehensive economic concept of the source of income is a predominant required to identify where the wealth originates (factor of economic allegiance under the Report). However, there is no clear answer on this question in modern economic literature[138]. Research on proper location of income source may boiling down to determination of specific "ingredients" of income earned within different kinds of business (operations). To identify economic relevant activities, two broad theories are mentioned in literature: (1) "supply approach" and (2) "supply-demand" approach[139].

To determine the source of income the supply approach relies on the geographical positions of assets and other production factors engaged in income generating business process (capital, labour forces and tangible property). In opposite supply demand approach focuses on the market features. Within such approach it assumed that interaction of supply and demand lead to generation of profits[140]. Generally, it looks like the supply approach is more preferable in doctrinal environment due to the doubts regarding the determination the place of demand[141]. Nevertheless, the discussion regarding relationships between approaches is not finalized and economic allegiance may be recognized on the basis of customer base location due to the reasonable arguments[142].

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[135] E. Kemmeren supra pg. 20
[136] K. Vogel, Worldwide vs. Source Taxation of Income: A Review and Re-Evaluation of Arguments, in: Influence of tax differentials on international competitiveness: Proceedings of the Munich Symposium on International Taxation p. 154 (Kluwer Law and Taxation Publishers 1990).
[137] Gadžo supra 3 Chapter 5.1.4
[138] Gadžo supra 3 Chapter 5.1.4
[139] M.F. de Wilde, "Sharing the Pie": Taxing Multinationals in a Global Market (Erasmus University Rotterdam 2015) pg. 302
[140] K. Vogel, Worldwide vs. Source Taxation of Income: A Review and Re-Evaluation of Arguments, in: Influence of tax differentials on international competitiveness: Proceedings of the Munich Symposium on International Taxation p. 160.
[141] Schäfer, Anne and Spengel, Christoph, ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation (2002). ZEW Discussion Paper No. 02-81, Available at SSRN: https://ssrn.com/abstract=392924 or http://dx.doi.org/10.2139/ssrn.392924 pg. 11
[142] Schön, supra 73 pg. 92.

In summary, to fulfil the requirements of economic allegiance nexus norms should consider the location income-producing factors and provision of public benefits relating to the respective economic activity[143].

3.5 The assessment of SDP ability to justify allocation of taxing rights from the perspective of economic allegiance.

At this stage it is relevant to reconsider the main criteria researched above to evaluate nexus norms under EU proposals. As mentioned before, nexus norms should be in line with the general requirements under the international law establishing the external boundaries of state's tax jurisdiction. Furthermore, nexus norms need to be evaluated from the perspective of economic allegiance in particular the involvement of taxpayer in economy of a source state.

Overall, in terms of normative standards provision regulating nexus should meet the following requirements: fulfil with boundaries set under the general international law in respect of income tax jurisdiction and represent requirements to proxy demonstrating economic presence of a taxpayer.

Rapid and comprehensive digitalization of global economy significantly changes the business model and economic landscape. Under this changes current nexus concept seems to be outdated and need to reconsideration for fair and effective taxation.

It was predictable that new digital environment requiring update of the PE concept was subject to tax research[144].

BEPS Action 1 reveal the idea to limit reconsideration of PE deeming rules only to highly digitalized transactions (e-commerce)[145] and some states have started consideration of unilateral measures (France, Belgium, UK, Spain and the list is not final).

The EU introduced a package of proposals in the field of digital taxation:

1) Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence COM (2018) 1 2018/0072 (CNS);
2) Proposal for a COUNCIL DIRECTIVE on the common system of a digital services tax on revenues resulting from the provision of certain digital services COM (2018) 148 final 2018/0073 (CNS);
3) Proposal for a COUNCIL DIRECTIVE amending Directive 2011/16/EU on administrative cooperation in the field of taxation COM (2020) 314 final.

To answer on research question, it seems to be relevant to focus on the provisions regulating significant digital presence.

