

The Tax Nexus in the Digital Economy

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Abstract. The current concept of permanent establishment has originated for physical presence of products and services and provides the opportunity to avoid taxation for digital economy service providers. The Organization for Economic Co-operation and Development suggests including the concept of "significant economic presence" in the definition of permanent establishment. To date there has been little agreement on what values are considered "significant" as the perception of the word is influenced by personal feelings, size of national economy and presence of digital economy in a country.

This paper discusses the results of the study where an alternative "nexus test" was developed for fair taxation of digital services in a small economy and which ensures the inclusion of the digital presence aspect and does not require extensive changes to national tax regulations.

Keywords: Taxation, Nexus, Digital economy, Permanent establishment.

1 Introduction

The digital economy is fast becoming a key trigger of world economy. The transactions of digital economy were measured \$ 29 trillion in 2017 (UNCTAD, 2017). The issue has grown in importance considering forecasts, where most professionals and analysts believe that digital economy continues to expand, possibly outpacing the growth of the "traditional" economy.

However, the governments all over the world to have not adequately prepared to tax the income generated within the digital economy yet. Haslehner et al. (2019) has previously stated two gaps of the existent tax system:

- inability to apply taxes to non-residents carrying out economic activities in the country without a real physical presence;
- lack of tools to measure these activities for tax purposes.

Inability to apply taxes without a real physical presence. To date taxation principles determined that the taxable income is taxed where the taxable value is created, thus avoiding double taxation (Bohorquez, 2016). However, this concept fails to consider which place should be identified as the source of income if all the value sold is generated in a company's country of residence, but the customers who determine its value as well as, generate demand and profit are outside its borders. Global digital economy

corporations around the world are now able to relocate their headquarters to a low-cost jurisdiction and enjoy the opportunity to sell worldwide paying tax at roughly 0,1% of their profit (Corkey et al. 2013). The traditional companies consider that their business is at significant risk as their current mode of operation, in contrast to the digital economy, is fully taxed (Meharia, 2012).

Meharia (2012) has also established that although the DESP do not have a physical presence in the country of their users' origin, users' countries provide various benefits to non-resident sellers (e.g. infrastructure, security, educational level etc.). These benefits justify the right of the users' country to tax the income earned by a non-resident, or at least a part of it.

Tools to measure activities for tax purposes. There is evidence that regulation of tax nexus plays a crucial role in the growing digital economy. By using tax nexus concept, a presence in a taxable jurisdiction would arise if the non-resident company has "a significant economic presence" e.g. purposeful and lasting interaction with the jurisdiction through digital technologies and other automated means.

It is considered, that corporate income tax is the most appropriate instrument, that is ultimately proportional to the creation of value in the country, and therefore, tax laws need to be reformed mostly in the field of corporate income tax (OECD, 2018).

As countries continued to develop tax policies based both on the place of income and the tax nexus principle (GAFA tax in France, advertisement tax in Hungary, the Diverted Profit Tax in United Kingdom and equalisation levy in India), it was increasingly important to be aware of the interrelationship between the two and to develop a concrete and comprehensible system to ensure a simple process worldwide (Corrie, 2020). For this purposes Action called Tax Challenges Arising from Digitalisation of the OECD BEPS was launched in 2015. Hopefully, 130 countries and jurisdictions have joined the Statement establishing a new framework for international tax reform that aims to update key elements of the century-old international tax system on 01 July 2021. The reform requires a two-pillar plan:

- Pillar One: will ensure re-allocation of taxing rights over MNEs (including DESP) with global turnover above 20 billion euros and profitability above 10% from their residence countries to the markets where they have business activities at the threshold of at least 1 million euros (with exceptions for economies with GDP lower than 40 billion euros), with nexus using a consuming jurisdiction revenue-based allocation key;
- Pillar Two: will introduce a global minimum corporate tax rate of at least 15%.

