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Expanding source state taxing rights through Articles 12A and 12AA: the United Nations Model Convention's response to the limits of transfer pricing rules in a digitalized economy

The current issue: an outdated OECD tax framework allowing companies to make profits within a jurisdiction without paying any tax

A company, resident in **State R**, provides **services**, such as accounting and financial advise, to clients in **State S** via **digital means** (website, emails, video conferences).

It receives a fee of **€100,000** for those services.

The company has **no physical presence** in State S, as everything is proposed and delivered remotely via **digital means**.

No physical presence = **no permanent establishment** (PE) in State S, which **cannot tax profits derived from its territory** by a non-resident company without a PE.

No PE in State S = **no intragroup cross-border transaction** between the company and a related entity in State S = **transfer pricing** (TP) rules are not triggered and cannot be used to **allocate a portion of the profits** to State S.

Conclusion: a €100,000 payment arose from State S territory, **yet State S cannot tax anything**.

United Nations Articles 12A (2017) and 12AA (2025): allowing source states to levy a withholding tax on payments made to foreign service providers, even in the absence of physical presence there

If States R and S incorporate such a provision into their **bilateral tax treaty**, with a **15%** withholding tax, State S would be entitled to **withhold €15,000** on the €100,000 payment made to State R company for services rendered remotely via **digital means**.

Result: taxing rights are granted to the **market jurisdiction** (State S), where State R company **generates its profit**.

Problem: the withholding tax is levied on **gross payments**, not **net profit**.

Companies with **high expenses** may face a **disproportionate tax burden** compared to local **competitors** taxed on their net profit.

Does **a more satisfying solution exist?**

Recognizing a “virtual permanent establishment” (VPE) to enhance source state taxation?

A VPE creates a **taxable presence** in State S as soon as the **non-resident company** exceeds **certain economic thresholds**.

Examples: earning more than **€X million revenue** or concluding contracts with more than X clients in State S. **No physical presence requirement**.

Result: once the threshold is reached, State S gains the right to **tax the profits** attributable to the VPE's deemed activities in its territory.

Consequence: because there is a **head office** in State R and a **VPE** in State S, **TP rules** become applicable.

Problem: impossible to attribute functions, assets and risks to the VPE, as it has **no physical economic substance** in State S = under current TP rules, impossible to attribute a **meaningful share of profits to the VPE**.

Solution? Draw inspiration from **Pillar One**: redistribute a portion of the company’s **global profit** to market jurisdictions based on **revenue** generated and the number of **customers** present in **each state**.