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143 E. Escribano López, An Opportunistic, and yet Appropriate, Revision of the Source Threshold for the Twenty-First Century Tax Treaties, 43 Intertax 1, p. 9 (2015).

144 R.S. Avi-Yonah, International Taxation of Electronic Commerce, p.511

145 OECD, Addressing the Tax Challenges of the Digital Economy (OECD 2014), pp. 143-145.

3.5.1 Scope and taxable subject under the proposed significant digital presence rules.

SDP Directive propose to introduce significant digital presence rules which have the following wording:

> "1. For the purposes of corporate tax, a permanent establishment shall be taken to exist if a significant digital presence exists through which a business is wholly or partly carried on.
>
> 2. Paragraph 1 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 the purposes of corporate tax, whether specifically in relation to the supply of digital services or otherwise.
>
> 3. A 'significant digital presence' shall be considered to exist in a Member State in a tax period if the business carried on through it consists wholly or partly of the supply of digital services through a digital interface and one or more of the following conditions is met with respect to the supply of those services by the entity carrying on that business, taken together with the supply of any such services through a digital interface by each of that entity's associated enterprises in aggregate: (a) the proportion of total revenues obtained in that tax period and resulting from the supply of those digital services to users located in that Member State in that tax period exceeds EUR 7 000 000; (b) the number of users of one or more of those digital services who are located in that Member State in that tax period exceeds 100 000; (c) the number of business contracts for the supply of any such digital service that are concluded in that tax period by users located in that Member State exceeds 3 000.
>
> 4. With respect to using digital services, a user shall be deemed to be located in a Member State in a tax period if the user uses a device in that Member State in that tax period to access the digital interface through which the digital services are supplied.
>
> 5. With respect to concluding contracts for the supply of digital services: (a) a contract shall count as a business contract if the user concludes the contract in the course of carrying on business; (b) a user shall be deemed to be located in a Member State in a tax period if the user is resident for corporate tax purposes in that Member State in that tax period or the user is resident for corporate tax

> purposes in a third country but has a permanent establishment in that Member State in that tax period.
>
> 6. The Member State where a user's device is used shall be determined by reference to the Internet Protocol (IP) address of the device or, if more accurately, any other method of geolocation.
>
> 7. The proportion of total revenues referred to in paragraph 3(a) shall be determined in proportion to the number of times that devices are used in that tax period by users located anywhere in the world to access the digital interface through which the digital services are supplied.[146]"

The following elements of significant digital presence concept may be identified:

With respect to the matters subject to taxation the SDP Directive covers only income arising from provision of digital services. The scope of digital services under the SDP is limited to digital services and distinguished from supply of goods or services which are facilitated with using internet or other electronic networks. The importance of provision distinguishing electronic services from traditional services was noted in literature and its importance is stressed because of complexity to distinguish digital services and traditional commerce[147].

The following element relied to definition of digital PE is a number of users and business contracts originated from particular jurisdiction. It means that PE would be considered to exist if more than 100 000 users located in that Member State within tax period consumed the digital services or the digital services contracts concluded with users in that Member State exceed 3 000 in that tax period. According to the opinion of Hongler and Pistone such kind of thresholds may correspond to the public benefits consumed by the enterprise in a market state and the amount of value created therein[148]. Moreover such "user – based" approach is praised and reasoned by the OECD[149].

At the same time the SDP rules do not contain temporary criteria determining existing of deemed PE unless the OECD Model contains such threshold in current PE rules. The reference to temporary criteria in proposed rules is blurred and represented by phrase "… that tax period…". These criteria correspond with users and revenue thresholds.

Another alternative threshold is a revenue derived from treated as sufficient demonstration of territorial connection is a revenue generated from the territory of respective Member State (7 million EUR) within that tax period.

