

**Challenges Posed by Electronic Commerce to Certain Traditional  
Concept in International Tax Law**

**A technical report presented to the**

**Faculty of Law**

**University of Cape Town**

in partial fulfillment of the requirements for the

**Master of Laws**

**Degree in Taxation**

By

**Graeme Malcolm**

**November 1998**

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

## Preface

There has been much focus and discussion in the past few years regarding the potential impact which electronic commerce could have on the existing fiscal regimes, both from a domestic and an international perspective. It is against this background that I elected to research and present a dissertation on the implications of electronic commerce on certain aspects of international fiscal law. To give a more balanced perspective, I decided to add a section on other direct fiscal implications of electronic commerce, particularly from the perspective of fiscal administrations. The paper is therefore divided into two sections.

Had I know the scope of the assignment which lay ahead, I may have perhaps re-evaluated to merits of embarking thereon.

The principle difficulty in researching this topic, is the relative infancy of electronic commerce, and the corresponding shortage of established literature on the topic, particularly in the field of fiscal law. I found myself having to turn to the very medium of the Internet to locate contemporary literature on the subject and to find out what the international fiscal world was doing to deal with this new business form. For this reason, you will find references in the footnoted to certain web sites, which was a first for me. What complicates matters, is the speed at which technology is developing, and as the Internet and electronic commerce expand on the back of this technology, so the implications thereof develop at an

alarming pace. I found that various tax administrations, most notably those of the United States of America and Australia have brought out policy documents on electronic commerce. The Organization for Economic Cooperation and Development has held a convention on electronic commerce at Turku, Finland, and a vast amount of literature was submitted by various governments and other interest groups for discussion at the convention. There has been a proliferation of articles written by various international tax bodies, such as the International Tax Organization as well as well known academics in the field of international fiscal law. In the preparation of this paper I have drawn from these various sources, in an attempt to put down in a crystallized form, the various view points. This has been no easy task. There are, in addition, many questions, but not many answers to these questions. This reflects the international stance on electronic commerce. There is a growing awareness of the issues, but the solutions appear to be harder to find.

The first step in my inquiry was to gain a more than cursory understanding of how the Internet functions, so I could understand the various steps involved in any electronic commerce transaction. A good understanding of the intricacies of electronic commerce is essential if one wishes to evaluate the implications of this business form. It goes without saying, that from a tax perspective, the various stages involved in any electronic commerce transaction could have vast implications in the fiscal treatment of the transaction, particularly in the international context.

As my research progressed, so the vastness of this topic dawned upon me. I therefore chose to limit my inquiry to certain specific areas, and I elected to focus on international fiscal implications, as the very nature and revolutionary characteristic of electronic commerce is its international scope. The one area which stood out was the issue of permanent establishment and substance found in international tax treaties, as the difficulty in a State attaching a jurisdiction to tax in an international transaction, seemed to be embodied in the nature of electronic commerce, the Internet and the movement towards virtual shopping. The thing about electronic commerce, is that the citizens and companies of a State can now be reached through the telephone lines, without ever having to set foot in that country. What is more is that this can be done on-line and in real time, unlike mail order, for example, which can take up to weeks for a transaction to be completed and still requires the physical 'posting' of goods. In an extreme case, a company could establish itself in a tax haven, and through the Internet, sell goods and service to almost any person anywhere in the world without ever leaving the tax haven. This could be particularly so for the provision of certain services, like tax advice, for example, which could be done by video conferencing.

It seemed to me that the traditional tests used for determining when a company/person had established a taxable presence in a particular State, would have to be revisited, or the potential for large scale shifting of presence to low tax jurisdictions could be a real threat to tax administrations.

In order to fully appreciate the potentialities in this area of international fiscal law, I thought it is necessary to firstly understand how electronic commerce works, and to illustrate the capabilities of this business form. I also thought it is necessary to gain an understanding of the traditional means of applying the test of taxable substance in the sphere of tax treaties. The most commonly used test for establishing a taxing right being the existence or not of a permanent establishment of a taxpayer within a State. To do this, I chose to analyze the Organization for Economic Cooperation and Development's Model Convention for the Avoidance of Double Taxation, and in particular Article 7 (the business profits section) and Article 5 (the permanent establishment definition). As most people are not familiar with this document, I decided to include the wording of these Article in the paper. Hand-in-hand with the model tax convention, is the OECD's commentary there on, which is generally accepted by most countries world wide as the authoritative text on the interpretation of double tax treaties, particularly those modeled on the OECD's model convention. To expand on the OECD commentary, I have extracted what I believe are the most relevant sections from the book by Dr Klaus Vogel, Klaus Vogel on Double Tax Conventions, which is a very well respected and cited book in the field of tax treaty interpretation. The quotes I have included may seem excessive, but a good understanding of the existing interpretation methodology in international fiscal law is important when assessing the applicability thereof to commerce conducted electronically. The quoted text forms and integral part of the paper by sketching the background

against which an analysis of implications of electronic commerce should be evaluated.

The other area of international fiscal law I chose to address is the issue of transfer pricing. Again, I elected this topic as the potential implications of electronic commerce as regards transfer pricing are huge. The speed, intricacy, uniqueness, and anonymity of electronic commerce are not conducive to the traditionally accepted inquiry methodologies in determining the existence or not of a connected party transaction, and in determining the appropriate arm's length price for a transaction.

In the second part to the paper, I have briefly addressed other tax implications of electronic commerce, and looked at some of the challenges facing tax administrations going into the 21<sup>st</sup> century.

In closing the paper, I wished to illustrate the general stance towards electronic commerce of various governments, as this will, I believe have an instrumental role in how electronic commerce is viewed, administrated and possibly regulated over the next few years. The most concise way to achieve this was to quote from the findings of the OECD flowing from the Turku conference. I have accordingly closed with an extract from the OECD's summary of the responses of government from the Turku conference.

## Introduction

The rules of international tax law have developed around the need to regulate the fiscal treatment of persons affected by two or more sovereign jurisdictions, and in particular, around the need to eliminate the occurrence of double taxation and double no taxation.

Broadly, there are two traditional systems or bases upon which tax has been levied in domestic fiscal law systems - the source based system and the residence based system. The existence of these two different systems, and the fact that no jurisdiction adheres to a pure application of either system, together with the advent and expansion of international trade has increased, if not caused, the incidence of double taxation and double no taxation. Hence the growing body of international tax law which has developed in an attempt to regulate, globally, the incidence of tax in respect of persons and transactions in the international sphere.

The increased mobility of both capital and labour has complicated matters somewhat, as this has led to an ever increasing complexity in domestic fiscal legislation in an attempt to salvage a, potentially, ever decreasing tax base. As States tighten their domestic fiscal nets, so the flight of capital and skills becomes ever more attractive to the taxpayer. This has resulted in nations extending their tax jurisdiction beyond what was traditionally their geographic boundaries. As each nation follows suit, so the potential for, particularly, double taxation, increases.

In an attempt to regulate the flight of capital and skills, and to regularize the incidence of tax, the past few years, have seen a rapid growth in the network of double tax agreements (“DTA”) around the world. DTA’s are negotiated between countries to regularize the incidence of tax on residents/nationals of one State receiving income from, or trading within or with another State. This global network of tax treaties forms an important component of international fiscal law and is the framework around which much international fiscal jurisprudence is shaped.

Over time, a large body of international jurisprudence has evolved to aid the interpretation and application of international tax law, and particularly tax treaties. Various international bodies, most notably the Organization for Economic Cooperation and Development (“OECD”) and the United Nations (“UN”), have attempted to promote uniformity in the wording and interpretation of DTA’s by drafting model tax conventions for States to use as a basis when negotiating tax treaties. The OECD has brought out commentary on their model convention to aid in the interpretation of the provisions of the convention. There are already a large number of DTA’s drafted in accordance with the OECD model convention, particularly between developed states. Developing countries tend to adopt the wording of the UN model convention, as this wording favours the country of source more than the OECD convention, which tends to favour the country of residence, when assigning taxing rights to the particular States. As most

developing states are net importers of capital, the bias towards the source basis is in their favour.

Naturally, however, the jurisprudence and traditional international tax concepts, which have developed over time, have developed to deal with existing business and current business forms and methodologies. The ever present threat of shifting presence and income/profits to low/no tax jurisdictions has been handled based on existing techniques and technology, and the anti-avoidance methodologies and concepts which have evolved, have evolved along these lines.

As business had developed and communications have become more accessible and cost efficient, the borders between countries have become blurred and international trade has increased exponentially. The information technology ("IT") revolution has led to the evolution of the Internet and the world wide web ("WWW"), or the Web, as it is known and this in turn has led to the development of electronic commerce ("Ecom"). Furthermore, this technology is highly dynamic, changing and evolving on a daily basis, becoming faster, more efficient and more accessible.

The development of electronic commerce with the capacity to transact across borders by dialing a local telephone number and gaining access to a full range of goods and services anywhere in the world, some of which can be provided instantaneously and downloaded onto the user's personal computer in a digitized

form (computer software and music for example), have made it essential that adequate guidelines be introduced to deal with this type of commerce, particularly in the international context.

A complicating factor is the potential conflict of interest that could arise between tax authorities who are concerned about the impact of electronic commerce on their respective tax takes, and the strong arguments resounding from the business sector that there should not be any discrimination against this form of doing business. While regulatory aspects remain an issue, any tax, which distorts or hinders commerce, discriminates between different types of commerce or creates incentives that change the nature or location of a transaction, should be avoided. The principle of neutrality, as an underlying policy, has been accepted by most major trading nations. More importantly, the mobility of the factors of production could force the adherence to this policy as we go into the twenty-first century.

This paper is divided into two parts. The first part of the paper looks at the potential impact of electronic commerce on certain aspects of international fiscal law, in particular the traditional concept of 'permanent establishment' which is so widely used in double tax treaties in assigning taxing rights between States, and the requirement of substance in determining the existence or not of a permanent establishment, as well as the implications of electronic commerce in the realm of transfer pricing, particularly in the international context. The second part of the paper looks in more general terms at the impact and potential implications

electronic commerce could have on other direct tax issues, and the challenges which tax administrations could face as we move into the 21<sup>st</sup> century.