The aim of the research was to assess the solution of digital economy taxation proposed by OECD with respect to small and developing economies, which do not have enough resources for tax collection from big non-resident corporations.

Throughout this paper:

- "digital economy" refers to the definition by OECD, e.g. all economic activity reliant on, or significantly enhanced using digital inputs; including digital technologies, digital infrastructure, digital services, and data.

- "tax nexus" refers to a connection between the taxing authority and an entity that must collect or pay the tax.
- "permanent establishment" refers to the concept that originate from the Model Tax Convention of the League of Nations in 1927 and then in 1963 to the model of the OECD Tax Convention.
- "DESP" (digital economy service providers) are companies that perform their business activities using online platforms (e.g. online retailers, social media) or via subscriptions and collaboration platforms.

2 The design and methodology of the study

In order to understand how the OECD proposal regulates digital economy taxation, the authors analysed the international principles of taxation and the recommendations of industry professionals in tax adaptation to the digital economy in small countries.

As the first step the authors used in-depth analysis to expose and explain in detail the issue or phenomenon. The analysis was based on the conceptual framework for evaluating tax proposals of American Institute of Certified Public Accountants' (AICPA) in order to ensure that analysis does not contain personal opinions of the authors. To measure the advantage of each evaluation criteria a 5-point Likert scale was used: (1) Very beneficial; (2) Somewhat beneficial; (3) Neither beneficial nor disadvantageous; (4) Somewhat disadvantageous; (5) Very disadvantageous.

At the second step the focus group was made up of a small number of people (10), that were carefully chosen from the target group of tax policy makers and tax professionals from the Baltics, based on criteria that everyone has knowledge about the problematic of digital economy taxation and feels comfortable enough to share their ideas, experiences and opinions. This method was considered as feasible, as most of the investigated case studies conclude that the results of the experimental tax system are in tatters and there is evidence that the focus group helped to analyse tax compliance offering an advantage of answering the question: "How do people consider, perceive, react and experience specific policy measures and approaches?" in advance.

The participants were provided with non-prescriptive questionnaire. The questionnaire consisted of open-ended questions that had been grouped into three categories according to American Institute of Certified Public Accountants' (AICPA) guiding principles, for better communication. For each category (advantages of rights; administration issues; effective outcome principles) a mix of introductory, probe (used to ask for more information or more detail) and follow up questions was created. Closing and demographical questions were introduced, allowing to participants to express their overall view/ position on the topic and to researchers to notice international or institutional differences.

Once the data was collected, the raw data was coded, classified, and transformed to conceptions. Further, the comparison analysis was carried out, to detect divergent views both amongst participants and to the hypothetical model. The results were used as exploratory material to adjust the hypothetical model and to generate ideas for future research.

3 The development of the hypothetical model

3.1 The in-depth analysis of the OECD model

Two main theories exist in the literature regarding the fairness of distinctive taxation of digital economy "sourcing" and "benefit":

- the sourcing theory justifies introduction of some kind of matching fee to level the playing field for DESP and companies of the traditional economy, thus ensuring equal treatment of both domestic and foreign companies;
- the theory of benefit states that all recipients of services have an obligation to cover the costs of society that have been invested or used in order to provide the service. Referring to the digital economy, this theory empowers countries to refer to legal framework, intellectual property protection, energy supply, infrastructure, et al. costs of public services that are provided to all businesses on the given territory, even if the services are only virtual. (Hongler & Pistone, 2015)

Ergo, it is now well established from a variety of studies that digital economy must be somehow liable to tax. Debate continues about the best strategies for the fair taxation of the digital economy and suggests three conflicting approaches:

- existing taxation systems are being disadvantaged and require targeted reforms;
- some basic tax concepts leading to speculations are challenged (e.g. permanent establishment);
- no significant changes are required. (Robert, 2018)

The first group highlights the fact that there is a mismatch in the taxation of profits generated in relation to the place of real income, and that targeted changes are needed to address this issue.