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[146] Proposal for a COUNCIL DIRECTIVE laying down rules relating to the corporate taxation of a significant digital presence COM/2018/0147 final - 2018/072 (CNS) Article 4

[147] Gadžo supra 3 Chapter 6.4

[148] . Hongler & P. Pistone, Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy, SSRN Scholarly Paper ID 2586196, Social Science Research Network, p. 16 (2015), available at http://papers.ssrn.com/abstract=2586196. Pg. 25

[149] OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, pp. 110-111

The role of originated from exact state revenue threshold is to prove the economic allegiance according to provisions Final Report on BEPS Action 1[150]. It is assumed that the main reason to use three thresholds alternatively to avoid narrow scope of regulated relationships and effective capture of business models with indirect revenue generation[151].

According to the para 6 of Article 4 to identify territorial localization of users the IP address or any other method of geolocation are referred. This element of thresholds is subject to some concerns expressed in literature. First of all, the technical side of the IP address as a territorial link is subject to concern.

IP address is understanding as a form of geo-location technology translating Internet Protocol of a device into its geographical location via providers of geo-location services[152]. The accuracy of the technology because of its nature is discussed at present time and confirmed by the providers of such services[153]. Moreover, users apply technologies hiding their true location on the voluntary basis and this factor increase the equivocality of the proposed technology of users' identification[154].

As it was mentioned the proposed PE rules are ground-breaking compared to existing concept of PE regulation. It provides source states to tax income of non-residents which are not physically presented in the state's territory in in terms of existing PE concept. Such innovative approach substantiate needs to examine it's compliance from the perspective of general international law regulating tax jurisdiction's matters. As was mentioned in previous chapter states have to establish genuine link with taxable subject in spatial (territorial terms) terms according to international law. It is the only requirement in respect of "proxies" pointing the location of source of income from the perspective of international law. Thus, proposed significant digital presence rules do not breach the international law. Regardless the discussion on relevance of IP address as a geographical proxy of the source, the source of income is geographically linked via localization of users, concluded contracts and revenue thresholds under the presented rules. Therefore, it seems that proposed SDP should not be rejected as being contradicting to general international law[155].

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[150] OECD, supra n. 155, p. 107.

[151] European Commission, Commission Staff Working Document, Impact Assessment, Accompanying the document Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence and Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, Brussels, 21.3.2018 SWD(2018) 81 final/2, p. 29 and 45

[152] Svantesson, D. (2007). E-commerce tax: How the taxman brought geography to the 'borderless' Internet. Revenue Law Journal, 17(1). https://rlj.scholasticahq.com/article/6696 pg. 5

[153] Svantesson, D. pg 7

[154] Escribano, Eva, A Preliminary Assessment of the EU Proposal on Significant Digital Presence: A Brave Attempt that Requires and Deserves Further Analysis (January 1, 2019). Almudí Cid, J.M; Ferreras Gutiérrez, J.; Hernández González-Barreda, P. (2018): Combating Tax Avoidance in the EU: Harmonisation and Cooperation in Direct Taxation (Alphen aan den Rijn: Kluwer Law International 2019), Available at SSRN: https://ssrn.com/abstract=3191787 or http://dx.doi.org/10.2139/ssrn.3191787 pg. 588

[155] W. Schön, International Tax Coordination for a Second-Best World (Part I), 1 World Tax J. (2009), Journal Articles & Opinion Pieces IBFD (accessed 21 May 2021) Chapter 4.2.1

Considering from the perspective of equal distribution of taxing rights among the states involved to some extend in generation of the cross-border income compared to traditional PE nexus the SDP rules seems to be more advantageable providing wider taxing rights to non-PE market states. Considering that SDP rules follow the opinion that the market states provide access to public benefits, consumed withing generation of non-residents business income, even there is no physical presence - they may justify taxing rights under the benefit theories[156]. User and revenue thresholds localizing at particular territory seems to be recognize economic allegiance to market states and are a good proxy for public benefits[157].

4 Conclusions.

The purposes of this research were to reconcile nexus under the EU Commission proposal of significant digital presence with general international law requirements in respect of nexus and its boundaries and understand whether the proposed rules justify allocation of taxing rights from the perspective of economic allegiance.

The concept of "nexus" in tax matters originates from the United States legal system. The development of this concept in the US tax system shows extension from the physical presence concept and its reconsideration in broader meaning instead of narrow treatment on the basis of the physical realm.