*The New Age taxation does not happen to be new, and it is not just any tax change or tax reform. It very deeply needs and wants to be new because traditional principles and systems of taxation no longer adequately perform their role. New Age taxation is not trendy and it is even less faddish. It is fundamentally innovative and marks the transition from twentieth to twenty-first-century taxation..... New Age taxation is pervasive and massive. It changes direct taxes as well as indirect taxes, tax thinking as well as tax practice, tax principles as well as tax rules, substantive tax law provisions as well as tax procedures, tax policies as well as tax legislation, administration and jurisprudence.<sup>1</sup>*

---

<sup>1</sup> Professor Luc Hinnekens, University of Antwerp 'New Age International Taxation in the Digital Economy of Global Society' Intertax, Volume 25, Issue 4, Kluwer Law International 1997

## PART ONE

- ELECTRONIC COMMERCE IN THE INTERNATIONAL SPHERE  
WITH PARTICULAR REFERENCE TO THE IMPACT OF  
ELECTRONIC COMMERCE ON THE TRADITIONAL CONCEPT OF  
PERMANENT ESTABLISHMENT AND SUBSTANCE AND THE  
IMPLICATIONS OF ELECTRONIC COMMERCE TO  
TRANSFERPRICING IN THE INTERNATIONAL FISCAL ARENA -

## CHAPTER ONE

---

### The Internet, the World Wide Web and Related Concepts

#### The Internet, the World Wide Net and the Information Superhighway

Before it is possible to investigate the impact that electronic commerce could have on the traditional international tax concepts, one needs to understand what electronic commerce is, and how it works.

Electronic commerce has evolved with the advent of the 'information highway'. The information highway is not a single computer network or means of communication, but is the convergence of separate computer systems into a global network of networks.<sup>1</sup> The concept of the information highway is the merging of all sources of information into a single retrievable database.<sup>2</sup> This network of networks includes telephone networks, cable and satellite networks and computer networks.

---

<sup>1</sup> Selected Tax Policy Implications of Global Electronic Commerce. US Department of Treasury, November 1996 as published in Intertax, vol. 25, issue 4

<sup>2</sup> Muscovitch, Z April 1996. Taxation of Internet Commerce. [http://www.globalserve.net/-zak/Taxation.htm#N\\_7\\_](http://www.globalserve.net/-zak/Taxation.htm#N_7_)

The term 'electronic commerce' refers to the use of the information highway to facilitate transactions involving the production, distribution, sale, and delivery of goods and services in the marketplace. In simple terms, it is the conducting of commerce electronically via the internet. However, while many people associate electronic commerce purely with the buying and selling of information, goods and services over computer networks, the components of electronic commerce are really more diverse. Not only can electronic commerce embrace the streamlining of the relationship between the consumer and business, it also embraces more efficient processes within a firm and inter-firm<sup>1</sup>.

The applications of electronic commerce are as diverse as they are numerous. These would include the paperless exchange of information within and between business entities using electronic data interchange technology (EDI), electronic mail (e-mail), conferencing software and electronic bulletin boards, and electronic funds transfers. More importantly to this discussion, the term electronic commerce is used to refer to the 'online approach' to conducting business with customers including marketing, advertising, entering and processing orders, payment and customer support.

Before we proceed any further, I would like to explain the meaning of certain well known but not so well understood concepts, which are central to an understanding of electronic commerce and how it is conducted.

---

<sup>1</sup> Howard E Abrahams and Richard L Doernberg - How Electronic Commerce Works – Tax Notes International May 12, 1997 at 1573

The Internet (**interconnected networks**) is a term that refers to thousands of interconnected logical networks linking millions of computers worldwide. The Internet refers to the logical connection between computers and not to the physical connections (e.g. phone lines, cable, radio transmissions). These interconnected computers include stand-alone computers and computers connected to the Internet through various networks including local area networks (LANs), metropolitan networks (MANs), and wide-area networks (MANs).

The term 'World Wide Web' is some time used interchangeably with the term 'Internet'. More accurately, the WWW is a navigation tool for locating and accessing information presented in graphic form available on hard drives and other storage facilities, known as Web servers, on the Internet. The WWW allows access to information in a multi-media format, featuring colour, graphics, audio and video. Users can access the Web through Web browser software like Netscape or Microsoft Internet Explorer, and can travel from site to site easily by clicking on a word or picture on one site that takes the user to another site.

The 'information superhighway' is best thought of as an evolving superset that includes the Internet along with the physical telecommunication networks, cable TV, mobile and cellular networks. Essentially, it describes a high-capacity (broadband), electronic highway that is capable of simultaneously supporting a

large number of electronic commerce applications that permit interactive connectivity between users.<sup>1</sup>

While strictly speaking, the Internet is not the same thing as the information superhighway, for ease of reference in this paper, I will use the term Internet to refer to what is essentially the information superhighway.

Having briefly looked at the concept of 'the Internet' in general, the rest of this chapter will be devoted to an explanation of certain concepts which underlie the functioning of electronic commerce, the understanding of which are central to an understanding of how electronic commerce takes place, and to fully appreciating the fiscal implications which this business form pose.

### Digitization

Historically, commerce has been conducted based on the existence, in a variety of forms, of physical presence. Face to face business meetings, written memos, exchanges of bills of lading or other contracts, and physical delivery of goods and services have been the order of the day. What has allowed the Internet, and therefore electronic commerce, to come into existence, is the digitization of information – a revolutionary change in the way information is communicated.

---

<sup>1</sup> Howard E Abrahams and Richard L Doernberg - How Electronic Commerce Works – Tax Notes International May 12, 1997 at 1574

Digitization refers to the process of converting information (text, sound, images, video etc.) to a sequence of numbers or a common digital format. The numerical sequence could represent images, speech, music, diagrams, computer software or the written word. Digitization of information allows the information to be communicated anywhere in the world at the speed of light, where the recipient can convert the digitized information back into its original form. A further advantage of the digitization of information and the subsequent digital communication of that information as opposed to an analog transmission, is increased accuracy.

The information is reduced to 'bits' with each bit representing an 'on' or 'off' state. A bit is the most basic form of information. Eight bits of information, forming a 'byte', can be transmitted, providing perfect information. The technological revolution is about the global movement of 'bits' that are colourless, sizeless, and weightless.<sup>1</sup> Once information has been digitized, the ability to transmit that information is a function of the Internet infrastructure.

### The Network Infrastructure

The **physical network infrastructure** comprises the physical components of the Internet that allow the information to actually be transmitted from one computer to another. The physical network infrastructure alone does not enable computers

---

<sup>1</sup> Negroponte – Being Digital 14 (1995) as quoted in Howard E Abrahams and Richard L Doernberg - How Electronic Commerce Works – Tax Notes International May 12, 1997 at 1574

to communicate with one another. The **logical network infrastructure** provides the laws by which information is communicated down the physical network infrastructure.

The **physical network infrastructure** is comprised of three major components: network access equipment, local on-ramps and telecommunication networks. Network access equipment refers to the end user's terminal equipment, usually a home or business computer. The device which allows the access equipment to connect to the information superhighway, is the local on ramp, commonly a modem (**modulator/demodulator**) which changes digital signals coming out of a computer to analog tones for the journey down the phone line wires, and visa versa. Once the information has reached the information highway, the information must travel over the Internet until it reaches its destination, usually another user's access equipment. The world's telephone companies provide the most important network for the transmission of information globally.

One of the technical barriers to the growth of the Internet and electronic commerce is bandwidth. Bandwidth refers to the speed at which data can be transferred over the system. As of November 1996, at the transfer speeds available to most consumers at that time, it would have taken about two days to transfer the entire contents of a music CD across the internet.<sup>1</sup> The physical

---

<sup>1</sup> Selected Tax Policy Implications of Global Electronic Commerce – Department of the Treasury Office of Tax Policy – USA Government – November 1996 at 3.1.4

network structure is constantly evolving, becoming faster and more capable of rendering electronic commerce globally significant. Already, fiber optic cables are replacing the traditional copper telephone cables. A fiber the size of a human hair could deliver every issue of the *Wall Street Journal* ever published in less than a second.<sup>1</sup> This refining and advancement in technology is rendering electronic commerce the most efficient and effective business form of the future.

The **logical network infrastructure** can be thought of as the collection of laws that govern the movement of traffic down the network highways.<sup>1</sup> The logical network infrastructure controls the use of the physical network, and allows the physical network to work as an efficient medium through which digitized information is transmitted on a global scale. Moreover, the various networks, which comprise the Internet, need to communicate with, and therefore understand, each other. This, too, is a function of the logical network infrastructure.

Internet Service Providers (ISPs) have emerged to offer commercial access to the Internet. These ISPs form the various networks of the Internet. The smooth functioning of the Internet is facilitated by peering agreements. A peering agreement, which may be bilateral or multilateral, is a reciprocal agreement by an ISP to carry the traffic of another ISP on its network. It is this collective action which ensures that the Internet never breaks down.

---

<sup>1</sup> Negroponte, *supra* note 3 at 23 as quoted in Howard E Abrahams and Richard L Doernberg - How Electronic Commerce Works – Tax Notes International May 12, 1997 at 1578

## CHAPTER TWO

---

### Electronic Commerce

Now that we have an over view of the structure of the Internet and how it works, let us take a closer look at what exactly electronic commerce is, and how it is conducted.

*Electronic commerce is the ability to perform transactions involving the exchange of goods or services between two or more parties using electronic tools and techniques.<sup>1</sup>*

The Australian Taxation Office describe electronic commerce as:

*Electronic commerce is the buying and selling of goods and services on the Internet. Goods can be of a conventional kind, such as books or CDs, where delivery is effected by conventional methods from a contract executed on the Internet, or digital goods, including money, software, music, copyright images, personal signatures, and detailed specifications to build physical products, where both the contract of sale and the delivery of goods is made*

---

<sup>1</sup> Howard E Abrahams and Richard L Doernberg - How Electronic Commerce Works – Tax Notes International May 12, 1997 at 1579

*via the internet. A very wide range of services is also now available on the Internet. Goods and services are generally acquired from websites.<sup>2</sup>*

In practice, electronic commerce operates as follows. A user who wishes to access the Internet will dial a local telephone number or use a direct connection to an ISP via a network which has an interface with the Internet. This point of interface provides a point of presence (POP) for the user on the Internet. The user will then send their message to the ISP who then uses the telecommunications infrastructure to send the message to the main operating center. At the main operating center, the client's identification is authenticated using a password, and the client is then connected to the Internet. The ISP usually operates the POP using modems and switching or routing equipment, while the main operating center will include high speed data transmission equipment. The user can dial into their own ISP from anywhere in the world.

Having gained access to the Internet, the customer is free to select the appropriate Internet address of the company/individual with which they would like to transact. If the customer does not know the particular Internet address or if the customer is looking for the appropriate website, they would use one of the Internet search engines to assist them. Any person/business can create their own web page or website on a dedicated server, which is connected to the ISP's point of presence.

---

<sup>1</sup> XIWT Cross-Industry Working Team – Electronic Commerce – 1995 –  
[http://www.cnri.reston.va.us:3000/xiwt/documents/Ecomm\\_doc/ECommTOC2.htm](http://www.cnri.reston.va.us:3000/xiwt/documents/Ecomm_doc/ECommTOC2.htm)

<sup>2</sup> Australian Tax Office – Discussion Report of the ATO Electronic Commerce Project – 1997 – at 3.1.2

Once a site has been selected, the customer can browse the company's site and select the product or service to be purchased. In certain extreme cases, a company could have a 'cybermall' in which the Internet user could browse for goods and services. Upon selection of the products to be purchased, the customer can click on a payment icon that either transfers electronic cash to the company, or provides the necessary credit card information to conclude the sale/transaction. Once payment has been effected, the company may permit the customer to download information onto their hard drive for those products, which are capable of being delivered in this way (e.g. computer software, videos, books, text and other data). If the payment is for services, a video conference might be established between the customer and a consultant of the company. If the items ordered do not lend themselves to delivery in this way, the company will then arrange for the goods to be physically delivered to the customer. In this regard, the customer could download the payment receipt and the shipping information.

