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MASTERS IN TAX LAW

**THE PERMANENT ESTABLISHMENT CONCEPT  
IN RELATION TO ELECTRONIC COMMERCE**

SUPERVISOR: JUDGE DENNIS DAVIS

WORD COUNT: 14, 082

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## **DECLARATION**

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14 September 2015.

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## **LIST OF TREATIES**

The OECD Model Tax Convention on Income and on Capital as it read on 22 July 2010 herein referred to as the OECD.

The League of Nations Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes dealing with Income and Property taxes, 1927.

# CHAPTER ONE

## INTRODUCTION

### 1.1 BACKGROUND OF THE PROBLEM

The right to tax is traditionally based on connection to jurisdiction. Taxation is divided into international and domestic systems. An international tax system subjects its residents to tax on their income from all around the world while a domestic tax system subjects its residents to tax only on income arising out of a source within the borders of such a State.<sup>1</sup>

Under the international tax system, a State's right to tax firstly depends on whether the taxpayer deriving the said taxable income is a resident of that country or not. With respect to an entity or enterprise, its place of effective management or its headquarters within a State is used to establish residence of such an entity in the State hence making the entity taxable.

Where the enterprise does not have a place of effective management or headquarters in a State, hence rendering such enterprise a non-resident, treaty rules have established that the permanent establishment concept be used to tax business profits. The permanent establishment becomes the minimum criteria for establishing that such an enterprise has an economic presence within the borders of the source State.

In the presence of an enterprise having cross-border transactions, it is possible for the enterprise to be subject to taxable under both the domestic tax system of the State within which it is a resident as well as under the international tax system of the source State within

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<sup>1</sup> Olivier, Lynette and Honiball, Michael *International Tax: A South African Perspective* 5<sup>th</sup> Ed (2011) Cape Town, South Africa.

which it has a permanent establishment, thus arising the question of double taxation. To help solve such a situation, legal instruments, arising in the form of tax treaties were created to combat double taxation of income arising out of cross-border transactions.

Integral in solving this situation is the concept of permanent establishment. The permanent establishment is a source rule; thus a basic requirement to be met before business profits of a non-resident that are attributable to its permanent establishment in the source State are taxed in that State.<sup>2</sup>

However, technology developments and the rise of electronic commerce are rising problems on the application of the permanent establishment concept in relation to taxing income from international sources of such businesses.<sup>3</sup> The broad meaning of the permanent establishment concept, particularly its requirements, make it difficult and ambiguous during its application to enterprises that conduct their businesses electronically or via the internet.

The Internet has vastly altered how businesses are conducted at local and international levels. The development of information and communication technologies has led the internet to be a more secure, quick and versatile way of conducting business and transacting.<sup>4</sup> While the Internet is mostly used to market businesses, its most economic impacts arise from its ability to provide vital business functions and services over the Internet. Business functions such as product innovation, production (including delivery of services), administration, accounting and finance, and customer service have all been made more efficient through the use of new communications technologies.<sup>5</sup>

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<sup>2</sup> Olivier op cit (n1) 1.

<sup>3</sup> OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing

<sup>4</sup> Doernberg, Richard and Hinnekens, Luc *Electronic Commerce and International Taxation* Prepared under the auspices of the International Fiscal Association

<sup>5</sup> Technical Advisory Group on Monitoring The Application of Existing Treaty Norms for Taxing Business Profits, *'Are The Current Treaty Rules for Taxing Business Profits Appropriate for Taxing E-Commerce'*, Final Report

Hence the development of the internet in return brought the emergence of electronic commerce. The term 'electronic commerce' refers to a wide array of commercial activities carried out through the use of computers, including on-line trading of goods and services, electronic funds transfer, online exchanging of financial instruments and data between and within companies.<sup>6</sup> Electronic commerce is here; it is growing; and it provides new matters to be taken into account at all taxing stages of a State.<sup>7</sup>

With the growth and expansion of electronic commerce, it is imperative to discuss how established tax principles can be applied to such businesses. As stated, international tax rules provide that the income may be taxed based on different criteria such as residence, domicile or citizenship with respect to individuals, or incorporation, or place of effective management, with respect to entities.<sup>8</sup> This residence jurisdiction gives a State the right to tax the worldwide income of persons within their limits. A State may also base its jurisdiction to tax on the source of the income being situated within the territory of that state, known as source jurisdiction which is basically income that arises from sources within that State.

For these reasons, the permanent establishment concept, particularly its definition and requirements, makes it one of the vital concepts of international taxation to be discussed when it comes to businesses and cross-border transactions conducted electronically.<sup>9</sup> The current permanent establishment requirements bring about problems when they are applied to electronic commerce hence this paper shall elaborate on the said requirements as well as those problems.

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<sup>6</sup> Doernberg op cit (n4) 2.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid.

<sup>9</sup> Cockfield, Arthur J *Should We Really Tax Profits from Computer Servers? A Case Study in E-Commerce Taxation* (2000) 21 Tax Notes International 2407, 2407.

## 1.2 STATEMENT OF THE PROBLEM

Taxation of business profits relating to cross border transactions is governed by principles provided for in international tax treaties or conventions which have established rules to combat double taxation. These conventions outline what State has preference to tax business profits of a non-resident that arise within its geographical limits.

However, with the emergence of cross-border businesses and transactions conducted electronically, this paper shall focus on how these principles in international conventions, specifically the Permanent Establishment principle, can be difficult to apply to electronic transactions conducted around the world.

Integral to the permanent establishment concept is the fixed physical presence of a business in a source based State. Electronic commerce is conducted via the internet, a world-wide network that lacks no central physical presence or organisational structure, enabling businesses to be present in a certain State without any geographical and physical means hence rendering current permanent establishment rules difficult to apply.<sup>10</sup> The Internet enabled businesses to access markets and consumers in other States without having any physical presence in such States and, thus, avoiding the enterprises' qualification as a permanent establishment in such other States.

Because electronic commerce is conducted with no physical presence in the source State, such a State will normally face problems taxing such entities under international tax rules on profits arising out of its territory despite such electronic business being economically present in its geographical limits.

This research paper will focus on how the development of technology has brought about new ways of conducting business calling for the

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<sup>10</sup> Westin, Richard *International Taxation of Electronic Commerce* (2000) Kluwer Law International, The Hague Netherlands.

need to change the existing source rule of permanent establishment created in a different technological era in order to accommodate electronic commerce transactions for purposes of taxation.

### **1.3 OBJECTIVE OF THE RESEARCH**

The objective of this research paper is to observe whether the permanent establishment concept as provided under international tax conventions can be appropriately applied to tax businesses conducted electronically. The issues that will be addressed include the ability of an electronic business to have an economic presence in a State without being liable to taxation due to the absence of a physical connection as provided for under current tax treaties and the application of source rules with respect to world-wide income from enterprises.

### **1.4 SCOPE AND METHODOLOGY OF THE RESEARCH**

The research is a descriptive study and entails a literature review of and reference to international tax Treaties and their commentaries, and published articles and textbooks.

The approach will be analytical, one that will start by observing the permanent establishment concept as provided for in tax treaties and further explained by commentaries of such tax treaties followed by analysing how the concept, as stated in the tax conventions, can effectively be applied to electronic businesses.

This research paper shall focus on the OECD Model Tax Convention on Income and Capital [as they read on 22 July 2010] with its commentaries as updated from time to time.

## **1.5 RESEARCH OUTLINE**

Chapter one focuses mainly on the introduction, which gives an overview of what the research is about. The chapter addresses issues of background, statement of the problem, methodology and objectives of the study.

Chapter two discusses the concept of permanent establishment as provided for in the international tax conventions stated in the scope and methodology of this research as well as electronic commerce. The chapter explains the concept of permanent establishment, what it includes and how it is applied in taxation of business profits. The chapter also describes what is meant by an electronic commerce.

Chapter three discusses how the permanent establishment concept is applied to electronic businesses. This shall include the criteria required for the permanent establishment concept to apply and whether such criteria can suffice its application in relation to electronic businesses.