The specific goal of EU primary law puts the double taxation matter beyond its regulation. The ECJ practice shows that double taxation issues are not subject to the concern of ECJ if the state's regulations do not breach fundamental freedoms. Considering that EU primary law does not concern regarding double taxation issue, it is necessary to resolve it according to requirements of international law. International public law seems to be relevant to regulate the matter of connection between state and enterprise, in particular, in cases of extraterritorial application of taxing rights.

From the perspective of international law, fiscal residence and source of income concepts reflect of the principle of territoriality for the purpose of income tax. Territoriality connection under fiscal residence and source of income concepts relate to subjective and objective elements of taxable matter, respectively. The only requirement set under the general international law is a reasonable territorial connection to execute fiscal residence and income source concepts.

Elimination of simultaneous exercising of jurisdictions is one of the core goals of international law. It is generally recognized the genuine link on the basis of the territory or personality. Customary international law approach to boundaries of such connection is malleable on case-by-case basis. It is predetermined by rapid changes in the economic and political environment. Particular fields of law determine the boundaries of such link. The tax

[156] P. Hongler & P. Pistone, Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy, SSRN Scholarly Paper ID 2586196, Social Science Research Network, p. 16 (2015), available at http://papers.ssrn.com/abstract=2586196. P.24

[157] Gadžo supra 2 Chapter 7.1.1.1

jurisdiction of a state reflects state sovereignty. Substantive tax jurisdiction consistency with general international law determines limitations of reasonable connection between state and taxable persons or taxable event.

At the present moment, qualifying connections are implemented under three concepts: nationality, fiscal residence, and source of income.

On the example of existence residence and source of income concepts it was demonstrated the reflection of territoriality principle in income taxation of cross-border cases. The territoriality principle under residence and source concepts is implemented within the subjective and objective elements. Thus, the reasonable geographical (territorial) connection is the only requirement limiting tax jurisdiction.

The concept of fiscal residence is the usual ground for exercising of tax jurisdiction. Fiscal residence mostly represents genuine link between state and personality. However, the territoriality principle is partially implemented in the residence concept. In respect of individuals, the limitation of the link is based on temporal and physical parameters (time of being physically present on the territory of the state). The similar approach applies to the limitation of connection with legal entities.

Degree of economic interest (engagement in economic life) of non-resident taxpayer limits application of source of income concept to execution of substantive tax jurisdiction. Genuine link between earned income and territory of a state justifies taxing rights of a source state which needs formalisation via legal acts (bilateral DTT, domestic act etc.). Localisation of income earnings substantiates the link with state for allocation of taxing rights. Source rules under Model Conventions are subject to discussion from the perspective of international law.

General international law regulation of substantive income tax jurisdiction is limited, and the state's imposition of income tax claims is mostly a matter of tax policy. It is necessary to gain political decisions and develop tax allocation rules on the EU level instead of unilateral measures to avoid double-taxation risks.

The proposed SDP nexus concept seems to be source rules and requires analysis from the perspective of the economic allegiance concept. Economic allegiance of objective element requires to consider placing of income-generating factors and place where the public benefits were consumed within the process of income earning.

Value creation principle seems to be doubtful and controversial as a ground for allocation of taxing rights. It is proved by lack of unanimity regarding the meaning of the concept, ambiguity and complexity of identification of the rights place where the value is created.

Public benefits provided by market states where the income is generated may be treated as a justification of a tax claim. Accordingly, when a non-resident alien enjoys benefits from the public sector of the taxing state, the taxing claim may be deemed justified.

Though changes in modern business models may require to reconsider factors determining economic allegiance to identify the exact location where the income is earned.

Economic allegiance is a core connection between a state and subject matter in the existing international tax environment.

Provided under the proposal of SDP users and revenue thresholds may be considered as relevant and sufficient to determine territorial connection where the income is earned.

Technical problems of identification where the users placed and income originated are subject to discus and required solutions, but it seems to be acceptable.

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