Electronic commerce is growing across the globe. It is a convenient, accessible and cost effective way of conducting business. It also allows companies/individuals in one part of the world to conduct business with companies/individuals in other parts of the world and in other countries. All that is required is a personal computer ("PC") and an Internet connection. As the technology, which is the Internet, become more and more advanced and refined, so the scope for conducting business via the Internet increases. The opportunities

for conducting business internationally are perhaps the most exciting, and it is this growth in trading between States, facilitated by the Internet, which is essentially the subject of this paper. It is not that international trade and commerce are new phenomena, it is the magnitude, in number and extent, of cross border transactions which the Internet has facilitated, which is having such a revolutionary impact on international fiscal regulation.

## CHAPTER THREE

---

### Permanent Establishment

The term 'permanent establishment' is well known and well accepted in international tax law. It is a concept, which has developed, particularly in the context of double tax agreements, as a means of assigning taxing rights to one or other State when two States could claim a jurisdiction to tax.

The general principle in most DTA's is that profits of an enterprise resident in one State are taxable only in that State unless the enterprise carries on business in the other State through a permanent establishment. This is usually set out in the 'Business Profits' section of most DTA's. The provision then generally goes on to state that, where an enterprise of one State does in fact conduct business in the other State through a permanent establishment, the enterprise shall be liable to tax in the source State on the profits attributable to the permanent establishment, based on the 'arms-length' principle. For illustrative purposes, the wording of the relevant subsections of the business profits article, Article 7, of the OECD model double tax convention (OECD MC) is set out below:

**Article 7****Business Profits**

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as are attributable to that permanent establishment.
2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of earning the profits of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.
4. .....
5. .....
6. .....
7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

From the wording of this section, it is apparent that for the application of the DTA, one must be able to ascertain in any given cross border commercial scenario when an enterprise of one State is conducting business through a permanent establishment in the other State. In this regard, some international, generally accepted, guidelines would exceedingly helpful, if not essential, to harmonize the different interpretations of various States in international transactions. To this end, the OECD MC contains a definition of permanent establishment in Article 5, which for ease of reference is set out below:

## **Article 5**

### **Permanent Establishment**

- 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.**
- 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. Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include:
- (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
  - (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
  - (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
  - (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
  - (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
  - (f) the maintenance of a fixed place of business solely for any combination of activities, mentioned in sub-paragraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
5. Notwithstanding the provisions of paragraphs 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.
6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. **The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.**

In an attempt to foster uniformity in the interpretation of the treaty, the OECD has brought out commentary on the various provisions explaining how the provision should be interpreted. Although each State tends to develop its own jurisprudence on any subject, the OECD's commentary is generally accepted as the most authoritative explanation of the aforementioned provision, and is generally used and applied by States when interpreting specific provisions and more importantly, specific internationally recognized concepts in DTA's, like the concept of 'permanent establishment'. Below, I have extracted what I believe are the most relevant parts of the commentary, to this dissertation, on the 'permanent establishment' provision:

## **A. General Remarks**

### **MC Commentary**

1. **[Purpose of the rule]** The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7, a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.

## **B. Regarding Art. 5(1)**

### **I. MC Commentary**

**[Fixed]** According to the definition, the place of business has to be a 'fixed' one. Thus in the normal way there has to be link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site.

**[Permanence]** Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. If the place of business was not set up merely for a temporary purpose, it can constitute a permanent establishment, even though it existed, in practice, only for a very short period of time because of the special nature of the activity of the enterprise or because, as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated. Where a place of business which was, at the outset, designed for a short temporary purpose only, is maintained for such a period that it cannot be considered as a temporary one, it becomes a fixed place of business and thus - retrospectively - a permanent establishment.

**[Carrying on business]** For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 3 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

**[Business need not be carried on personally]** The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorized to conclude contracts if he works at the fixed place of business. But a permanent establishment may nevertheless exist if the

business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

## **C. Regarding Art. 5(2)**

### **I. MC Commentary**

**[General remarks]** This paragraph contains a list, by no means exhaustive, of examples, each of which can be regarded, prima facie, as constituting a permanent establishment. As these examples are to be seen against the background of the general definition given in paragraph 1, it is assumed that the Contracting States interpret the terms listed, 'a place of management', 'a branch', 'an office', etc. in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1.

**[Place of management]** The term 'place of management' has been mentioned separately because it is not necessarily an 'office'. However, where the laws of the two Contracting States do not contain the concept of 'a place of management' as distinct from an 'office', there will be no need to refer to the former term in their bilateral convention.

## **E. Regarding Art. 5(4)**

### **I. MC Commentary**

**[Principle]** This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of

business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in sub-paragraph (e), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover sub-paragraph (f) provides that combinations of activities mentioned in sub-paragraphs (a) to (e) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.

**[Summary]** Sub-paragraph (a) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Sub-paragraph (b) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. Sub-paragraph (c) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in sub-paragraph (d) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many 'tentacles' of the parent body; to exempt such a bureau is to do no more than to extend the concept of 'mere purchase'.

**[Activities of an auxiliary character]** Sub-paragraph (e) provides that a fixed place of business through which the enterprise exercises solely an activity, which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. The wording of this sub-paragraph makes it unnecessary to produce an exhaustive list of exceptions. Furthermore, this sub-paragraph provides a generalized exception to the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organization which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognized that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the purpose of advertising

or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

**[Distinction]** It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of sub-paragraph (e).

Although the OECD commentary is a useful starting point for the analysis of what constitutes a permanent establishment, the commentary is fairly general in its explanations and in its application. It is useful, in order to gain greater insight into this evasive concept, to read from some of the more authoritative texts on the subject. For the purposes of expanding the analysis, I have chosen to quote from the work of Professor Doctor Klaus Vogel of the University of Munich, a well known author in the field of double tax treaties. In his book *Klaus Vogel on Double Taxation Conventions – explanatory notes on the Model Conventions*, Dr Vogel makes the following comments on Article 5 which are relevant to this enquiry:

## **II. Explanatory Notes on the Model Conventions**

- (c) **Fixed place of business:** Taxation of profits made by an enterprise in the other contracting State is envisaged only in cases where the enterprise's business activities there have taken on certain **consolidated** forms. Mere business relations with enterprises or other customers in the contracting State would be insufficient.

The very terms employed make this point clear, though admittedly in different ways; the equivalent used in the French text of the English term 'permanent establishment' is 'établissement stable', the English text stressing the aspect of **permanence**, the French text that of **situs** (stable). In contrast, the German term 'betriebsstätte' is less indicative. It is only by defining this term as a 'feste Geschäftseinrichtung' that the aspects of the original English and French texts are given consideration. In regard to its contents, however, the definition in Art. 5 of the MC has been influenced considerably by German law (though it is narrower than the latter, particularly on account of the exceptions enumerated in Art. 5(4)). A '**place**' though normally a particular portion of space, must be read here in the light of its being used to define 'establishment'. A '**place of business**' therefore, means all the **tangible assets** used for carrying on the business; in marginal cases, one such tangible asset would be sufficient (cf. RFH RStBL.840, 841 (1935): Germany's DTA with Switzerland 1931; Dorn, H., 3 Stu W 97, 107 (1926)). Rights, such as participation in a corporation, claims (as well as accounts) or intangible property rights (patents, software, etc.) do not amount to a permanent establishment (see Skaar, A., supra m.no. 1, at 121ff.). The term covers both premises and other tangible assets **used** by the enterprise, i.e. the 'place of business' as a whole must be '**used**' and not necessarily each of its individual component parts. Special facilities for carrying on the business are not necessarily required. An empty room in which the enterprise's business is carried on could qualify as a 'permanent establishment'. Moreover, the weight attaching to the 'use' criterion is all the lighter, the more the actual business activity is exercised outside the place of business. That is why even the living accommodation of a travelling salesman may well be classifiable as a permanent establishment (see BFH 4 BFH/NV 119 (1988)).

The place of business must be a '**fixed**' one. The existence of a link between the place of business and a specific geographical point would be sufficient. The facility need not be an integral part of the plot of land on which it stands

The enterprise's business must be carried on **in** or **through** or **by** the fixed place of business, i.e. the fixed place of business itself must not be produced, traded or processed by the entrepreneur. If a place of business, is transferred for use to another enterprise, the abandoning enterprise does not, in principle, execute any further activity or business. This is different, however, if the transferee conducts the establishment at the cost and danger of the transferring enterprise (FG BW 40 EFG 653 (1992): Germany's DTC with Switzerland).

31 (f) The **type of business** engaged in by the enterprise is irrelevant. In particular, the permanent establishment need not be a branch in the nature of a facility engaged in activities of the same type as those of the head-office organization. Nor need the place of business contributed directly to the enterprise's profits (para 3 MC Comm. Art. 5, see supra m. no. 11). All that its business must do is to serve the enterprise's overall purpose. But it must be an 'activity'. Hence, the mere transportation of oil or similar substances through a pipeline or like installation as well as the conduction of electricity through cables would not be considered as an activity and would, as a result, not constitute a permanent establishment (BFH BStBl. II 111, 112 (1978) with further references; the Danish Minister of Finance from 23 November 1993, 9 TNI 505 (1994), referring to the OECD MC Commentary; varying, though not directly in conflict: FG Düsseldorf, 40 EFG 717 (1992)). This is not the case, however, with fully automatic pumping stations and similar facilities, see infra m. no. 35.

34 The activity exercised within, by or through the facility must, however, be a **business** activity. The facility must have features characteristic of a place of 'business'. That is why social facilities such as rest homes for, or living quarters of employees are **not** permanent establishments as defined by the MCs (FG München, 16 EFG 55, 56 (1968); Germany's DTC with Italy 1925; and BFH BStBl. III 349 (1959); III 52 (1961); iii 156, 157 (1963)).

The activity need not necessarily be performed by a human being. **Vending machines and other automated devices** may very well be permanent establishments if the enterprise engages in business beyond the mere installation of such machines. Even fully automated pumping stations and similar facilities should be considered permanent establishments.