Chapter four is the conclusion. This chapter briefly analyses the findings of the research. In addition, recommendations will be provided on the way forward.

## CHAPTER TWO

### ELECTRONIC COMMERCE AND THE CONCEPT OF PERMANENT ESTABLISHMENT

#### 2.1 INTRODUCTION

The permanent establishment principle was developed in the late 19<sup>th</sup> century as a result of the second industrial revolution which saw the expansion of businesses into other States and continents. Business around this time shifted their capital resources from working capital into fixed capital which was invested in tangible equipment such as machines and plants.<sup>11</sup>

With the ending of the First World War, governments needed revenue to rebuild the destroyed economies and infrastructure; hence they began taxing foreign businessmen and traders as well as profits on goods of foreign companies brought in by such businessmen. This led to double taxation of businessmen and foreign companies trading through such businessmen hence the League of Nations established, in 1927, a draft of a Bilateral Convention for the Prevention of Double Taxation,<sup>12</sup> which introduced the permanent establishment concept to be used to allocate taxing rights among two or more States with taxing claims to profits of a foreign business.

Within the traditional concept of permanent establishment, a State had taxing rights on foreign business profits if that business developed tangible economic activities within its geographical limits

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<sup>11</sup> Avi-Yonah, Reuven S *International Taxation of Electronic Commerce* (1997) 52 Tax Law Review 507

<sup>12</sup> Double Taxation and Tax Evasion Report, League of Nations Doc. C.126.M.85 1927 II (1927)

for a certain minimum time frame. It is this structure of international taxation of foreign businesses that was developed in the 1928 League of Nations Model treaty forms the basis of tax treaties existing even today.

The claim of source States to tax foreign business on income derived within their geographical limits rests on the notion that such States have sovereignty over all natural resources within their borders and thus are supposed to have a certain share of the income arising out of the utilisation of such resources. Further, the claim of such States on the derived income is to compensate costs of services incurred by their government in maintenance and protection of such resources.

With the development of science and technology, an inconsistency developed between law and technology mostly because technology changed how business are conducted different from when laws were created to tax such businesses.<sup>13</sup> It is the development of technology that has brought about questioning of the fixed physical presence requirement encompassed in the permanent establishment concept, a requirement that was established in the early years of commerce before technology.

In the 1967 case of *National Bellas Hess*,<sup>14</sup> involving a mail order company conducting business in a State without having a physical presence in such State, the United States Supreme Court affirmed the physical presence requirement need for the application of the permanent establishment rules. Twenty-five years later, in 1992, the Court re-examined its *Bella Hells* decision in *Quill Corp. v. North Dakota*,<sup>15</sup> another case of a mail order company with no physical

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<sup>13</sup> Hoffart, Benjamin *Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through an Access to Markets Proxy Approach* (2007) Northwestern University School of Law, Scholarly Commons.

<sup>14</sup> *National Bellas Hess, Inc. v. Department of Revenue* 111, 386 U.S. 753 (1967)

<sup>15</sup> *Quill, Corporation v. North Dakota*, 504 U.S. 298 (1992).

presence in a certain State. While majority of the Justices reaffirmed the previous judgment, one Justice White noted in his dissent that ‘in today’s economy, physical presence frequently has very little to do with a transaction a State might seek to tax.’<sup>16</sup>

From Justice Whites’ view, the Internet has revolutionised the way business generate profits with the dispensing of tangible property used by businesses to produce income. Today, electronic transactions are conducted without having a physical presence in a State<sup>17</sup>; hence erasing connections between income-producing activities and a geographical physical location.

The requirements under the permanent establishment, mainly a fixed place of business, geographical location and permanency that were developed in the early years bring about difficulties when applied to modern economies that are controlled by the internet. In the modern economy, an entity or individual of a State be economically present within the geographical limits of another State by conducting business with customers located in that country via the internet, without having a dependent agent or tangible equipment that will render such business physically present in that other State for purposes of taxation under international tax treaties.

The permanent establishment principle gives one Contracting State the right to tax the profits of an enterprise of another Contracting State as long as such profits originate from a source within its geographical area. However, in an era where non-resident taxpayers can conduct business and derive vast amounts of profits from source States without being physically present or having an agent, doubts are being raised whether such a concept can provide sufficient taxing

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<sup>16</sup> Quill, 504 U.S at Page 328 (White, J., dissenting).

<sup>17</sup> Avi-Yonah, Reuven S *Tax Competition and E-Commerce* (2001) Tax Notes Int'l 23, no. 12: 1395-400

rights, especially where the profits from such transactions go cannot be taxed in source States despite such States claiming to have provided resources under their territories that are used to derive such profits.

Different scholars have called for the current rules to be adjusted to reflect how modern businesses are conducted. Arguments have been raised for the permanent establishment of businesses to be established by their economic and not physical link to a source State. However, the OECD has maintained that current permanent establishment requirements are versatile enough to be applied to businesses conducted electronically.<sup>18</sup>

## **2.2 ELECTRONIC COMMERCE**

Electronic commerce, or e-commerce, has been defined broadly by the OECD Working Party on Indicators for the Information Society as 'the sale or purchase of goods or services, conducted over computer networks by methods, such as extranets or electronic data interchange, specifically designed for the purpose of receiving or placing of orders'.<sup>19</sup> Products may be inquired and ordered via such methods. However, payment and delivery might vary according to the ordered goods and services. Payment and delivery may be done electronically or physically.

In broad terms, electronic commerce involves the utilisation of computers linked together by the internet to perform business tasks for customers such as delivery of goods and services efficiently as well as the management of such businesses. It encompasses activities such as sharing of information between entities, facilitation of

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<sup>18</sup> OECD Model Tax Convention.

<sup>19</sup> OECD (2011), *OECD Guide to Measuring the Information Society 2011*, OECD Publishing.

electronic payments and communication between the business entity and its customers.

Electronic commerce can be performed between enterprises, households, individuals, governments, and other private and public organisations. Electronic commerce can be used to procure goods and services that might be delivered physically and offline or electronically.<sup>20</sup>

Electronic commerce contains three important aspects; (i) the different ways in which electronic commerce can be implemented in business; (ii) if commerce is to be conducted electronically, what payment systems will be utilised; and (iii) the confidentiality of information released on such online transactions.<sup>21</sup>

## **2.3 MODELS AND IMPLEMENTATION OF ELECTRONIC COMMERCE**

### 2.3.1 Customer-to-business models

This refers to the customer's knowledge of the business' goods and services through online adverts. The customer could acquire the advertised goods and services through electronic or conventional cash as well as have the business deliver the goods either via conventional delivery modes or digitally.

### 2.3.2 Business-to-business models

The great part of electronic commerce consists of businesses outsourcing goods and services from other businesses. This can

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<sup>20</sup> OECD *Key Tax Principles and Opportunities for Base Erosion and Profit Shifting* (2013) OECD Publication.

<sup>21</sup> OECD op cit (n19) 10.

include an enterprise purchasing bulks of goods online, which it then sells to customers online or through retail stores. It also includes the provision of goods and services to other businesses such as logistic services, content management services and auction solution services.<sup>22</sup>

### 2.3.3 Business-to-consumer models

This model falls into several categories, including, the so-called “pure play” sellers with no physical presence, “click-and-monitor” businesses that supplemented existing consumer-facing businesses with online sales, and manufacturers that use online business to allow customers to order and customize directly. Goods sold by this model can be tangible or intangible.<sup>23</sup>

### 2.3.4 Consumer-to-consumer models

Businesses under this model play the role of intermediaries by linking up consumers. This is achieved by allowing consumers to use their websites to advertise their products for sale or renting. This kind of businesses conduction is achieved by various ways such as (i) online bidding on online auctions held via portals (ii) peer-to-peer systems that permit inter-user data sharing, and (iii) classified ads portals providing an interactive, online marketplace permitting commercial exchanges between buyers and sellers.<sup>24</sup>

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<sup>22</sup> OECD op cit (n19) 10.