The analysis of the current model of permanent establishments shows that none of the existing articles of the model of Tax Convention can be applied to the non-resident DESP in other jurisdictions. Several case studies have examined the success of introducing changes in segregate manner and all of them exposed challenges: Rozin (2018) reported subjective choice of the tax administration expanding the definition of permanent establishment in Israel; India's concept of a revenue threshold failed as the tax administration did not have sufficient resources for tax collection from non-resident companies (Jain, 2018); Kacaljak & Cibula (2018) confirmed ineffectiveness of the new establishment as it created additional new administrative responsibilities for the tax administration, without additional profits for the treasury in Slovak; the absence of the service contract challenged the "virtual permanent establishment" in Saudi Arabia (Gidirim, 2016). Therefore, it is now well established, that simple modifications to the model would not be enough: the OECD would need to create a completely new chapter specifically on the aspect of the significant economic presence of digital business.

The third opinion implies, that the tax policy of given countries is the one that best suits DESPs' preferences and other countries must compete globally with their taxing systems.

Having defined the existing evidence of the digital economy taxation, the in-depth analysis of the OECD model was examined the causes of the OECD model for small economies under three headings: (1) policy and rights, (2) administration, and (3) effective outcomes.

Policy and rights. The OECD model states that: (1) business decisions should be motivated by economic rather than tax considerations; (2) taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Table 1. Evaluation of the OECD proposal from small economy rights perspective.

Principle	Score	Comments
Equity and fairness	1	Similarly situated taxpayers can be taxed differently depending on their users' country's GDP, but not on the service provided from the country. On the other hand, differently provided benefits (e.g. infrastructure, security, etc.) face the similar taxation rules.
Transparency and visibility	1	Taxpayers obviously don't know whether a tax exists in small economies as they obscure the value created by this economy, as well as how and when it is imposed upon them, e.g. the usage of platform users.
Accountability to taxpayers	1	Absence of the tax nexus test introduces inconsistency with the accessibility of information on tax laws for DESP.
Certainty	1	The tax rules are dependent on the GDP threshold set, therefore the DESP cannot consider whether it is resident in a country.

Administration: Upon the OECD model: (1) the tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including the knowledge of when, where and how the tax is to be accounted; (2) compliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible; (3) structural features should keep pace with technological changes.

Table 2. Evaluation of the OECD proposal from small economy tax administration perspective.

Principle	Score	Comments
Convenience of payment	5	Required tax payment time and a manner is most likely convenient for the taxpayer.
Simplicity	3	The desire to include all revenues from transactions that the company has entered remotely with customers in the country is likely the easiest way of tax collection (Rodriguez, 2019). The burden is to communicate tax exemptions and claims.

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continuation of Table 2

Principle	Score	Comments
Infor- mation se- curity	5	Taxpayer information is most likely to be protected from disclosure.
Effective tax admin- istration	1	The most important of the criticism is that a simple test of "significant presence" does not indicate the need to register a virtual permanent establishment. The administration must fully rely on the belief that the existing scheme allows to identify DESPs' value added chain through intermediaries of non-resident country.

Effective outcome principle states, that: (1) the systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments; (2) the potential for tax evasion and avoidance should be minimized while keeping counteracting measures proportionate to the risks involved. (3) taxation should produce the right amount of tax at the right time.

Table 3. Evaluation of the OECD proposal from small economy outcome perspective.

Principle	Score	Comments
Appropriate government revenues	2	The proposed tax system is not linked to users' country's cost amounts and investment timing.
Economic growth and efficiency	5	The proposed approach of taxing for only those companies with a significant digital presence would allow income-generating countries to "catch only the big fish" thus also saving start-ups in the digital economy, and not restricting their development.
Minimum tax gap	2	Caused by uncertainty already mentioned in the Table 1 DESP, considering that they are non-residents, are more likely to avoid paying taxes than traditional economies.
Neutrality	3	The tax system affects DESPs' decisions how and where to carry out a particular transaction.