(a) **Main features:** Art. 5(2) gives substance to the general 'permanent establishment' concept. The examples enumerated make the definition of Art. 5(1) more specific while not doing away with the necessity to apply the latter. The examples are such as correspond to, and must be viewed in the light of, the general rule. In other words, a place of business of the kind envisaged by Art. 5(2) cannot constitute a permanent establishment unless it meets the requirements of the general permanent establishment definition laid down in Art. 5(1). That it does so should by no means be taken for granted (para 12 MC Comm. Art. 5, see supra m.no. 41; RFH RStBl. 840, 841 (1935); Germany's DTC with Switzerland;

Flick/Wassermeyer/Wingert/Kempermann, Art 5, Anm. 28; Debatin/Walter, re Art. II para 28; van Raad, K., supra m.no. 1, at 501; as for Germany's DTC with Austria, cf. Lang, M., supra m.no.1, at 363; different view held by Korn/Debatin, Syst. IV, Rdn. 56). What must particularly be examined in each individual case is whether the place of business satisfies the permanence criterion (supra m.no. 28), since the examples do not automatically refer to it. An office, for instance, set up for a short period during a fair or exhibition would not constitute a permanent establishment.

49(b) A place of management is a place where the business of the whole or part of the enterprise is conducted. ~~If the business of an enterprise is conducted from various places, for example, if the enterprise has one management for its commercial interests and a separate one for its technical interests, there may be more than one place of management~~ (Debatin/Walter, re Art. II, para. 29; Dirksen, WI, DBA Niederlande/Schweiz, Rdnr. 37 (1970)). Use of minor installations and facilities is sufficient for a business to be carried on at a place of management (RFH RStBl. 67, 70 (1937); RStBl. 788 (1939); both on Germany's DTC with Switzerland 1931). On the other hand, at least such minor installations and facilities are necessary for a permanent establishment to be constituted. The mere exercise of business activities or actual office work do not, by themselves, create a permanent establishment as long as no enterprise-owned facilities are available in such a case.

50 **Decisions** taken at a place of management must be of **significance** to the enterprise as a whole. Although the English term 'management' may be subject to a broader interpretation, the French version 'siège de direction' shows without a doubt that only managerial activities are intended (this result also reached by Huston, J., & Williams, L., supra m.no. 1, at 17ff.). Occasional shareholders' meetings are not sufficient to constitute a permanent establishment (Conseil d'État, req. Domicilgesellschaft (i.e. a company which is merely domiciled in Switzerland, but does no business there) is operated by its sole proprietor who is resident in another State, even the latter's living accommodation may be the 'place of management')

53(d) The term '**office**' denotes a facility that is used for handling the administrative side of the business and that requires neither any degree of independence nor any particular internal organization. This corresponds to what in former German law is referred to as *Kontor* (viz. a merchant's office) within the meaning of former

German law (cf. RFH RStBl. 54, 55 (1930): an office for planning and information purposes; RFH RStBl. 1516, 1517 (1935); BFH BStBl. II 776, 778, (1971)). Sales promotion centres designed to assist travelling salesmen will normally also be offices within the meaning expressed by MC (Ludwig, M.B., National Reporter, CDFI LII 501, 511 (1967)). Many of such offices, however, will be no more than facilities of an auxiliary character within the meaning of Art. 5(4) MC. The minimum requirements for an 'office' are discussed by Huston, J., & Williams, L., *supra* m.no. 1, at 15f.

.....

**108(a) Main features :** The facilities and activities enumerated in the list of **exceptions to the permanent establishment concept** do not constitute permanent establishments even if they satisfy all the requirements laid down in Art. 5(1). The list refers to activities of a **preparatory and auxiliary character**, such activities being exempted from permanent establishment taxation. One reason for this is that taxation by the State in which these activities are exercised is not so evidently legitimate as taxation of more direct activities, and another reason is that it is particularly difficult and problematic to determine the share of business profits attributable to such auxiliary activities. The exemption of purchasing offices, distributing warehouses and other auxiliary facilities is moreover designed also to facilitate international trade. Skaar, A., *supra* m.no. 1, at 288ff., points out correctly that the exception is not justified if the 'supporting' installation is large and manages a significant percentage of the enterprise's revenue. According to the text of the MC, however, such installations fall under the exception of para 4 (differing is Skaar, A., *loc. cit.*, 290, 325).

.....

**115(f) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.** There are two different requirements to be distinguished in this connection:

- **The character of the activity** exercised by the place of business : it must be preparatory or auxiliary;
- **the object of such activity** : it must be solely in favour of the enterprise to which the place of business belongs; it **must**, therefore, **not** aim at directly benefiting any **third party** as well.

**116** The activity must be of a **preparatory** or **auxiliary** character. Examples given in the text of MC 63 and in the Commentary on Art. 5(4) of MC 77 refer to fixed places of business maintained solely for the purpose of advertising or for the supply of information or for scientific research, all for the enterprise. While such places of business may well contribute to an enterprise making a profit, services they perform are so remote from the actual realization of a profit that it would be difficult to allocate any profit to the fixed place of business concerned (see *supra* m.no. 9; para 23 MC Comm. Art. 5, *supra* m.no. 99).

**116(a)** It is **only where** they are exercised **for the enterprise itself** that such preparatory or auxiliary activities do not constitute a permanent establishment. If they are services rendered for a consideration and **for a third party**, they will constitute the enterprise's **main object**, and corresponding facilities may well be permanent establishments (ÖstBMF 4 SWI 147 (1994) : DTC Austria/USSR; cf. also Korn/Debatin, Syst. IV, Rdn. 63).

The concept of 'permanent establishment' is central to the functioning of DTA's, being the connecting factor upon which the jurisdiction of the source State's taxing rights are based. A permanent establishment must be a fixed place through which business is carried on. Mere business relations with enterprises or other customers in the contracting State would be insufficient.<sup>1</sup> But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment.<sup>1</sup> Nor need the place of business contribute directly to the enterprise's profits. All that its business must do is to serve the enterprise's overall purpose. But it must be an activity. Hence, the conduction of electricity through cables would not be considered as an activity and would, as a

<sup>1</sup> Klaus Vogel on Double Taxation Conventions – Klaus Vogel – Kluwer Law International – Third Edition at 285

result, not constitute a permanent establishment.<sup>2</sup> The activity need not necessarily be performed by a human being. Vending machines and other automated devices may very well be permanent establishments if the enterprise engages in business beyond the mere installation of such machines.<sup>3</sup> What is trite, though, is that activities of a preparatory or auxiliary nature do not generally render a fixed place of business, a permanent establishment. This includes the maintenance of a fixed place of business solely for the purpose of collecting information<sup>4</sup> or for the purposes of display of merchandise<sup>5</sup>, which would generally also include soliciting for business, provided this solicitation is merely of a preparatory nature as regards the entire business transaction.

---

<sup>1</sup> Klaus Vogel *supra* at 284

<sup>2</sup> Klaus Vogel *supra* at 289

<sup>3</sup> Klaus Vogel *supra* at 290

<sup>4</sup> OECD Model Convention for the Avoidance of Double Taxation of Income and Capital – Article 4d

<sup>5</sup> OECD MC *supra* – Article 4a

## CHAPTER FOUR

---

### The Implications of Electronic Commerce

It has come to be accepted in international fiscal matters, that until an enterprise of one State sets up a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other States taxing rights.<sup>1</sup>

The concept of trade or business was developed in the context of conventional types of commerce, which generally are conducted through identifiable physical locations. Electronic commerce may be conducted without regard to national boundaries and may dissolve the link between an income producing activity and a specific location. Electronic commerce, in a manner of speaking, does not seem to occur in any physical location, rather, it takes place in the indefinite world of 'cyberspace'. The parties involved in electronic commerce transactions could be located anywhere in the world and each party may be ignorant of, or indifferent to, the others location.

Electronic commerce permits a foreign person to engage in extensive transactions with a State's citizens without entering the State. Although such persons are

clearly engaged in a trade or business, the question which will arise when the competing taxing rights of the States is to be determined, is whether they are engaged in a trade or business in the particular State, or through a permanent establishment in that State. In this regard, it will be necessary to clarify the application of the traditional trade, business and permanent establishment concepts to business conducted via electronic commerce. It will be important to consider the extent to which electronic commerce simply represents an extension of current means of doing business, the tax consequences of which are understood. To the extent that the activities engaged in via electronic commerce are equivalent to the mere solicitation of orders from a State's residents, without any other activity within the State's borders, it would not be appropriate to treat such activities as a trade or business in the State. In the context of electronic commerce, it becomes all the more important to consider whether it is appropriate or practical to treat foreign persons engaged in commerce via the Internet, and who are physically located outside the State as being engaged in a trade or business in that State.

A specific example is the treatment of persons who maintain or utilize a computer server in a State. Computer servers can be located anywhere in the world and their users are indifferent to their location. It is possible that such a server, or similar equipment, is not a sufficiently significant element in the creation of certain types of income to be taken into account for the purposes of determining whether a trade or business exists in the State. It is also possible that, if the

---

<sup>1</sup> US Department of Treasury Office of Tax Policy *supra* at 7.2.2

existence of server based in a State is taken into account for this purpose, foreign persons will simply utilize servers located outside the State.<sup>1</sup>

In this regard, consideration may also be given to the role other activities should play in determining whether a trade or business occurs within a State. For example, it may be decided that a foreign person who operates a computerized research service through computers located outside the State may not be engaged in a trade within the State unless other activities of the business take place in the State. However, residents of the State engaged in providing marketing and support services for a foreign-based provider of computerized research may create a trade or business for the foreign person within the State, even if the computer servers and other activities are located outside the State.

#### Permanent Establishment

To the extent that a foreign person is not engaged in a trade or business, then the absence of a permanent establishment is irrelevant since the State will not tax that person's active business income. However, some persons entitled to benefits under a State's income tax treaty will not be subject to that State's tax due to the lack of a permanent establishment, notwithstanding the fact that they may be engaged in a trade or business within the State.

---

<sup>1</sup> US Department of Treasury Office of Tax Policy supra at 7.2.3

A permanent establishment generally requires a fixed place of business in the State although a permanent establishment can also arise by imputation from the activities of an agent. Therefore, persons engaged in electronic commerce may not have a permanent establishment because they do not have a fixed place of business in the State, unless a permanent establishment is created by imputation.

Telecommunications or computer equipment owned or used by foreign persons engaged in electronic commerce raises a question as to whether this equipment could constitute a fixed place of business of the foreign person in the State, taking into account that there would not necessarily be any employees present. It will be necessary to consider whether a foreign person who owns or utilizes a computer server located in the State should be deemed to have a permanent establishment there. Again, it is useful to review the treatment of existing, traditional commercial activities and consider whether any existing exclusions from permanent establishment treatment should apply in this situation. For example, a permanent establishment generally does not include the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise.<sup>1</sup> For a business which sells information instead of goods, a computer service might be considered the equivalent of a warehouse. Examination and interpretation of the permanent establishment concept in the context of electronic commerce may well result in an extension of the policies and the resulting exceptions to electronic commerce.