<sup>23</sup> Ibid.

<sup>24</sup> Ibid.

## **2.4 IMPLEMENTATION OF ELECTRONIC COMMERCE**

### 2.4.1 The Internet and Intranet

The most widely publicised part of electronic commerce is the Internet. The internet has being described as a worldwide network of networks with gateways linking organisations in North and South America, Europe, the Pacific Basin and other countries.<sup>25</sup> With the aid of other computers normally referred to as routers that enable sending of data packets, the Internet can access one point to another without the presence of any central computer.<sup>26</sup>

With more accuracy and less expenses, the internet has facilitated the production and acquisition of goods and services worldwide. It has also enabled businesses of different scale to access markets that would be inaccessible by traditional business means. As a result, there has been an increase of electronically conducted business as well as the increase of markets in the past decade.<sup>27</sup>

An Intranet is a private network using the same internet protocol that is used on the public internet. Unlike the Internet, the Intranet is only accessible by specific users who are permitted to logon on the server only when authorized by the network server.<sup>28</sup>

Thus a company with offices located throughout the world might link those offices through an intranet to facilitate sharing of marketing information, training manuals, as well as financial information.<sup>29</sup>

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<sup>25</sup> Westin op cit (n9) 4.

<sup>26</sup> Ibid.

<sup>27</sup> OECD op cit (n19) 10.

<sup>28</sup> Kalakota & Whinston *Frontiers of Electronic Commerce* (1996) Addison-Wesley Publishing Company.

<sup>29</sup> Doernberg op cit (n4) 2.

## 2.4.2 Software Agents

Software agents perform tasks that are initiated by users proactively. The software thus acts as an agent of the user.<sup>30</sup> Software agents can be divided into static agents that reside on a principal's computers and mobile software agents that can travel to a remote location. Software agents can either be event monitors, work-flow assistants, and data gathering and retrieval agents.<sup>31</sup>

Software agents play an important role in electronic businesses. As growing competition in the development of operating systems, databases, web servers, and browsers reduced profits margins of electronic businesses, it also created new opportunities. On the other hand, the increasing number of software agents has forced e-commerce businesses to become more conducive and helpful consumers' needs.<sup>32</sup>

## 2.4.3 App Stores

The introduction of Internet access on smartphones and tablets has resulted in the increase of use of online services and the development of application stores, a type of digital distribution platform for software, often provided as a component of an operating system.<sup>33</sup> App stores take the form of central retail platforms, accessible through the consumer's electronic device, through which the consumer can browse, view information and reviews, purchase and automatically download and install the application.<sup>34</sup>

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<sup>30</sup> Kalakota op cit (n28) 13.

<sup>31</sup> Ibid.

<sup>32</sup> OECD op cit (n19) 10.

<sup>33</sup> Doernberg op cit (n4) 2.

<sup>34</sup> Ibid.

App stores include applications developed by the business operating the app store as well as those developed by third-parties. While many apps stores are targeted at consumers in particular geographical markets, applications are often cross listed on multiple app stores targeted at multiple geographical regions.<sup>35</sup>

#### 2.4.4 Virtual Currencies and Payment Systems

Virtual currencies are digital units of exchange that are not backed by government-issued legal tender.<sup>36</sup> Some virtual currencies are specific to a single virtual economy, such as an online game, where they are used to purchase in-game assets and services while in other cases, these economy-specific virtual currencies can be exchanged for real currencies or used to purchase real goods and services, through exchanges which may be operated by the creators or third parties.<sup>37</sup>

Some virtual currencies permit procurement of real goods and services. The most prominent example of this type are the various “cryptocurrencies”, including in particular bitcoins, which rely on cryptography and peer-to-peer verification to secure and verify transactions.<sup>38</sup> Despite having real economic value, some virtual currencies pose problems due to the anonymity of parties transacting. In the case of bitcoins, for example, transactions can be made on an entirely anonymous basis, since no personally identifying information is required to be provided to acquire or transact in bitcoins.<sup>39</sup>

The success or failure of electronic commerce is intertwined with the safety guaranteed via electronic payment systems. Traditional

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<sup>35</sup> Doernberg op cit (n4) 2.

<sup>36</sup> Ibid.

<sup>37</sup> Ibid.

<sup>38</sup> Ibid.

<sup>39</sup> OECD op cit (n19) 10.

payment methods such as bank cheques, cash deposits, or bank drafts may take time to process and eventually become costly.

Electronic payment methods include the following:<sup>40</sup>

- (a) *Electronic Cash*: this contain the following features: monetary value, interoperability, storability and retrievability, and security. This means electronic cash must be able to be backed by hard currency, be able to be exchanged for goods and services or any other purpose for which money is used.
- (b) *Smart Cards*: these exists as debit and credit cards that contain water thin micro-processors capable of storing more information than the traditional magnetic stripe. A customer can put the smart card in a card reader attached to a customer's computer and send the purchase price to the merchant's computer.
- (c) *Electronic Checks*: this serve as a credit-based payment system. A customer establishes a bank account which enables him to write electric checks that can be sent via email or some other electronic transport system.
- (d) *Credit cards*: online credit card payments take three forms: unencrypted, encrypted and third-party verification. The customer gains level of security and can send the merchant a digital signature that allows authentication of the user.

#### 2.4.5 Security Issues

If the information superhighway is to be used for commercial transactions, security must be established. There are various methods used to reduce security threats that might arise in electronic transactions.<sup>41</sup> This include the use of ordinary passwords or

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<sup>40</sup> Doernberg op cit (n4) 2.

<sup>41</sup> Ibid.

biometric passwords (face and voice recognition, fingerprints), use of software programs against malicious codes, setting up of firewalls between the corporate network and the internet and the use of private key encryption where both the sender and receiver of a communication share a key that is kept private. That is the sender can encrypt the message with a key, one that will also be used by the recipient to decrypt the same message.<sup>42</sup>

## **2.5 FUNCTIONS ENABLED BY ELECTRONIC COMMERCE**

The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits set up by the OECD Committee on Fiscal Affairs in January 1999 with the general mandate to “examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules”<sup>43</sup> provided for various business functions enabled by electronic commerce:

- (a) *Outsourcing*: new communications technologies allow businesses to procure goods and services from other businesses other than produce them themselves thus saving production costs. It also allows business to contact a vast number of businesses and to compare the said goods and services to be outsourced.
  
- (b) *Commodity suppliers*: Web-based systems allow supplying of goods and services to different markets that would not have being accessible via traditional supply methods.

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<sup>42</sup> Doenberg (n4) 2.

<sup>43</sup> Technical Advisory Group op cit (n5) at 3.

- (c) *Manufacturing*: Electronic commerce facilitates the making of goods at less costs as well as the procuring of manufactured goods at lower transaction costs.
- (d) *Retail distribution*: Through websites, business may sell goods and services to customers with high convenience.
- (e) *Delivery*: Efficiency of deliveries is ensured by electronic commerce. This is by enabling customers to track online the to-be delivered goods. It also provides instant delivery with respect to online delivery.
- (f) *Marketing and customer support*: Enterprises can advertise their products to different markets and customers located worldwide at less costs.
- (g) *Information*: The Internet allows the worldwide and quick delivery of information within the business as well as to customers enabling business to operate efficiently.
- (h) *Financial Services*: Financial services, such as banking, are currently offered online through online transactions.
- (i) *Digital products*: Various digital products such as software programs, e-books, music and games can be purchased and distributed electronically. This includes selling of such products, renting as well as pay-per-use of such products.

## **2.6 THE CONCEPT OF PERMANENT ESTABLISHMENT**

It is clear that in the international tax arena, the significance of having a permanent establishment in a country is that it gives the country in which it is situated the right to tax the entity under its domestic tax laws, notwithstanding the permanent establishment has no separate legal existence.<sup>44</sup> Article 5 of the OECD does not, in itself, create taxing rights, these can only exist under the domestic laws of a country.<sup>45</sup>

In terms of Article 7 of the OECD, the profits of an enterprise of a Contracting State are taxable only in the State, unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. The term ‘permanent establishment’ is defined in Article 5 of the OECD as a ‘fixed place of business’ through which the enterprise is wholly or partly carried on’.