Tables 1 to 3 present that the OECD model appears to be overambitious for small economies and introduce disadvantages of following principles:

- Equity and fairness: the thresholds offered are too big and fails to provide fair solution in relatively small economies;
- Transparency and visibility: small economies are given no explanation of how to control the presence of the digital economy for taxation needs;

- Accountability to taxpayers: no attempt was made to quantify the association between DESP and a certain country;
- Certainty: the model fails to consider the differing categories of damage that appears in countries with marginal thresholds especially for neighboring countries (for instance Latvia and Estonia are small economies, but Lithuania can be qualified as part of the non-exempt territory);
- Effective tax administration: procedures of are too vague for small economies; this can create additional complications or costs for tax administrations;
- Appropriate government revenues: tax rules are not linked to the promotion and maintenance of business environment in a certain country;
- Minimum tax gap: the OECD offers no explanation of how tax evasion and avoidance would be reduced, and what institution would minimize the unfair competitive advantage currently used by companies in the digital economy.

The next section will introduce the improvements made on the drawbacks of the OECD model considering small economies rights, administration facilities and effective outcomes.

3.2 The hypothetical model

When it was understood which factors plays crucial role in the digital economy taxation, the hypothetical model was developed. There were several important differences between the OECD model and the hypothetical model:

- defining the tax nexus principle by digital presence aspects, mainly with regards to the "digital footprint", e.g. number of connections from a particular jurisdiction;
- introducing a new tax base - "connection",
- introducing the flexible tax rate principle, that is linked on investments, DESI index, and number of Internet connections from a particular jurisdiction during the year.

Digital presence principle. The introduction of tax nexus principle based on significant digital presence has facilitated small economies rights to participate in DESP taxation: The threshold can be calculated taking into account a country's "internet population", impact factors and the number of people reached on a daily basis (Hung, 2007) or simply stated (Escribano, 2019).

The hypothetical model provides that a company can identify tax nexus and to proceed the registration of a virtual permanent establishment following these criteria:

- it is a non-resident in a country.
- the main activity of a company are digital economy services (enables to earn income in any country without a real physical presence).
- the threshold of digital presence detected by the number of visits to specific websites, is exceed.

By establishing nexus principle on the ground of digital presence the thresholds offered appears to be fair and equal, the procedure is transparent for DESP and tax administration. Recent cases reported by Rodriguez (2019) also support this part of the hypothetical model.

Connection as a tax base. A number of factors played a role in determining the connection as a key element (tax base) of the hypothetical model. Firstly, the tax administration can control digital presence but is unable to link it to revenue and especially to the base of corporate income tax. Secondly, the existing global business models leads to divide a supply chain of the DESP, where part of transactions are not done via fiat currencies. Lastly, the benefit theory clearly links a DESP tax base to connection as by means of connection a DESP consume demand, data and "free workforce", e.g. create a value. This has been seen in Hongler & Pistone (2015) and other studies.

A powerful effect upon tax evasion and avoidance through establishing the tax base in a way of the hypothetical model can be achieved. Hung (2007) have already studied the level of the digital economy by analysing the number of visits to specific websites, considering a country's "internet population", impact factors and the number of people reached on a daily basis. Recent developments of mobile application lead to the idea, that the analysis is to be expanded with different connection equipment.

Flexible tax rate. Several factors are known to affect the volume and type of digital presence of DESP. Hongler & Pistone (2015) confirmed the importance of legal system, protection of intellectual property rights, execution of company customer payments, maintenance of the digital environment, power supply, infrastructure, etc. To link tax rules to the maintenance of appropriate business environment the tax rate can be calculated, regularly reviewed and updated by each jurisdiction for the following year, by the arranged formula, which includes clear indicators: infrastructure used by the digital economy, the funds invested, the DESI ratio etc.

In this section, the view of the researchers has been explained. The section that follows moves on to consider the view of the policy makers, tax administrators and tax consultants to the provisions.