---

<sup>1</sup> OECD MC *supra* Article 5(4)

A trade or business or permanent establishment can also arise by imputation from an agent's activities. Agency issues arise from the relationship between a foreign person and a computer on-line service or telecommunications service provider. Even if a person engaged in electronic commerce does not maintain a computer service or similar equipment in the State, issues of a trade or business or permanent establishment could also arise. In most cases, information will be transmitted to the customer's computer through telephone lines. For example, a foreign person who operated a computerized research service might contract with a telecommunications company within the State to provide local dial access service so that the foreign person's customers, within the State, can access its computerized databases. Alternatively, the State's customers might access the foreign information seller's Web site using an Internet service provider based in the State. Presumably, the foreign person's relationship with a local telecommunications service provider is such that the telecommunications service provider would not be considered an agent of the foreign person. Even if an agency relationship were deemed to exist, the service provider would likely be considered an independent agent, with the result that a trade or business or permanent establishment, within the State would not arise. Nevertheless, it may be necessary to further clarify the applicable principles in this area and seek to create an international consensus on this issue.

## CHAPTER FIVE

---

### Solutions to the Challenges

The magnitude of the impact that electronic commerce is having on tax systems, is evidenced by the fact that more than 12 OECD countries now have Commissions, Committees or Ad hoc groups looking at the tax implications of the net; the US and Australia have already issued discussion papers on the subject; and the International Fiscal Association has launched an international research project thereon.<sup>1</sup>

To date, however, there are not too many answers to the many fiscal issues flowing from the exponential growth in the Internet and electronic commerce as a mode of conducting business. The OECD held an Electronic Commerce conference in Turku, Finland on 18 November 1997 to discuss the challenges posed to tax systems by Electronic Commerce. The issues which were put on the table at that conference, and the issues which are currently under investigation and debate are varied. From compliance to jurisdiction, collection mechanisms, data integrity, audit trails of transactions, data access etc. The one issue which seems to cut across most others, is the need for some sort of international co-operation to deal with this global phenomenon and the challenges it poses to tax systems, concepts and administrations world wide. The OECD's Committee on

Fiscal Affairs (CFA) is currently considering the tax policy and administrative implications of the communication revolution.<sup>1</sup> In order to foster international co-operation, this work is being carried out in a co-ordinated manner in close contact with the business and tax community. Of particular significance to this dissertation, is the work being done by Working Party No 1 of the CFA on Double Taxation, and Working Party No 8 on Tax Avoidance and Evasion. Working Party No 1 was due to present a report of their work and findings at a conference held in Canada, in October, but I have as yet been unable to ascertain what, if any, answers to the many questions came out of the conference. What will be of, perhaps, more interest, is to see the *modus operandi* in respect of the cooperation between business and Government which is expected to be proposed by the OECD.

Below are some of the issues, which have been identified by the OECD, the US Treasury and the Australian Taxation Office, amongst others, as requiring further investigation and for which solutions should be sought.

1. May the general conditions for the existence of a permanent establishment found in paragraph 1 of article 5 be satisfied by a web site on a server owned or used by a foreign enterprise, taking into account that there would not necessarily be any employees on the enterprise present in the source State?

---

<sup>1</sup> OECD Electronic Commerce: Challenges to Tax Authorities and Taxpayers – an informal round table discussion between Business and Government at page 32 (136)

2. Would such a web site constitute a 'place of business'?
3. Can the server be said to be 'fixed'?
4. Can the undertaking of periodical automated business functions (such as advertising, ordering, or payment) be said to constitute the carrying on of a business through a 'fixed' place of business?

As stated above, there are no definitive answers to these questions. However, there have been some proposals and comments advanced in this regard.

### Bit tax<sup>2</sup>

This is a controversial proposal to tax the transfer of information via the Internet. It would involve installing measuring devices, similar to the traditional electricity meters, which would measure the number of 'bits' of information sent/received by a user. There would be no distinction to the type of information sent, the tax would be based purely on the number of bits. There has been much criticism of this proposed tax, from a practical perspective and based on tax neutrality. It is a proposal which has been put forward, but has not received much support.

---

<sup>1</sup> OECD Electronic Commerce *supra* Annex at 36

<sup>2</sup> The "Bit Tax": the case for further study – Luc Soete and Karin Kamp – University of Maastricht – 12 August 1996

## A view of Business<sup>1</sup>

Although there may be a risk of tax base erosion from the use of electronic commerce, the risk should not be overstated. OECD countries should refrain from introducing burdensome substantive and compliance rules that, in an effort to capture tax revenues, would hamper growth of the industry or would merely invite noncompliance. The OECD should resist efforts to expand the concept of taxable presence in the area of electronic commerce. Electronic commerce equipment alone should not give rise to a permanent establishment. To do so would only disadvantage those providers whose technology is not mobile. In addition, the presence of intangible property should not be considered as giving rise to taxable presence, nor should there be a notion of 'virtual' presence.

- Mere accessibility of a Web site from a particular country should in no case be considered as giving rise to a place of business for tax purposes in that country.
- The ownership, or exclusive or shared use of equipment in a source country should not by its self give rise to a permanent establishment.
- An arm's length contractual relationship with an ISP or telecommunications provider located in a source country for the hosting of Web pages or transmission of data should not give rise to a permanent

---

<sup>1</sup>Mr Jeffrey Owens – Discussion paper provided by Deloitte Touche Tohmatsu International – OECD Turku conference - at page 2 (4&5)

establishment, in the absence of additional contractual authority delegated to the provider that would constitute an agency under existing rules.

### International Taxation Institute proposals<sup>1</sup>

The distinction between direct business activities, which will not lead to limited tax liability for non-resident taxpayers and business conducted via a permanent establishment, which will lead to limited tax liability, is unacceptable considering new technologies in global communication. Historically, this distinction was based on the fact that the personal material presence of the seller of goods and services in the same country as the purchaser is, business-wise, necessary. Today the technical opportunities to carry out a business via the Internet instead of founding a permanent establishment are given. There is no economic difference between business via direct activities and such activities via a permanent establishment and therefore there is no space for taxing the so-generated income in different ways. The following proposals are made:

- to reduce any kind of distortion in the entire tax system, the permanent establishment concept should be retained;
- supplement by extending the criteria for tax liability in case of business income for such income which is generated via a direct business activity,

---

<sup>1</sup>Commerce Electronique: the challenges to tax authorities and taxpayers – Discussion paper presented by Y Zollkau, Arthur Andersen and Dr G Strunk, International Tax Institute – OECD Turku conference

but limited to the cases where the usage or the utilization of the products and services takes place within a State;

- when selling to private persons, the usage or utilization will be assumed by legal fiction;
- when selling to a company, a usage or utilization will also be assumed, but counter evidence is possible;
- a withholding tax should be introduced, and all non-cash payments should be handled by credit card companies, banks or other similar facility;
- to prevent unacceptable taxation, a kind of delivery threshold should be introduced for direct sales to customers. Exceeding this threshold triggers limited tax liability.

The general consensus is that, as far as possible, the general laws as they exist at present should be applied to the electronic commerce context and transactions. Only to the extent that these laws are not able to deal with a particular transaction or situation, should new laws be introduced. The second area of agreement, is that States should adhere to the principle of neutrality, and not impose greater tax obligations/liabilities on this form of business. The aim should be to foster electronic commerce, while at the same time seeking not to lose the tax base.

## Transfer Pricing

### Background and General Principles

Transfer pricing is the description given to the pricing of transactions between members of groups of companies under the same or common control.<sup>1</sup> The issue with transfer pricing is that, while some price has to be allocated to transactions entered into between connected persons, it is often not a simple task to ascertain what that price should be, since the transactions are not open market transactions and the price is not fixed by external forces. Furthermore, the goods or services or technology, which is the subject of the transaction, are very often so special or unique that there are no obvious guides as to how they should be priced.

Transactions between companies within the multinational groups may involve, for example:

- sale of goods, including part-processed goods;
- transfers of technology, such as royalties and other payments for the use of patents or know-how or research and development;
- remuneration for services, such as the use of centralized group legal advisers, management assistance, advertising campaigns; and

- payment of interest on intra-group loans.

In the absence of external market forces, such as the open market, and in the absence of other guidelines as to how these transactions should be priced, it would be up to the parties involved to set the transfer price. In this case, it would stand to reason that the parties would price the transaction in such a manner as to be most advantageous and convenient to the group as a whole. This would often be in such a way so as to pay the least amount of tax.

In general, the *modus operandi* in such a case would be for a group company in a high tax jurisdiction selling goods to another group company situated in another high tax jurisdiction to arrange for the sale to take place through a third group company in a low tax jurisdiction. The first company would sell to the low tax company at a very low price, and this company would then sell the goods to the second group company, to which the goods were originally intended, at a high price. The result being that the majority of the group's profit would accrue in the low tax jurisdiction, suffering little, if any, tax.

It could also be possible for the group to structure its transfer pricing to take advantage of and accrue group profits in a group company with an assessed loss, thereby potentially reducing the group's overall tax burden.

---

<sup>1</sup> Maurice H Collins – Evasion and Avoidance of Tax at the International Level – European Taxation – September 1988 at 295

Most countries which are concerned about potential tax revenue loss resulting from transactions arranged, as set out above, have taken the view that it is necessary and appropriate, for tax purposes, to be able to adjust the transfer price charged between connected persons to reflect a price which would have been charged had the parties not been connected. In other words, most States reserve the right to adjust the price charged between connected persons to reflect the price which would have been charged by independent parties acting wholly independently of each other – i.e. acting at arm's length. This is called the 'arm's length' principle. In this way, States can place member firms of multi-national groups on the same footing as independent entities conducting the same or similar transactions, and remove the tax advantages which otherwise could have been obtained by collusive group action. At the same time, the States can protect their tax revenues from the potential negative effects of transfer pricing.

It is generally accepted that such government action is both fair and necessary in the global markets of today. Furthermore, to date, there have been no satisfactory alternatives offered to deal with the manipulation of profits which can result from the manipulation of transfer pricing.

However, while the principle may be sound, application thereof it is easier said than done. What is an arm's length price for any particular transaction, and how can this price be determined by group companies and by governments alike?

Ideally, the determination of an arm's length price requires evidence of comparable prices between unconnected parties. But these may very well not be available, or, if available, may be difficult to interpret. In the absence of usable comparable prices it may involve a fairly sophisticated assessment of a variety of factors such as costs of production, wholesaler's profit margins, the value of specialized technology, the element of risk and so on.

These assessments may have to be made on the basis of assumptions, which are arguable, and facts which are not clear, and may therefore require long and difficult negotiations with the taxpayer, who may well be more knowledgeable than the tax officials about the points at issue.<sup>1</sup>

What is more, it may often be just as difficult for the taxpayer to calculate the arm's length price. Transactions between connected parties are often highly intricate and highly interconnected and the subject of the transaction is often unique, particularly in the case of large multinationals, which may have a monopoly in a specific field or area. Fiscal evasion is not always the primary objective of multinational groups when selecting transfer pricing policies. Many multinational enterprises do seek to establish a transfer price which follows, as far as possible, the arm's length principle. The use of one price or another may simply reflect an honest judgement of an arm's length price and not a fraudulent intention.