The concept of permanent establishment hence forms the basic requirement needed to be proved before a source State may tax profits of non-residents. It provides for the criteria needed to establish that such a non-resident is present in the source State to the extent of being subjected to its tax laws.

## **2.7 DEFINITION OF PERMANENT ESTABLISHMENT**

The term “permanent establishment” is explained under Article 5 of the OECD Model which states:

1. *For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*

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<sup>44</sup> Olivier op cit (n1) 1.

<sup>45</sup> Ibid.

2. *The term “permanent establishment” includes especially:*
  - (a) *a place of management;*
  - (b) *a branch;*
  - (c) *an office;*
  - (d) *a factory;*
  - (e) *a workshop, and*
  - (f) *a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*
  
3. *A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.*
  
4. ....
  
5. *Notwithstanding the provisions of paragraph 1 and 2, where a person-other than an agent of an independent status to whom paragraph 6 applies-is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.”*

There are two notions of permanent establishment embodied in Article 5 of the OECD Model:<sup>46</sup>

- (1) *Physical permanent establishment:* this is a fixed place of business through which the business of the enterprise is wholly or partly carried on; and
  
- (2) *Agency permanent establishment:* this applies to dependant agents exercising their authority to contract.

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<sup>46</sup> Schwartz, Jonathan *Schwartz on Tax Treaties* 2nd Edition (2009) Wolters Kluwer Limited, London.

However, not all activities performed by a business shall constitute permanent establishment. Activities that are auxiliary to an entity's business or are preparatory in nature will not render the entity having a permanent establishment in the source State. The OECD model lists six circumstances in Article 5 Para 4(a) in which a fixed place of business is not considered a permanent establishment since the activities are preparatory or ancillary in nature since such activities might not produce any substantial profit to the enterprise. These exclusions are generally designed to remove from the scope of source-based taxation the use of facilities simply for storage or delivery, the maintenance of a stock of goods without more, the maintenance of a fixed place simply for purchasing goods, and the maintenance of a fixed place solely for a preparatory or auxiliary reason.

In essence, these exclusions remove casual or temporary business activities from the scope of source-based taxation.<sup>47</sup>

### **2.7.1 Physical Permanent Establishment**

The physical permanent establishment contains four requirements, namely:

- (a) There must be a place of business, normally premises, although it can, in certain circumstances be machinery or equipment; (*situs test*)
  
- (b) The place of business must be fixed, that is, have a certain degree of permanence. It must be located in a certain territorial area (*locus test*)

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<sup>47</sup> Schwartz op cit (n43) 21.

(c) The taxpayer must have a certain right of use over the fixed place of business (*ius test*)

(d) The activities performed through the fixed place of business must be of a business character, as defined in the treaty law and in the domestic tax laws (*business activity test*).<sup>48</sup>

Although the term 'business' necessitates the making of profit, a permanent establishment does not need to have a productive character per se. The reason is that although it is assumed that each part of an enterprise contributes to the productivity of the enterprise as a whole, each part does not necessarily need to be productive on its own (para 1(3) of the OECD Commentary on Article 5).

In addition, time spent on setting up a permanent establishment is not taken into account. A permanent establishment is only created once the businesses carries its business through an ascertainable fixed place. Similarly, although temporary interruptions of operations do not amount to closure of the permanent establishment, an enterprise ceases to exist when operations stop or when they are disposed of (para 11 of the OECD Commentary of Article 5).<sup>49</sup>

### 2.7.1.1 Place of Business

A permanent establishment will only exist if the enterprise has a physical presence in the source State. According to the OECD commentary on Article 5, the term 'place' connotes tangible assets of the business used in conducting its business. Thus emphasis is given to physical things of the business such as premises, equipment and

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<sup>48</sup> HMRC, International Tax Manual, 'Non-residents trading in the UK: Treaty Permanent Establishment: Commentary to OECD Model Treaty' INTM266030.

<sup>49</sup> Olivier op cit (n1) 1.

accessories that are used by the entity in conducting its business in the source State. The tangible assets need not be physically attached to the soil. By virtue of being tangible, such assets are in their own right a 'place of business'. Hence floating tangible assets may form a permanent establishment.

The size of the premises and the equipment that constitute a permanent establishment depends on the nature of the business. It is however irrelevant if the premises are rented or owned by the enterprise (para 1(4) of the OECD Commentary on Article 5).<sup>50</sup> No legal entitlement by the enterprise over the tangible assets is required to form a permanent establishment. Hence an illegal use or ownership of a place of business can create a permanent establishment.<sup>51</sup>

### 2.7.1.2 Fixed

For a place of business to be fixed, two components have to be met, namely:

- (1) a specific geographical spot has to exist, referred to as the 'location' test; and
- (2) there must be a certain degree of permanence at each geographical spot, referred to as the 'duration' test.

The location test, sometimes referred to as 'situs' test means that the tangible asset of the enterprise which constitutes a place of business should have a certain specific connection to a geographical point. The location test means that the business should be capable of being pointed out to contain a certain point or place which is stationary and not moving. Hence there must be some visibility of the business

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<sup>50</sup> Olivier op cit (n1) 1.

<sup>51</sup> Ibid.

in the source State. Where no distinct place of business exists, no permanent establishment exists, irrespective of the length of time which the operation continues.<sup>52</sup>

Under the duration test, a certain degree of permanence is required. Permanence in this regard is not on the premises but the conduction of the business activities. Isolated activities or activities of a temporary nature will not constitute a permanent establishment since they lack continuity and regularity. In *Applegate v. FCT*<sup>53</sup>, Sheppard J said the following on permanence of a place of business:

*“...permanence is used in the sense of something which is to be contrasted with what is temporary or transitory. It does not mean everlasting. The question is thus one of fact and degree”*

In this regard para 1(6) of the OECD Commentary on Article 5 states that experience has shown the following with regard to degree of permanence:

- (i) where the business is conducted for less than six months, a permanent establishment normally would not exist;
- (ii) where the business is conducted for a period longer than six months, but less than twelve months, a permanent establishment possibly exists; and
- (iii) where the business is conducted for a period longer than twelve months, a permanent establishment is likely to exist.

Permanence or temporariness of a business in a source State is determined through a subjective test – the non-resident’s intention. On the other hand, a permanent establishment can occur even when the non-resident had no intention of creating such in the source

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<sup>52</sup> Olivier op cit (n1) 1.

<sup>53</sup> *Applegate v. FCT* (1978) 8 ATR 372 at 378.

State. When such situation occurs, the objective test and not the subjective test applies in determining the permanence of the business in the source State.

However, two exceptions to this general rule are mentioned in para 1(6) of the OECD Commentary. The first is in respect of activities of a recurrent nature, where it is suggested that each period of time should be considered in combination with the number of times during which the place is used. The second is in respect of a business which is carried on exclusively in the source country, where it is suggested that even though the business may be of short duration due to its nature, it acquires a strong economic connection to that country once it is wholly carried on in the said country, giving the source country the right to tax the income.<sup>54</sup>

### 2.7.1.3 Through which the business is carried on

The business of the enterprise need to be carried through the said fixed place of business. 'Carried on through' does not mean that the entire business should be conducted via the place of business.<sup>55</sup> A fraction of the enterprises' business activities conducted through the place of business is sufficient in making a permanent establishment. This condition can be fulfilled by determining the 'business activities test'. The business activity test shall determine what the business is as well as its activities. The activities need not be of a permanent nature but should possess continuity. Hence one time activities cannot be said to be business activities even if conducted via the place of business.

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<sup>54</sup> Olivier op cit (n1) 1.

<sup>55</sup> Ibid.