3.3 The results of the focus group

As explained earlier, the focus group offers an advantage to observe how do people whom the policy is addressed perceive their future experience. The section follows the structure of the focus group questionnaire.

Discussions about advantages of rights. Overall, the participants favored to the hypothetical solution, as more feasible for smaller countries. However, a small number of those interviewed suggested that the OECD minimum conditions are a necessary barrier that allows to introduce DESP taxation only in countries with enough administrative capacity.

A common view amongst interviewees was that both models can complement each other, e.g. that incomes can be evaluated from connections if accidental connections are excluded, or that progressive taxation approach can be introduced using connection as a tax base. As there were some negative comments about DESP taxation as lifeblood source, all agreed that connection awareness can clearly link the tax to benefits or costs

and ensure robustness of the tax system. The shared individual views surfaced mainly in relation to the itemization of a formula for determining the tax base.

Discussions about tax administration and collection risks. Concerns regarding technical implementation were more widespread. Whilst a minority mentioned digital tax proposed by the hypothetical model as a possible solution, all agreed that corporate income tax is more appropriate approach. Interviewees argued that pure digital tax without linking to income will lead to falsifying, manipulating, and corraling digitally obtained data, whereas a corporate income tax (the OECD solution) creates a risk of fragmentation of large companies to smaller ones that are out of international scope.

A variety of comments were expressed on the proposal to develop a testing platform-robot, which can collect both connection and income information in order to understand which of the two sets of data is more viable: "nor any connection to a website would be taxable", "how to distinguish services/products that are already covered by the VAT", "how to identify the contribution of the certain country's users, if they use different IP addresses being highly mobile", "the tax administrations of the countries where DESP are registered are mostly very poor, and therefore unable to manage, collect, and distribute income tax to other countries".

Discussions about effective outcome. When asked about tax evasion, the participants were unanimous in the view that the threshold in the OECD solution and unidentified connections in the hypothetical solution are red flags. Interviewees argued that large DESP have resources and tax specialists who would allow to manipulate the threshold parameters and connection location protocols. Concerns expressed about the OECD were flatter as it was supposed that small economies will be unable to control part of their tax system. The OECD model can be maintained only globally, and digital environment can perform transactions outside of fiat currencies. It was suggested that tax administrations of the users' countries collect information based on the unified methodology and exchange with other countries, thus maintaining some kind of "global balance".

When the participants were asked about the risks of digital economy development, the majority commented that generally this is not a threat at least for larger DESP not. Nevertheless, the threshold might affect a choice whether to enter a market. Some felt that that the hypothetical model is clearer for understanding this choice, while others considered that the model requires additional resources for connection accounting both from a DESP and from a tax administration. The next part discusses the obtained results.

4 Results and discussions

A strong relationship between provided benefits for DESP and costs of the users' country justified the rights eve of small economies to participate in the taxation of DESPs'. In reviewing the literature, no data was found on the association between economy GDP and digital tax, that appears in the OECD model as a threshold. Such

approach has failed to address the interests of small economies. Therefore, the initial objective of the study was to identify the fairness of the OECD model for small economies, and to discuss a hypothetical solution if the principle appears not proper. The urgency of the current situation is significant as global digital economy drives out local traditional business and causes tax evasions.

The current study found that the OECD model is not transparent from the small economies' perceptions. Nevertheless, there are various solutions to upgrade the tax system. The principle of tax nexus based on digital presence (number of connections) is one of the solutions. The main advantage of the solution is the possibility of including non-residents who are present in the country only virtually, but with a significant (for the certain economy) digital presence, with minimal regulatory changes. The results of this study indicate that the hypothetical solution is precepted as fairer, since it can be applied in smaller and poorer countries. However, with a small focus group size, caution must be applied, as the findings might not be applicable to other small countries outside of the Baltics. A note of caution is due here since the location of the servers may not be linked to a DESP's jurisdiction.