The threat of fiscal evasion through the manipulation of transfer pricing is, however, very real, and can amount to a significant loss in revenue to a State's tax authorities. States have generally developed transfer pricing legislation and policies to aid and regulate the setting of transfer prices according to the arm's length principle, within their fiscal jurisdiction's. The scope and extent of this policy and legislation may vary from State to State, the complexity thereof often dependent upon the exposure of the particular State to possible transfer pricing abuse. The US, for example, has very detailed rules and policies on transfer pricing, as well as an extensive jurisprudence on the subject. South Africa, on the other hand, a State which has only recently, through the relaxation of exchange controls, really become exposed to significant transfer pricing fiscal risk, has one section<sup>1</sup> of a few lines in the South African Income Tax Act (SAITA) which embodies the principle of arms length pricing between connected parties.

Section 31 (2) of SAITA reads as follows:

---

<sup>1</sup> South African Income Tax Act 58 of 1962 as amended Section 31

*Where any goods or services are supplied or acquired in terms of an international agreement and –*

- (a) the acquiror is a connected person in relation to the supplier; and*
- (b) the goods or services are supplied or acquired at a price which is either –*
  - (i) less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length (such price being the arm's length price); or*
  - (ii) greater than the arm's length price,*

*then, for the purposes of this Act in relation to either the acquiror or the supplier, the Commissioner may, in the determination of the taxable income of either the acquiror or the supplier, adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services.*

Another area in which the arm's length pricing principle is applied, is the attribution of profit to a permanent establishment. In terms of most DTA's, including both the OECD<sup>1</sup> and UN<sup>2</sup> model conventions, the source State may levy

---

<sup>1</sup> OECD Model Convention on the Avoidance of Double Taxation and Fiscal Evasion Article 7(2)

<sup>2</sup> UN Model Convention for the Avoidance of Double Taxation and Fiscal Evasion Article 7(2)

tax on so much of the profits of an enterprise of another State as are attributable to a permanent establishment in their jurisdiction through which the enterprise carries on business. For the purposes of calculating the profits attributable to a permanent establishment, the arm's length principle is generally followed, and profits are calculated as if the PE and the head office were separate and unconnected legal entities dealing wholly at arm's length.

## Some Transfer Pricing Methods

The determination of a transfer price can be an extremely complex task, depending on each specific transaction undertaken. There have developed through time some generally acceptable starting points for the determination of an arms length price. The general principle is to apply the simplest methods first, and only if these are not appropriate to the specific transaction, to look at the more complex methods. In practice, certain methods have been found most suitable to certain transactions, and these methods would then be the starting point for these types of transactions. In this section, I will give a brief overview of the three simplest methods used, as well mention some alternative, more complex methods.

### Comparable Uncontrolled Price

This is, if applicable, probably the best method for determining what an arm's length price should be for any particular transaction. It involves taking the transaction for which an arm's length price is sought, looking at the nature of the transaction, the parties involved, and the circumstances and conditions under which the transaction is entered into. Then seeking out a comparable transaction with comparable subject matter between comparable unconnected entities dealing wholly at arm's length under the same or similar conditions and in a similar market. It stands to reason that, if such a similar and comparable transaction between unconnected third parties can be found, the price charged for that

transaction would reflect an arm's length price which could be applied as the transfer price. If the two transactions are not identical, but are significantly similar, adjustments and allowances can be made for the differences and a transfer price can be accordingly identified.

An uncontrolled transaction is comparable to a controlled transaction for the purposes of the CUP method if one of two conditions is met:

1. none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or
2. reasonably accurate adjustments can be made to eliminate the material effects of such differences.<sup>1</sup>

Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arms length principle. Consequently, in such cases the CUP method is preferable over all other methods.

---

<sup>1</sup> OECD Transfer Pricing Guidelines July 1995 at II2 C (i) 2.7

### Resale Price Method

This method begins with the price at which a product, that has been purchased from an associated enterprise, is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin (the resale price margin) representing the amount out of which the seller would seek to cover its selling and other operating expenses and, in light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded as an arm's length price for the original transfer of property between the associated enterprises.

The resale price method is often applied in the case of marketing operations carried out by a group marketing company.

The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions. Also, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide.<sup>1</sup>

---

<sup>1</sup> OECD Transfer Pricing Guidelines July 1995 at II-5 C (ii) 2.14 and 2.15

### Cost Plus Method

This method begins with the cost incurred by the supplier of goods or services in a controlled transaction for goods and services provided to a related party. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and market conditions.<sup>1</sup> The price arrived at by adding an appropriate mark up to the supplier's costs may then be regarded as an arm's length price for the original controlled transaction.

This method is probably most useful where semi-finished goods are sold between related enterprises, or where the controlled transaction is the provision of services.

Again, the cost plus mark up of the supplier should be established by reference to the cost plus mark up that the same supplier earns in comparable uncontrolled transactions. Alternatively, the cost plus mark up that would have been earned in comparable transactions by an independent enterprise, may serve as a guide.

### Alternative Methods

There are a host of alternative methods for determining the appropriate arm's length price in a given transaction including the transactional profit methods and the non-arm's length, global formulary apportionment approach. These methods

---

<sup>1</sup> OECD Transfer Pricing Guidelines July 1995 at II-5 C (iii) 2.32

are appropriate for differing transactions and transactional conditions. The OECD, in its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, canvasses many of these alternative methods, giving good concise explanations and application examples for each.

The transactional profit methods can be used to approximate arm's length conditions when the traditional transaction methods cannot reliably be applied on their own. Profit methods are considered because the complexities of real life business might put practical difficulties in the way of the application of the transaction based methods.<sup>1</sup> Where transactions are very interrelated, it may be that they cannot be evaluated on a separate basis. Under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split. Accordingly, the profit split method seeks to eliminate the effect on profits of special conditions within a controlled transaction, by determining the division of profits that independent enterprises would have expected to realize from engaging in those transactions.<sup>2</sup>

---

<sup>1</sup> OECD Guidelines at 130

<sup>2</sup> OECD Guidelines at 131

## CHAPTER SIX

---

### Electronic Commerce Challenges to Transfer Pricing

Multinationals are increasingly engaged in manufacturing, procurement, selling and R&D activities in a global environment. Within this global environment, inter-company transactions are increasingly taking place over the Internet and other, private networks, rather than through more traditional methods. In addition, the increased ease with which multi-jurisdictional commerce can now take place and the scope and opportunity for smaller players to become involved, should result in tax authorities increasingly needing to apply transfer pricing principles to electronic commerce transactions. Failure to achieve international consensus in this arena may lead to double taxation of profits, which could seriously impede the global development of electronic commerce.

#### OECD Guidelines

Ideally, the arm's length principle should be applied on a transaction by transaction basis. However, the OECD recognizes that situations often arise where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. The acceptance by the OECD of a profit split approach and the transactional net margin method acknowledges the

relevance of a net margin method of measurement for highly integrated operations.

Due to the nature of business transactions undertaken through the electronic medium, clearly, continuous exchanges may often arise in this context. Such continuity is probably most familiar in the area of innovative financial transactions, such as global trading, where the profit split method is often advanced as the most appropriate transfer pricing method.

The traditional transfer pricing approach has two fundamental characteristics elaborated by the OECD's 1995 transfer pricing guidelines. To require a transactional approach, and to improve the comparability analysis. The revision, in 1995 of its earlier 1979 transfer pricing report, was prompted, to a large extent, by the increase in the number and complexity of cross-border transactions, the proliferation of multinational enterprises (MNEs), and the difficulty in finding comparable market transactions to price controlled transfers involving non-routine intangible property.<sup>1</sup> It was argued at the time that the arm's length principle was unworkable, and should be discarded in favour of a system of world-wide income apportionment according to a pre-determined formula (the global formulary apportionment method (GFA)). The problem with this system is that it produces an arbitrary allocation of the tax base by each State according to their policy, and there was little chance of obtaining agreement on a general formula to be applied

---

<sup>1</sup> Tax and the Web: New Technology, Old Problems – Frances M Horner and Jeffrey Owens IBFD Bulletin, December 1996 at 517

by all. The result could be serious double taxation with the concomitant disincentive to expand global trading.

At the same time, new transfer pricing methods were introduced in an effort to handle cases thought to be beyond the scope of the more traditional methods (e.g. the CUP method). This saw the advent of the comparable profits method and various profit split methods. The CUP, cost plus and resale minus methods were said to be insufficient to handle all cases, because they rely too heavily on transactional similarity. The profit based methods have, however, been heavily criticized as being arbitrary, and not within the ambit of the arm's length principle

In the face of this uncertainty and debate, the OECD opted to follow a balanced approach. To preserve the arm's length principle, as the most effective means for dealing with transfer pricing, but to interpret it broadly enough so as to permit the use of non-traditional methods as a last resort, but with strict limitations. The non-traditional methods would have to be applied in such a way as to adhere to the arm's length principle. The insistence on a transactional approach and a more thorough comparability analysis followed from this reasoning.

A transactional approach was considered important to the net profit method because global profits could be influenced by many factors wholly unrelated to particular transactions between related companies. The thorough comparability approach was needed to ensure that any adjustments which needed to be made

would achieve the same result that would have been realized by independent enterprises in comparable circumstances.

In the profit split method, however, the focus on comparability is less significant, because the profit split method relies more heavily on internal than external data. While the OECD guidelines do request tax examiners to seek external data that is informative of how independent parties would have divided the profit from a comparable transaction, in practice, internal data is the most significant factor in setting, particularly, the profit split percentages. The arm's length principle is adhered to, not so much by using comparable external data, as by using the approach of dividing the global profits in a way independent parties would have found acceptable.<sup>1</sup>

#### Application in the Internet Context

In light of the background sketched above, one can easily see why the communications revolution poses challenges to traditional transfer pricing methodology. The speed, frequency and intergration of exchanges over the Internet and, perhaps more significantly, the development of private networks within multinational companies, will require an innovative approach in applying the separate transactional analysis. As far as comparability is concerned, it becomes more difficult to determine what the transaction actually is. What is

---

<sup>1</sup> Tax and the Web: New Technology, Old Problems – Frances M Horner and Jeffrey Owens IBFD Bulletin, December 1996 at 520

more, it becomes exceedingly difficult to find a third party transaction about which enough is known to conclude that it is comparable. Transfer pricing will increase in complexity, particularly if the multinational is intentionally attempting to shift income among related parties.