When an enterprise sets up a fixed place of business in the source country but then rents it out and does not undertake to maintain the place of business, the third requirement of the permanent establishment definition is absent (para 8 of the OECD Commentary on Article 5). A distinction should be made between a permanent establishment ‘serving’ an enterprise and one through which the business of the enterprise is carried on. In this regard, Skaar<sup>56</sup> states the following principle:

*‘An important feature of the ‘place of business’...is that its purpose is to serve the business activity, not to be subject to business activities. The mere ownership of a fixed asset, for instance a real estate, is not sufficient for a permanent establishment...This general principle is helpful, however, when it comes to foreign investments in real estate, management of investment capital, as well as leasing activities and bare boat chartering of large tangible assets, for instance drilling rigs. Although some of these assets could obviously be a foreign place of business for somebody, they will not always be for the owner’.*

The requirement that the business needs to be carried on through the permanent establishment should not be interpreted that a permanent establishment will only exist if individuals are present. Individuals might be needed to establish the fixed place of business in the source State but their regular presence in such fixed place is not required to create a permanent establishment.

## **2.7.2 Agency Permanent Establishment**

If a business does not meet the physical permanent establishment requirements, a permanent establishment may still be established if an agent of that business or company regularly conducts business in the source State on behalf of the enterprise.<sup>57</sup> The dependant agent sub article replaces the requirement of a fixed place of business

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<sup>56</sup> Skaar, Arvid A *Permanent Establishment: Erosion of a Tax Treaty Principle* (1991) Kluwer Law and Taxation Publishers.

<sup>57</sup> Olivier op cit (n1) 1.

under the basic rule contained in Article 5 (1), as is the case with the building site and construction site window period contained in Article 5 (3).<sup>58</sup>

The agency permanent establishment contains four requirements, namely:

- (a) There must be a person with authority to act on behalf of the enterprise;
- (b) The agent must be dependent on the enterprise he acts on behalf
- (c) The authority to act on behalf of the enterprise must be habitually exercised; and
- (d) The authority needs to be exercised in the source State

Not all agents of the business in the source State shall create a permanent establishment. Article 5 of the OECD states that only 'dependent agents' on the business shall create a permanent establishment. This means the agent's activities must depend on the enterprise and such agent need not be an employee of the enterprise.

The 'dependent agent' should have the authority to conclude contracts on behalf of the enterprise and habitually exercise this authority in the source State. Activities of a broker, general commission agent or other agent of an independent status cannot create a permanent establishment in the source State if the agent is acting in the ordinary course of his or her business (Article 5(6) of the OECD).

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<sup>58</sup> Olivier op cit (n1) 1.

In determining the status of an agent in relation to a business, the “dependency test” is conducted through the following factors;

- (i) The amount of freedom the agent possesses to enter into binding contracts on behalf of the enterprise
- (ii) Entrepreneurial risk: if the risk is borne by the agent, he or she acts independently (Para 37-38 of the OECD Commentary of Article 5).

A person will only be a dependant agent if he or she has authority in respect of the core activities of the enterprise. The dependent agent’s authority to enter into binding contracts on behalf of the enterprise must be habitually exercised meaning there must be some degree of continuity in the exercise of such authority and not merely in isolated cases. In addition, such authority must be habitually exercised in the source and not residence State (Para 5 of the OECD Commentary on Article 5).

## **CHAPTER THREE**

### **APPLICATION OF THE CURRENT PERMANENT ESTABLISHMENT CONCEPT TO ELECTRONIC COMMERCE**

#### **3.1 INTRODUCTION**

Physical presence to perform the traditional commercial activities is no longer required; technological invention has replaced the physical transaction with bytes of data.<sup>59</sup> Due to non-existence of geographical boundaries in the e-commerce world, the question, where profits should be taxed becomes crucial.<sup>60</sup> The task of taxing e-commerce is frightening, since the data flowing through the Internet is intangible and the network on which it is built is spread all around the world and caters to globally located customers.<sup>61</sup> This raises cross border issues. It also challenges the fundamental principal and assumptions of International Taxation such as physical presence, place of residence of a person etc. that are the very basis of ascertaining tax liability, is under serious challenges.<sup>62</sup>

The importance of the permanent establishment concept is that it governs tax relations between the non-resident's resident and source State by acting as a subjecting the enterprise to the domestic tax laws of the source State.

As a result, determining at what point the non-resident creates a permanent establishment in the source State, crucial enough to be subjected to its domestic tax laws, becomes a significant and interesting topic.

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<sup>59</sup> Hoffart op cit (n12) 8.

<sup>60</sup> Ibid.

<sup>61</sup> Ibid.

<sup>62</sup> Ibid.

The OECD and other tax treaties have, without giving a concise definition of it, proposed the 'fixed place of business' as a crucial attribute in creating a permanent establishment in the source State. The term has thus been applied according to legal doctrine, case law, and continuous revisions to the OECD Commentary since its inception. Interpretations provided for the term fixed place of business have all being applicable to traditional business means without too many difficulties. However, the emergence of new business methods conducted via the internet have challenged the fixed place of business itself as well as its interpretations. The advent of the internet which resulted into the emergence of electronic commerce has led many scholars to question the use of the permanent establishment to tax business profits derived in the source State.

These arguments are based on the idea that, while permanent establishment was an effective criterion in the pre-digital age when cross-border commerce required a physical presence to conduct business, this criterion is no longer viable in an age where technology allows buyers and sellers to conduct cross-border business without ever establishing a physical presence in a non-resident state.<sup>63</sup> These criticisms are accompanied by a diverse array of reform suggestions including the permanent establishment status be determined by economic rather than physical nexus.<sup>64</sup> Despite the frequent calls for change, the OECD and other tax theorists maintain that the current PE rules are robust and flexible enough to respond to the challenges presented by the digital.<sup>65</sup>

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<sup>63</sup> Hoffart op cit (n12) 8.

<sup>64</sup> Ibid.

<sup>65</sup> Ibid.

## **3.2 APPLICATION OF TRADITIONAL SOURCE RULES TO ELECTRONIC COMMERCE**

In order to understand the complications brought about by the application of the permanent establishment as stated in the OECD to electronic commerce, one need to understand how such businesses are technologically arranged and performed.

In most cases, electronic business are conducted with the involvement of two or more jurisdictions as explained below.

### **3.2.1 Illustration 1: Three Jurisdictions in digital commerce**

*A Corp, an online audio and video music retailer incorporated and managed in country A (A's residence State as well as its place of website ownership) leases and pays for server space from another enterprise located in country B (B Corp. is A Corp's Internet Server Provider (ISP)) to have its website hosted for its customers in country C.*

*Country C's customers can buy A's goods from the website hosted by B Corp. Delivery of goods by A Corp. to a customer in country C can either be physical (via a music CD or flash disk) or digital (customer C downloads the music or video to his computer directly from the website after payment).*

*Customers located in country C can also pay for membership to stream audios and videos of A Corp on its website without having such goods physically or electronically delivered to them.*

### 3.2.2 Illustration 2: Two jurisdictions in digital commerce

*A Corp. conducting the same business and incorporated in country A (its resident State) could own or lease a server in country A. Hence country A becomes A Corp's place of website and server ownership. However, the customers of A Corp are situated in country C where they can access A Corp's goods through its website as well as pay for them through the said website.*

## **3.3 DIFFICULTIES IN APPLICATION OF THE PERMANENT ESTABLISHMENT CONCEPT TO THE ABOVE MENTIONED ILLUSTRATIONS**

### 3.3.1 Blurring of a "Fixed place of business"

The permanent establishment principle as discussed in Chapter Two stipulates the need of a fixed place of business with a geographical location in the source State.

From illustration 1, country A will be A Corp's residence State since it is incorporated and effectively managed there. However, country C will be the source State of A Corp's business profits from selling of music videos and audios.

In order for country C to tax under its domestic laws the business profits of A Corp, it will have to establish that A has a permanent establishment within its geographical borders. It is obvious that a website, lacking tangibility as well as being incapable of possessing and geographical location, though used to by customers in country C to buy and gain electronic delivery cannot constitute a permanent establishment.