This study confirms that that the OECD model is associated with the risk of tax evasion. Therefore, another significant important improvement offered by the hypothetical model was offered, stating that connection can be a tax base for DESP instead the standard corporate tax base, which is beyond the control of the users' state administration. Surprisingly, the idea was found to be at greater risk than the OECD proposal. This result may be explained by the fact that tax administrations of small economies are underconfident about their IT capabilities. Another source of uncertainty is unclear link from connection in users' country to a specific virtual object of DESP e.g. a collaboration platform or an application with a clear commercial income generated by the connection. These results reflect those of Wagh (2013). It can therefore be assumed that the interdisciplinary research, involving computer science specialists is required to provide a connection verification model. There are also many unanswered questions raised by the participants that can be an object of additional case studies: the exclusion of the accidental connection, deals made by present or virtual visitors of the country; fragmentation of the virtual value chain are worth studying.

The results of this study did not show that the OECD model has an effective outcome for DESP. The tax level is the same in their users' countries whether benefits to non-resident sellers (e.g. infrastructure, security, educational level etc.) are at highest level or poor. Therefore, the hypothetical model was improved by rate differentiation possibility. Contrary to the expectations, this improvement was less commented than others. A possible explanation of the indifference might be that this asks for a clear statement about the two previous questions.

In general, therefore, it seems that some parts of the hypothetical model, for instance, the tax nexus tests based on the digital presence provide further support for the improvement of the OECD model for small economies' needs. However, the researchers group still believes, that setting national taxation rules is not feasible in modern global economy, therefore, a global solution of the taxation parameters in small economies are still required; the findings of this study have important implications for their developing.

To develop a full picture of the tax nexus for small economies, additional studies will be needed that identify (1) how to apply the new regulation to the countries, so that DESP can apply the virtual presence itself in a particular jurisdiction as soon as it has achieved a significant digital and economic presence; (2) how to calculate taxable connections as a new tax base (or new statistics that amend a new tax base); (3) how the introduction of a new tax burden affects traditional and digital businesses, consumers, public administration and tax administration.

5 Conclusions

The aim of the present research was to examine the solution of digital economy taxation proposed by OECD with respect to small and developing economies, which do not have enough resources for tax collection from big non-resident corporations. This paper discussed the benefits and disadvantages of the OECD model, proposed improvements of the revealed inconsistencies by the introduction of the "nexus test", a tax base and a tax rate based on the aspect digital presence, that can be more or less be dealt with by the small economy tax administration. The hypothetical model was triangulated by focus group of tax professionals from the Baltics.

The in-depth analysis has identified that the OECD model does not fit AICPA's principles of good tax policy at least regarding small economies, due to the absence of control of the presence of the digital economy for taxation needs and linkage between certain DESP and certain country; risks of being be at the margin of thresholds; vagueness of the procedures; ignorance of cost principle; and high risk of tax evasion and consequent commercial risks of traditional businesses.

The focus group confirmed concerns of the in-depth analysis, but also provided significant criticism of the hypothetical model. However, the relevance of digital presence to tax nexus was clearly supported by the current findings. These investigations suggest that tax nexus can be achieved through proper calculation of digital presence. Simultaneously this study has raised important questions about the nature of digital economy as well as legal and technical possibilities of tax administration to retrace the transactions that there exist. Taken together, these findings complement to promoting of IT skills of tax administration staff and interdisciplinary researches.

The insights gained from this study may be of assistance to BESEP to have better insights of needs of small economies by providing the perception of their tax professionals. This new understanding should help to improve predictions of the impact of the unified taxation of digital economy to the economies of different countries.

Being limited to the Baltics, this study lacks to explain the perception of other small economies. Notwithstanding these limitations, the study suggests that comprehensive measurement of the digital presence can improve fairness of the taxation and prevent tax evasion. Therefore, further investigations on common DESP nexus test for self-registration in a particular jurisdiction and on introduction of taxable connections statistics would be a fruitful area for further work.

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