The essence of the challenges which flow from transfer pricing in the electronic commerce arena, is that business conducted electronically can be seen as a bundling of activities, which in most cases will be performed by more than one affiliate belonging to the same multinational group. The typical transfer pricing approach would be to analyze the bundling of activities, risks and assets in ascertaining the appropriate price. The transfer pricing analysis will consist of a functional analysis, a selection of the pricing method, and an economic analysis to quantify the prices and profits of the participants. As with any other transfer pricing situation, in an electronic commerce transaction, the main issue is allocating the compensation to one or more participants who have operations in various countries. In the context of permanent establishment, the question is whether there is a sufficient nexus with a tax jurisdiction to subject a foreign company to tax on profits it earns in that particular jurisdiction. Perhaps an equally important question is how much of the income from a particular multinational transaction should be subjected to tax in each State which can found jurisdiction to tax.

---

### Functional Analysis

The functional analysis in the context of electronic commerce will focus on the contributors who perform functions for the transacting parties, as well as the function of the software involved. What is significant, is that a large number of functions can now be performed electronically. From customer service, order taking, payment and order fulfillment, to, in certain cases, delivery. This functional analysis should result in a set of facts emerging after breaking the transaction down, as far as is possible, to its constituent parts, including identifying the various parties involved and their function.

### Pricing Method

Assuming that the functional analysis identifies which types of intra-group transactions take place, one would then look to the OECD transfer pricing guidelines to ascertain what pricing method should be applied.

In the electronic commerce context, affiliates of a multinationals could be engaged in electronic commerce through a cost and/or revenue sharing agreement. For example, the cost of establishing, maintaining and conducting business operations electronically could be shared among the affiliates. In this case, the revenue generated by the electronic commerce will have to be attributed to the

affiliates, based on their proportionate share of the costs and revenue, and the cost of any technology contributed.

### Economic Analysis

The function of the economic analysis is, essentially, to determine the market value of performing an activity, after taking into account business risks assumed and/or the employment of assets. Given the facts and the pricing method(s) applied, the OECD Guidelines require multinationals to look for comparable transactions between unrelated parties. Alternatively, under strict conditions, the OECD allows the use of the profit ratios of unrelated parties to benchmark the arm's length nature of one or more affiliates' profitability levels.<sup>1</sup>

This principle may require taxpayers to obtain additional data to support the pricing methodology and profit level of their intra-group transactions. In practice, most of the comparable data may already be available within the multinational.

For example, an affiliate distributes CD-ROM players in one country, while a third party distributor is doing the same thing in another country. Assuming that, except for geographical differences, both distributors are performing the same functions, the remuneration paid to the third party distributor could be used to determine the level of compensation for the affiliated distributor (as a so-called

---

<sup>1</sup> Business Perspectives on the Taxation of Global Electronic Commerce – The Electronic Commerce Tax Study Group – Turku, Finland November 18, 1997 at page 9

“internal comparable”).<sup>1</sup> A second source of information is public data on third parties, such as audited financial statements. In the electronic commerce context, however, since the electronic medium is a relatively new concept, the number of comparables available in these databases may be limited.

The proliferation of what is known as ‘global collaboration’<sup>2</sup> underlies the complications which electronic commerce bring to the transfer pricing arena. Global collaboration merely refers to the collaboration between connected parties to shift profits between them so as to minimize the group tax burden. An example is the increased ability of banks and other financial institutions to conduct global dealing. Global dealing is “the capacity of financial intermediaries, mainly banks and securities firms, to execute customers’ orders and to take proprietary positions in financial products in markets around the world and around the clock.”<sup>3</sup>

Global dealings could not take place without modern computers and communications, which permit a firm’s trading position to be transferred around the world as markets open and close. The crux of the matter is the same as that in the case of permanent establishment – the communications revolution does not necessarily present new or different problems. The communications revolution

---

<sup>1</sup> Business Perspectives on the Taxation of Global Electronic Commerce – The Electronic Commerce Tax Study Group – Turku, Finland November 18, 1997 at page 10

<sup>2</sup> US Department of Treasury, Office of Tax Policy – Selected Tax Policy Implications of Global Electronic Commerce at 7.5.1

<sup>3</sup> US Department of Treasury *supra* at 7.5

just presents all the old problems more quickly. Everything is more mobile, faster, and increasingly more complex.

Global collaboration is not a new phenomenon and it is not only found in the context of electronic commerce. It is equally found in the context of the manufacture and sale of goods. The difference, however, is that current transfer pricing principles are focused on global collaboration in the manufacture and sale of goods and in the creation and transfer of intangible property. The sphere of global dealing has, to a large degree, not required focus. Global dealing income has tended to be allocated through a case-by-case negotiated process between the competent authorities and the parties involved.

## CHAPTER SEVEN

---

### Conclusion

The debate around electronic commerce and the implications which it may have in the sphere of international tax continues to rage on the international canvas. The competing focus of business and tax authorities has the international community tugging in different directions. While certain administrations, like the Clinton administration, have come out strongly in favour non-discrimination against electronic commerce in regulating this developing business form. While from commercial perspective this is a favourable approach, from the perspective of tax administrations which are always a step behind the private sector, this may result in a loss in tax revenue while the procedures are put in place to deal with the tax implications of electronic commerce.

While I am not convinced that electronic commerce necessarily poses any specifically new issues, what cannot be denied is that electronic commerce takes the magnitude and extent of existing international tax issues to new heights. The proliferation of international commercial transactions which will be facilitated by electronic commerce, and the practical difficulties in tracking and regulating these transactions will make to collection of tax in this sphere extremely difficult. A whole new body of jurisprudence will need to be developed to deal with the particular issues raised in electronic commerce transactions. For example, the tests used to determine the existence or not of a permanent establishment in the

electronic commerce context may well need to be refined and developed, just like the existing tests were developed to deal with existing business forms.

Another factor which makes the regulation of electronic commerce so difficult, is the international mobility of this business form. Unlike most traditional business forms which require a certain amount of physical presence or substance, electronic commerce could theoretically exist almost exclusively on a virtual level - from shopping malls, to virtual service providers, and everything in between.

Again, although electronic commerce may not, necessarily, have introduced a new field of transfer pricing, different interpretations of the OECD Guidelines on transfer pricing by various tax authorities may create conflicts and the risk of double taxation. Application of transactional methods in practice will be limited, depending on the availability of price and/or profit data of comparable transactions and/or companies. Also, the global geographical coverage of the sales functions through the use of electronic commerce will limit the comparability with local and more regional types of sales transactions. As a result, it is likely that proper transfer pricing of electronic commerce will require a rigorous analysis of the fact pattern, including especially the relative contribution of each participating entity. As in the case of global trading of financial products, it may be advisable for the OECD and member countries to consider profit split approaches.

That is not to say regulation of this business form is impossible. What is essential, though, is that the implications of electronic commerce are identified and recognized so they might be adequately addressed.

I believe the approach of the Clinton administration in pushing for non-discrimination against electronic commerce as a business form is a sound one, as from a commercial perspective, the development and fostering of electronic is highly advantageous, and is ultimately a commercial necessity. The coordinated approach of the OECD is also to be commended. This is, I feel, the only way the international community will be able to regulate electronic commerce without inhibiting its development. It is also by approaching the regulation of electronic commerce in a globally coordinated way that the business form can be effectively regulated by States without promoting the flight of the tax base to countries with a more favourable regulatory framework.

## PART TWO

- THE IMPLICATION OF ELECTRONIC COMMERCE ON OTHER DIRECT TAXES AND THE CHALLENGES FACING TAX ADMINISTRATIONS IN REGULATING ELECTRONICALLY CONDUCTED COMMERCE -

## Chapter Six

---

### Other Direct Tax Issues

#### Digitized Information : Characterization of Income

The ability to digitize data and sell digitized data over the Internet presents issues under the income characterization rules of tax treaties. Any type of information that can be digitized, such as computer programs, books, music, or images, can be transferred electronically. For example, a person in State B could connect with a computer in State A and download a computer program or digitized image in exchange for a fee. The purchaser's rights in the information transferred could vary depending on the contract between the parties. For example, the purchaser of a digitized image could obtain the right to use a single copy of the image, the right to reproduce ten copies of the image for use in a corporate report, the right to reproduce the image for use in an academic work that is expected to have a limited press run, or the right to reproduce the image in a mass-circulation magazine. It may be argued, some of these transactions are equivalent to the purchase of a physical copy of the photograph, which would result in business profits, while other of these transactions would result in royalty income, which would be taxable in the source country. Consequently, existing income

characterization principles may require modification in light of the ease of perfectly reproducing and disseminating digitized information.

Article 12, paragraph 2 of the Model Convention defines "royalties" as "payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic work including cinematograph films ..."<sup>1</sup> It is not always clear how this definition applies to the sale of digitized information. On the one hand it may be arguable that some of these transactions, such as the electronic purchase of a digital book, are merely substitutes for conventional transactions involving physical objects and that it would be inappropriate to treat them as creating royalty income. On the other hand, it is arguable that the transactions could involve considerable differences in substance, for example, a consumer purchasing a physical copy of a book is usually unable to manipulate the data in the book, while a consumer downloading a digital copy of the book will be able to alter its format, manipulate the date, etc. Whether, and to what extent, the definition of royalties needs to be adapted needs further consideration.

Digitized information also poses problems for the definition of services income, as distinguished from sales of goods income or royalties. Previously a reference work, such as an encyclopaedia, would have been sold as a set of bound volumes and the sale of the bound volumes would have resulted in sale of goods income, notwithstanding the fact that the cost of printing and binding represented only a small fraction of the encyclopaedia's value. Now, instead of purchasing a bound

volume, a potential purchaser might be able to choose between a set of CD-ROMs and a computer on-line service through which the encyclopaedia's content can be accessed. If the customer has a sufficiently fast modem connection, there may be little practical difference between accessing the on-line service and the CD-ROMs on the customer's personal computer. Yet the sale of the CD-ROMs still results in the sale of goods income while the character of the income arising from the on-line service is not clear. It may be necessary to reconsider existing principles in this area in relation to income, and sales and consumption taxes.

The ability of taxpayers to electronically sell digitized information and services may have an effect on existing regimes that seek to limit the use of tax deferral through foreign corporations. Many countries have regimes whereby income earned by controlled foreign corporations may be currently taxed to the corporation's shareholders. If controlled foreign corporations can engage in extensive commerce in information and services through Web sites or computer networks located in tax-haven jurisdictions, it may become increasingly difficult for tax administrators to enforce these anti-deferral regimes. It may also be necessary to broaden the scope of the income subject to these regimes.

---

## Residency

Communications technology has the potential to affect residence tests for countries that rely on the location of management functions. This is relevant for the operation of the "place of management", or "central management and control" tests in determining fiscal residence. The OECD's Commission on Fiscal Affairs ("CFA") is currently considering an amendment to the definition of "royalty" in the Commentary to the OECD Model Convention<sup>1</sup> that would take into account the unique characteristics of computer software and digitized information.<sup>1</sup> This new analysis recognizes that software can be distributed either on a physical media, such as a diskette or CD-ROM or by electronic transfer, such as downloading the software from the Internet. This analysis also takes into account the ease of perfectly reproducing computer software and the fact that the acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software.