Economically, A Corp has a business life in country C though not physically as required by the OECD to create a permanent

establishment. It could be said that A Corp carries on its business, the OECD's third requirement for a permanent establishment, through the website used by country C's customers. However, the enterprises business should be carried through a fixed place of business and since a website cannot be a "fixed place of business" then such cannot fulfil the third requirement of a permanent establishment.

In the event A Corp decides to physically deliver the goods to customers in country C, such delivery, though physical, cannot constitute a permanent establishment. Delivery of goods is an auxiliary activity to A Corps business of selling music and the OECD under its Article 5 does not consider auxiliary activities as business activities integral to create a permanent establishment. A Corp could also hire a delivery agent of independent status to deliver the goods to customers in country C, making it more difficult for the permanent establishment concept to apply to A Corp in State C.

With regards to B Corp, A Corp's internet service provider, its activities cannot be said to create a permanent establishment for A Corp in country B. Although a server, being a physical equipment that possesses a geographical point, could create a permanent establishment, an ISP is normally an independent agent. Even if the server located in country B was owned by A Corp, still activities conducted through the server would not constitute a permanent establishment if the server was only used to store information on A Corp's customers as this would not meet the "business activities test" requirement since A Corp is in the music retail business and not internet service provision business. Furthermore, country B will hardly qualify as a source State since business profits of A Corp are being derived from its customers located in country C. Country B will only qualify as a place of locating expenditure used to conduct A Corp's business activities in country C.

From this illustration, the requirement of “fixedness” of a “physical place of business” will not apply in A Corp’s business regardless of it having an economic presence in country C, the source State. The website through which A Corp conducts its business is not tangible and hence lacks a link to a specific geographical location within country C’s borders.

### 3.3.1.1 Illustration 3: Two jurisdictions in pre-digital commerce

*A Corp, incorporated and effectively managed in country A, would have a physical store in country C where customers would physically purchase goods. Country B, the server location place, would not be existent and nor will the website used by A Corp. A would also have persons (an individual or corporate body) acting as its agents in country C.*

In the pre-digital economy, it would be unlikely for A Corp to conduct its music retail business without having a physical store in country C as well as having physical products in the stores. This would also mean the non-existence of country B (place of server location) since A Corp would have a tangible store. The physical store would create a permanent establishment for A Corp in source State C as was envisaged by the OECD tax treaty when they were created. Cross-border transactions would not be applicable without having physical presence.

### 3.3.2 Blurring of a “dependent agent”

Under Article 5(5) of the OECD, an enterprise will be deemed to have a permanent establishment in the source State if it utilizes a person (other than an independent agent described in Article 5(6) for the purposes and in the manner described therein, even if the enterprise does not have a fixed place of business in the source State.

Application of the agency permanent establishment in e-commerce poses a problem in two ways:

### 3.3.2.1 Personal Agents

From this illustration, A Corp. may have concluded contracts with B Corp to have a server space which is used to host its website that will be visible to its customers located in country C.

Even if B Corp, an ISP, was said to be an agent of A Corp, such concluded contracts will not be on behalf of A Corp since its core business activity is trading in music videos and audios and not internet service provision. The mere fact that B Corp ensures A Corp's website is available to its customers in country C does not make B Corp a dependent agent of A Corp. This is because B Corp only provides internet service, and has no authority to habitually enter into contracts with A Corp's customers, a basic requirement of agency permanent establishment. It also happens that B Corp and a customer in country C might never be familiar with each other, let alone physically meet.

Arranging for A Corp.'s potential customers to obtain internet access so that they can view A Corp's web page would appear to be an activity that is 'preparatory or auxiliary' to A Corp's business of selling music videos and audios.<sup>66</sup>

Furthermore, entrepreneurial risks of hosting the server space for A Corp's website will be borne by B Corp itself. B Corp will most likely ensure that the computer equipment of the server operates smoothly and is updated when need be and all costs for such maintenance will not be borne by A Corp. A Corp will only pay rent for having the

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<sup>66</sup> Doernberg op cit (n4) 2.

website hosted hence the entrepreneurial risk test used to establish agency permanent establishment will not apply.

### 3.3.2.2 Software Agents

Article 5(5) of the OECD is established on the fact that even though an enterprise may not have a physical permanent establishment in the source country, the nature and level of activities conducted by the enterprise's dependent agent are sufficient to subject the non-resident enterprise to the domestic tax laws of the source State.

However, the availability of software agents may render such application invalid in electronic commerce since software agents perform tasks based on a general set of standards issued by the user proactively. The following illustration explains more on the difficulty of agency permanent establishment in relation to electronic commerce:<sup>67</sup>

#### 3.3.2.2.1 Illustration 4: Software Agents in digital commerce

*Suppose a potential customer located in country C, the source State, through his computer clicks on a hyperlink on the image displayed on A Corp's website. A Corp's server located in country B then dispatches a software agent to the customer's browser, the software agent being capable of answering business related questions, displaying goods, providing pricing information and modes of payments as well as concluding sale contracts that bind both the customer and A Corp. No human intervention is required for all these functions to be done by the software agent even if they are performed habitually and continuously.*

In the pre-digital economy, the above illustrated functions could not be executed without a 'person'. The said functions, being core to A

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<sup>67</sup> Doernberg op cit (n4) 2.

Corp's business would have created an agency permanent establishment as envisaged by the OECD rules. It thus explains why the current rules were drafted to include execution of such functions being capable of creating an agency permanent establishment since they would have being performed by a 'person' acting on behalf of the enterprise.

However, a software agent, though it performs the same functions as a 'person' agent cannot constitute a permanent establishment under Article 5(5) of the OECD. This provision refers to a 'person' acting on behalf of an enterprise. The term "person" is defined in Article 3(1) (a) of the OECD to mean "an individual, a company and any other body of persons." A software agent is not a 'person' within the meaning of the current OECD.

If the reason of Article 5(5) of the OECD in creation of an agency permanent establishment is the nature and the level of authority conducted by the agent in country C, it seems irrelevant to country C's taxing authority where that authority is executed by a software agent.

Even if Article 5(5) defined a 'person' to include software agents that habitually concluded contracts in the name of the enterprise, technologically there is no difficult in arranging for the conclusion of the contract to take place on B Corp.'s server located in country B or elsewhere rather than on the customer's computer in country C.<sup>68</sup>

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<sup>68</sup> Doernberg op cit (n4) 2.

### **3.4 THE OECD COMMENTARY ON SERVERS AND WEBSITES AS PERMANENT ESTABLISHMENTS**

Computer servers and websites exist at the core of implementing electronic commerce. This section shall observe how the OECD has defined the existing tax rules regarding servers and websites used by business to create a permanent establishment. The United Kingdom has also published its own commentary on Article 5 of the OECD guiding how they treat servers with respect to creating a permanent establishment within their geographical limits.

The OECD, a global body that sets out international standards for taxation, provided commentary on the application of Article 5 of its convention in relation to electronic commerce. At the Ministerial Conference on Electronic Commerce held in October 1998 in Ottawa, the OECD's CFA published the 'Taxation Framework Conditions', a document relating to taxation of electronic commerce. In December 2000, proposed changes on the OECD Commentary to Article 5 were published adding Paras 42.1 to 42.10.

#### **3.4.1A Server can qualify as a Permanent Establishment**

A server can be defined as a "computer networked to the Internet that enables businesses, *inter alia*, to post websites and sell goods or services over the Internet."<sup>69</sup>

A server is thus an electronic machine that responds to a certain set of programmed commands known as software. A server, being a tangible equipment with a physical presence in a certain geographical location can create a permanent establishment if the conditions set out in Article 5 of the OECD Model Tax Convention are met.

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<sup>69</sup> Cockfield op cit (n8) 4.

Hence to constitute a permanent establishment, the server must be a fixed place of business which occupies a specific geographical location, and for a certain period of time be used by the enterprise to wholly or partly carry on its business (OECD Commentary on Article 5, Para 42.1-42.2). To constitute a place of business, the enterprise must conduct its main or essential business activities through the server. This means the networked computer should be used to carry business activities of the enterprise.

Human intervention on operation of the server is not required to form a permanent establishment. The Commentary on Article 5 Para 42.6 provides that “if an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment”.

If a server is owned by an Internet Service Provider (ISP) which hosts a website of an enterprise, such server cannot create a permanent establishment for the enterprise. Furthermore, the ISP will not create an agency permanent establishment for the enterprise which it hosts for a website on its server (OECD Commentary on Article 5, Para 42.3 and 42.9).

### 3.4.2A Website cannot qualify as a Permanent Establishment

A website is a combination of software and electronic data, both of which do not form part of tangible property capable of having a physical presence. A website is normally stored in a server in the form of electronic bits of data that cannot be perceived by human senses. A website will thus not be capable of forming a permanent establishment since it cannot be a fixed place of business that can be located in a certain geographical point (OECD Commentary on Article 5, Para 42.2).

Thus the report by the OECD in relation to electronic businesses can be summarized as follows:

1. Websites, being intangible, cannot create a permanent establishment as they cannot be a fixed place of business
2. Website hosting arrangements on behalf of an enterprise cannot create a permanent establishment for that enterprise
3. Internet Service Providers cannot create agency permanent establishment since they lack authority to enter into contracts that will bind the enterprise
4. Servers, located in the source State for a suitably long period of time and being used by the enterprise to carry on its business can create a permanent establishment for such enterprise.

With regards to the summarized OECD's position, different countries have varying ideas with regards to servers and websites being able to create a permanent establishment.

Portugal and Spain do not consider tangibility and physical presence as compulsory requirements for electronic commerce to have a permanent establishment. Thus enterprises conducting business in these countries through a website can have a permanent establishment despite the OECD Commentary stating that a website, being intangible, cannot meet the requirements of Article 5 of the OECD Tax Model.

In 2012 in Spain, the Spanish Central Economic-Administrative Court held that Dell Products Ltd had a permanent establishment in Spain. Dell Product Ltd, through its subsidiary in Spain hosted a website out of Spain that was used for Spanish sales with the

subsidiary mainly translating webpages and administering the Dell website.<sup>70</sup>

With regards to servers, the United Kingdom takes the stand that a server as well as websites hosted in it that are used by electronic commerce business cannot create a permanent establishment notwithstanding the server is rented, owned or at the disposal of the enterprise.

The United Kingdom is of the view that most electronic business normally have computers set up in a State without personnel active for the business thus a server cannot constitute as a permanent establishment.

France on the other hand holds that a server alone cannot constitute a permanent establishment unless there are employees of the enterprise operating on the server, a view different from the OECD approach which holds that the presence of employees is not mandatory.

For a server to create a permanent establishment in France, it should be used to perform all aspects of a business transaction including the presence of employees.<sup>71</sup>

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<sup>70</sup> Sprague, Gary *Spanish Court Imposes Tax Nexus by Finding a 'Virtual Permanent Establishment'* (2013) *Tax Management International Journal*.

<sup>71</sup> Altman, Jorn *Grid Economics and Business Models* (2008) 5<sup>th</sup> International Workshop, GECON, Springer Science & Business Media, Las Palmas de Gran Canaria, Spain.

# **CHAPTER FOUR**

## **RECOMMENDATIONS AND CONCLUSION**

### **4.1 Recommendations**

With the emergence of digital businesses and transactions, there is a need to modify the existing permanent establishment rules or to formulate new rules that will cater for such new businesses. The following recommendations are thus proposed:

#### 4.1.1 Economic Presence Test over Physical Presence Test

In the pre-digital era when the current permanent establishment rules were formulated, it was impossible to envisage the conduct of business without having a physical presence in a certain geographical location.

This physical presence was brought about by the existence of either a retail shop, a warehouse, storage facilities or employees that fascinated the business of the foreign enterprise in the source State.

It thus explains why the current rules had the physical presence test as a fundamental requirement in enabling foreign enterprises to be rendered liable under domestic taxation laws of Source States.

The development of the internet resulting in the emergence of digitally controlled and conducted businesses and transactions dispensed with the physical presence of foreign businesses in source States rendering the traditional permanent establishment rules inadequate to respond to such businesses.

While the location of profit production has remained the same, the access to such locations has evolved.<sup>72</sup> Electronic businesses can access source States without possessing any physical presence. They thus have economic presence within the geographical boundaries of source States without having any physical place of business, a location with permanency in the source State.

The test for determining a permanent establishment for electronic businesses should not be physical but rather economic. Economic activities of an enterprise of another contracting State should allow the source State to extend its tax jurisdiction to the profits of the said enterprise arising out of such activities being conducted within its borders regardless of the enterprise having a physical presence or not.

All economic activities of a cross-border transaction should be observed to determine whether an enterprise has a permanent establishment or not. Economic activities differ between businesses and thus the test could as well be factual depending on how each business is conducted.

The use of economic activities as a test for creating a permanent establishment is much wider than that of a physical permanent establishment.

This is because economic activities will tax profits as much as they can be attributed to business activities pertaining to a particular enterprise according to its business that are conducted in a source State to derive profits regardless whether the said enterprise has a permanent physical place of business in the source State.

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<sup>72</sup> Hoffart op cit (n12) 8.

### 4.1.2 Place of Consumption over Place of Production

The pre-digital permanent establishment rules were created during the industrial revolution which saw an expansion of traders and merchants into foreign States. The industrial revolution brought about industries in the developed nations that depended on raw materials from and markets situated in less developed nations. This meant the location of industries was the location or place of production while the less developed nations became places of consumption since they created markets for industrial goods.

The current permanent establishment rules emphasize the place of production rather than the place of consumption since they were created to ensure that much of industrial profits were taxed in the developed nations - the place of the industries' residence as well as the place of production. Places of consumption, normally places of consumption, could only tax such industrial profits if the industry had a physical permanent establishment within their borders. With the emergence of e-commerce, places of consumption cannot tax such profits since most industries or businesses possess no physical presence in the place of consumption, normally the source State.

The rise and expansion of electronic businesses should allow focus on the permanent establishment rules to shift from the place where goods and services are created to the place where such goods and services are actually consumed. The use of the place of consumption as a basis of taxing profits rests on the reasoning that the consumption places create market opportunities which enable electronic businesses to produce profits through cross-border transactions.<sup>73</sup> In addition, most economic activities that produce

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<sup>73</sup> Cockfield, Arthur J *The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles* (2002) 56 Bull. For International Fiscal Documentation.

such profits happen in the places of consumption either physically or virtually with less of those happening in places of production.

Emphasizing the place of consumption also helps to combat income shifting and tax competition, one of the main goals of the OECD Tax Model. This is because the act of consuming goods and services requires a real human being as well as a legal person, both of which must have a certain geographical space, whereas the act of producing such goods and services might not require any aspect that occupies a geographical space or might have a geographical space in a place that has no value-adding economic activity.<sup>74</sup>

*Example: A Corp, an online audio and video music retailer incorporated and managed in country A (A's residence State as well as its place of production) leases and pays for server space from another enterprise located in country B, a tax haven State. A Corp's website is thus hosted from a low tax jurisdiction to its customers in country C, the place of consumption.*

The server in country B, assuming it is owned by A Corp and is capable of creating a permanent establishment, could be located in a tax haven State where A Corp would shift its profits and pay less taxes. Country C, the place of consumption and where A Corp might be economically present but not physically present, would require a real human being and most likely it would not be a tax haven since customers of different States could purchase A Corp's products through the website. Production of A Corps sold music in country A might not require any human intervention as well but consumption in country C must have a real human or legal person, the said having a geographical space in country C.

Thus a shift into places of consumption would reduce allocation of servers in tax haven nations and prevent income shifting by

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<sup>74</sup> Hoffart op cit (n12) 8.

electronic businesses.<sup>75</sup> The tax haven nations where servers that create a permanent establishment are situated might have no real value-adding economic activity since the server only hosts and stores the website data. However, most activities that will happen in places of consumption normally add value hence profits to businesses.

#### 4.1.2.1 Administering of the 'Place of Consumption' Principle

The principle of place of consumption can be administered by firstly modification of States as to the interpretation of what constitutes a 'source'. In *CIR v Lever Brothers and Unilever Ltd*,<sup>76</sup> Watermeyer CJ provided that a source of an income is not the quarter which it comes from but its originating cause which might be in the form of work, a business carried on, an undertaken enterprise of personal exertion.

Such interpretation of 'source' bases itself on the place of production since that is mostly where the originating cause will be located. However, with regards to electronic commerce, an enterprises' originating cause of income may be situated in one country but it could obtain profits from many other different countries without having a physical presence to create a permanent establishment and such interpretation overlooks the entire transaction leading to profits.

The originating cause interpretation of source does not take into account the entire transactions that take place through electronic commerce that result into profits. The originating cause may represent a small fraction of a transaction that results into profits that should have been taxed. Businesses in the contemporary world

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<sup>75</sup> Hoffart op cit (n12) 8.

<sup>76</sup> 1946 AD 441, 14 SATC 441.

are far complex and a regard of originating cause will only disregard profits that arise from such businesses.

In line with commercial developments, the United Kingdom has taken the 'profits in substance' case to determining profits taxability. The House of Lord's decision in *Firestone Tyre & Rubber Co. Ltd v Lewellin*<sup>77</sup> provided that:

*"A place of sale will not be the determining factor if there are other circumstances present that outweigh its importance or unless there are no other circumstances that can"*

The House of Lords provided that the location of a non-resident's trade is not only a sufficing factor to determine the source of profits. The place where the non-resident's trade is merchanting should also be taken into consideration thus the application of the profits in substance test. In the case of buying and selling of goods, the trade is exercised where the sale contracts are concluded. But where there are other trade activities, consideration should also be given where operations are carried out. The United Kingdom thus not only considers the profit-providing activities but also where such activities are carried out.<sup>78</sup>

The 'profit in substance' test thus does not only consider the operations of a business which result into the profits (the operations being the originating cause). The place where such activities are carried out is also taken into consideration. In most electronic businesses, the operations resulting in profits take place in the place of consumption. Hence the modification or expansion of the interpretation of 'source' to include not only the taxpayers originating

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<sup>77</sup> 37 TC 111.

<sup>78</sup> HMRC, International Tax Manual, 'Non-residents trading in the UK: Place of Contract may not be decisive' INTM263050 available at <http://www.hmrc.gov.uk/manuals/intmanual/INTM263050.htm> accessed on the 24 August 2015.

cause but in some cases, depending on the facts, the place where the taxpayer is merchanting or the place where the originating cause is carried out.

This would include the consideration of the businesses' operations, the place where such operations are carried out, the place of contracting, place of sale, mode of transacting and many other factors that might help deduce the source of the profits in substance. The 'profits in substance' test will also be in line with the 'economic activities test' discussed.

#### 4.1.3 Need of a Digital Permanent Establishment

The OECD Model proposes the permanent establishment as a source rule where source States can tax profits of a foreign enterprise that has a physical presence within its geographical area which it uses to derive profits.

The internet has however enabled foreign business to be present in the geographical limits of a source State without having any tangible object in such a State. This is managed by the use of websites to conduct business in source States, a website being intangible.

This paper recommends the need to create a digital permanent establishment which will help combat the problem posed by electronic commerce in relation to the physical presence test. A digital permanent establishment could be created by the use of a website in a source State to conduct business.

#### 4.1.3.1 Number of Days vs Number of Transactions

A website alone though present in a source State and being used to earn profits, cannot reasonably create a permanent establishment using the economic activity test or physical presence test.<sup>79</sup> This is because a website is not tangible and its presence alone does not constitute a business activity in the source State. Its presence in the source State would only facilitate acquisition of goods and services by the consumer.

This would require further proposals on criteria to be used to enable a website to create a digital permanent establishment. Such other criteria could include the number of days a website present and used in the source State as well as the number of transactions conducted through the website for as long as it is present.

Article 5 of the OECD has shown that time can be used to create a permanent establishment in a source State (6 months or 12 months in relation to a fixed place of business). Hence the same could be used over websites to create a digital permanent establishment. However, the number of days a website is present in a source State, is, in itself, not a sufficient factor to create a digital permanent establishment since a website could be present in a State without having any business activities conducted through it.

The number of transactions conducted through the website should thus be taken into consideration before such website creates a digital permanent establishment. The number of transactions over a certain period of time could be used to establish digital permanency of such website in the source State as well as the extent of its economic or business activities.

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<sup>79</sup> Wagh, Sagar *Digital Permanent Establishment (Digital PE): A Road Ahead for E-Commerce Taxation* (2013) Mumbai, India.

Digital permanency would thus be created if a certain “number of transactions” are conducted through a website present in a contracting State over a certain “number of days”, that website being used by a party of another contracting State to conduct business.<sup>80</sup>

Ownership of the website by the enterprise should not be taken into consideration when creating a digital permanent establishment, nor should its legality in terms of its presence in the source State as well as the legality of the transactions conducted through it.

All profits attributable to the transactions performed through the website in the said number of days would be profits attributable to a digital permanent establishment and would be taxable in the source State as per Article 7 of the OECD Tax Model. The number of days as that of transactions would be determined by the domestic tax laws of each State.

With regards to allocation of business profits to a digital permanent establishment, this paper recommends modification of Article 7(2) of the OECD. This is because the sub-Article states that in attributing profits, the permanent establishment would be treated as *“if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise”*.

Since most enterprises with electronic businesses do not own the websites used, they do not assume risks and assets in their maintenance and such may be borne by an independent internet service provider. An enterprise could pay for a virtual space in a server that is owned by an independent ISP, the latter being responsible with all risks and assets necessary in hosting the website ensuring its presence and accessibility as well as monitoring the transactions conducted through the website.

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<sup>80</sup> Wagar op cit (n79) 49.

Modifications should include taking into account ‘functions performed, assets used and risks assumed’ by other *parties, either of dependent or independent status, in the hosting and maintenance of the website that is used by the enterprise for its economic activities in the State.*

The risks borne and assets used by the independent ISP would only be for attribution of profits to the digital permanent establishment and not to create an agency digital permanent establishment.

## 4.2 Conclusion

With the emergence of electronic businesses and transactions, calls for changes of the traditional and current permanent establishment principles have been worldwide. However, a number of scholars have maintained that the current principles can actually be interpreted to encompass electronic businesses and thus no change or modification of the rules is required.

Those advocating for the maintenance of the traditional permanent establishment rules have raised certain arguments including the flexibility of the current rules, the existence of other principles such as transfer pricing to remedy the inefficiencies caused by the current rules as well as the lack of evidence to support tax avoidance by electronic businesses in source States.

They maintain that while the internet has revolutionised how business is conducted today, the foundation of profits has remained the same, that is where the costs and risks to develop the goods and services that produce profits. However, the internet can divert such places of costs and risks into other places which never formed part of the foundation of creating profit-producing goods and services.

The presence of other tax principles such as transfer pricing does not help in the problem posed by electronic commerce in relation to the current permanent establishment rules. This is because most of those principles can only be applied once the permanent establishment is established, an aspect not possible under the current rules. Moreover, the other principles do not serve as “source rules” in that they do not enable source States to extend their taxation jurisdiction into foreign profits. The other principles only determine the amount of profits to be included in taxation but do not create a taxing right of foreign profits.

The arm’s length principles under transfer pricing in attribution of profits to a permanent establishment can only be applied once the

permanent establishment is in itself determined. It is certainly difficult to apply arm's length principles in situations where no permanent establishment exists.

Hence the current permanent establishment rules should be changed or modified to reflect the ever changing commercial world brought about by the Internet so that new ways can be included in creating permanent establishment in source States.

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