Under this proposed analysis, the character of payments as either business profits or royalties would depend on the nature and extent of rights that the transferee acquires under the arrangement regarding the use and exploitation of the program. Copyright law principles would be used to determine the extent of the rights transferred. Copyright law generally distinguishes between rights in the underlying copyright and rights in a copy of the computer program, whether or

---

<sup>1</sup> OECD Model Tax Convention Article 12

not such copy is embodied in a material medium or provided electronically. Payments made for the acquisition of partial rights in the copyright will generally represent a royalty. Such arrangements will include licenses to reproduce and distribute the copyrighted program to the public.

In other types of transactions, the transferee only acquires the rights necessary to operate the program and essentially only acquires rights equivalent to those in a program copy, even though the transaction may be considered a license for copyright law purposes. Although the transferee generally acquires the right to copy the program onto a computer hard drive or make an archival copy of the program, these rights are essential to the utilization of the program. Therefore, it has been proposed that rights in relation to these acts of copying, where they do no more than enable the effective operation of the program, should be disregarded in analyzing the character of the transaction for tax purposes. Payments for these types of transactions would be dealt with as business profits. In addition, "site licenses", arrangements in which the transferee obtains rights to make multiple copies of the program only for use within its own businesses, will also generally be considered to be business profits.

The CFA also intends to study whether the principles used to characterize computer software transactions can be extended to all other types of digitized

---

<sup>1</sup> OECD Directorate for Financial, Fiscal and Enterprise Affairs – Committee on Fiscal Affairs, Implications of the Communications Revolution for Tax Policy and Administration at page 22.

information.<sup>1</sup> Software is simply one form of digitized information and there may not be any relevant distinction between transactions concerning computer software and those concerning digitized text, images, music or motion pictures.

The development of videoconferencing facilities and the relaxing in many countries of company law requirements for board meetings already facilitates board meeting being undertaken simultaneously in more than one jurisdiction. The Internet may soon be able to allow simultaneous (and relatively inexpensive) audio, video, and online communications between a number of users. This may make it easier, for example, for a company's place of effective management either existing in more than one location or not capable of being pinpointed to a specific location.

As well as presenting difficulties with determining the legal status of a company, there would be compliance and enforcement problems. For example, the Internet could allow a company operating offshore to be significantly managed from onshore without the tax authorities being able to establish an evidentiary connection to determine the company as being a resident.

The ability of residents to establish offshore non-resident companies, when combined with the highly mobile nature of electronic commerce, could lead to a tax driven migration of businesses to the Internet and Internet businesses (web

---

<sup>1</sup> OECD Directorate for Financial, Fiscal and Enterprise Affairs – Committee on Fiscal Affairs, Implications of the Communications Revolution for Tax Policy and Administration.

sites and individuals providing services) to low tax jurisdictions. This will place even greater importance on the role of controlled foreign corporations measures and their current effectiveness in addressing Internet operations.<sup>1</sup>

Even if residence rules and controlled foreign corporation measures prove to be capable of applying adequately to electronic commerce, potential for complete anonymity for Internet users could facilitate widespread offshore activity which derives low or no taxed income that cannot be traced back to users. This would be of particular concern given the ease with which individuals and small businesses will be able to access arrangements previously the domain only of multinational enterprise. Of even greater concern is the potential for possible complete anonymity for Internet users to facilitate widespread domestic activity that would result in taxable income that cannot be traced back to users.

### Source Rules

The Internet is expected to pose challenges to the operation of the traditional source rules. The ability to apply domestic source rules to Internet businesses could become crucial if most Internet businesses eventually migrate to low tax jurisdictions, which are generally expected to fall outside tax treaty networks.

---

<sup>1</sup> Intertax – International Tax Review, Volume 25, April 1997 at 143.

Potential jurisdictional and enforcement issues for source rules will be common and are likely to benefit from a co-ordinated approach.<sup>1</sup>

---

<sup>1</sup> Electronic Commerce: The Challenges to Tax Authorities and Taxpayers – OECD Turku Conference at page 29

## Chapter Seven

---

### **Tax Administration and Compliance Issues**

#### **General.**

In the area of tax administration and compliance, electronic commerce may create new variations on old issues as well as new categories of issues. These developments require that practical techniques be developed to deal with these technological innovations. In many cases, the products and techniques that will be required cannot be developed or implemented by tax administrations on a unilateral basis. Private sector and international co-operation is likely to be necessary to develop and implement appropriate software and hardware technologies.

Electronic commerce is still developing and no electronic money system has yet achieved widespread usage. Nevertheless, it is important to consider these issues now since some issues may require that the needs of tax administration be addressed while electronic commerce systems are still under development.

### Categories of issues

These technological developments create many different issues for tax administrations. The broad categories of issues, which are discussed below, are:

- (i) electronic money;
- (ii) identity verification;
- (iii) record keeping and transaction verification for electronic transactions; and
- (iv) disintermediation and information reporting.

### Electronic money

Developments in electronic payment systems have the potential to create "electronic money". Electronic money is a broad term, and just as electronic money systems differ in their technical features, they also differ in the extent to which they create issues for tax administrators. Depending on the type of system used, electronic money can be either an advantage or a disadvantage for tax administrators.

Electronic money poses a tax evasion potential similar to that created by paper money. This raises the issue of whether the evasion potential is manageable and what must be done to manage it. It is possible that the techniques that have been

developed over time to combat evasion using paper money can be adapted and expanded to evasion through electronic money. In particular, it may be necessary to consider the role that issuers of electronic money can play in this effort, since they represent the interface between the physical economy and the electronic economy. In general, however, the extent to which electronic cash will be a problem will likely depend on the extent to which it results in an extensive payment system outside of normal banking channels.<sup>1</sup>

#### Accounted system

Electronic money systems can be distinguished, in part, based on whether they are accounted or unaccounted systems. In accounted systems, the electronic money issuer maintains a central record of the flow of its electronic money through the economy. In unaccounted systems no such central record exist. Accounted systems are unlikely to present substantial tax administration concerns because the central record of transactions, if it is available for examination on audit, will permit tax administrators to match payments and receipts to specific taxpayers. In fact, the growth of accounted systems will be an advantage for both taxpayers and tax administrators since the central records maintained by an accounted system could be used by taxpayers and auditors to verify payments. Some taxpayers may therefore choose to use accounted systems when a record of the transaction is necessary for tax or other purposes.

---

<sup>1</sup> INTERTAX – International Tax Review, Volume 25, April 1997 at 143.

### Unaccounted systems

In contrast to accounted systems, problems may arise with unaccounted systems, which maintain no such central record and are therefore analogous to cash. The extent of this problem will be measured by the extent to which unaccounted systems are used instead of accounted systems. It may be that unaccounted systems will be used primarily for certain types of small transactions. In many cases consumers will prefer existing payment mechanisms, such as credit cards, for the payment terms and the consumer protection that they provide. In other situations, consumers will use electronic money but will use accounted systems in order to have a central record in case a dispute arises with the merchant. While unaccounted electronic systems are unlikely to completely displace other payment systems, the tax evasion potential they create could be substantial.

Transactions using unaccounted electronic money create the opportunity for both not reporting or underreporting the resulting income, since detection of these transactions is difficult. For example, a taxpayer might sell physical goods in exchange for unaccounted electronic money, which might be transferred via a card-based system. This problem currently exists for paper currency-based businesses. However, it has been historically possible to examine a business' flow of inventory and similar physical indicia of the magnitude of the taxpayer's business. This may not be possible for a taxpayer who sells electronic goods or

services. There is unlikely to be any physical indicia of the amount of the taxpayer's receipts.

### Bank secrecy

Finally, electronic money creates increased opportunities to deposit unreported income in a bank or other financial institution. As a result of electronic money's advantage in transmitting large amounts of money with relative ease, combined with the continued use of cash, the problem of an underground, unaccounted for economy is likely to be exacerbated.

Electronic money and the Internet substantially increase the ease and safety with which bank accounts can be opened abroad, letterbox companies and trust accounts can be established abroad, and funds transferred anonymously. Unlike paper currency, electronic money can be securely and instantaneously transmitted anywhere in the world. It is now possible to open a bank account over the Internet in a bank secrecy jurisdiction, without actually travelling to the bank's location. Electronic money could be instantaneously and anonymously transferred to such an account, thereby eliminating the risks and reporting requirements involved in transferring cash.

### Identity verification

On the Internet it is possible to use a false identity and it is not currently possible to independently verify a party's identity. This raises a number of issues because the identity of a counterparty is important for numerous tax provisions. For example, if securities are purchased electronically, the issuer may still be subject to information reporting and record keeping requirements. If the purchasers are non-resident aliens or foreign corporations, payments of interest and dividends may be subject to withholding and reporting requirements, depending upon the particular jurisdiction. This withholding may be reduced or eliminated by a tax treaty if the beneficial owner is entitled to treaty benefits. Claiming an expense deduction obviously requires proof of the payee and the transaction. Finally, if tax returns and other documents are to be electronically filed, an acceptable form of digital signature will be required.

Verification of identity is also a problem for consumers, who want to be assured that the persons with whom they do business are who they claim to be. As a result, companies engaged in electronic commerce are developing "digital certificates" or "digital IDs"<sup>1</sup> that can be used to verify a person's identity over the Internet. "Digital certificates" are issued by a trusted intermediary who verifies the identity of a person and performs appropriate background checks, depending on the lever of assurance to be granted. Once a person's identity has been verified, he is issued a digital ID, which is the on-line equivalent of a driver's

license or passport, which can be transmitted to a potential customer. The certificate is created using public key encryption techniques which makes it independently verifiable by the recipient and immune from tampering.

If they operate as designed, these digital IDs are likely to represent an important means by which taxpayers and tax administrators can prove the identity of electronic counter parties.

### Record keeping and transaction verification

Taxpayers are required to keep accurate books and records which are subject to scrutiny by tax authorities to verify the income and expenses reflected in the taxpayer's return. While many taxpayers keep these records electronically now, many transactions still leave a physical paper trail which can be used to verify the accuracy of the electronic records. As transactions are conducted more and more through the electronic medium, so the physical paper trail dwindles, leaving only the electronic records. This creates the opportunity for evasion and fraud, as electronic records can be altered easily, and without trace. Electronic documents need to be verifiable in order to minimize the potential for tax evasion.

However, commercially, businesses face the same problem. The public key encryption techniques, which are used to create digital identity certificates, can also be used to verify that electronic documents have not been tampered with.

---

<sup>1</sup> <http://www.verisign.com>

One system claims to provide the equivalent of a notary stamp which can be used to certify and seal digital records in content and time so that it can later be proved that the electronic record was created when claimed, and was not subsequently altered.

### Disintermediation and information reporting

Contemporary tax reporting relies, in part, on the use of centralized institutions and intermediaries that can be used to comply with information reporting and withholding requirements. As it is now possible for individuals and relatively unsophisticated taxpayers to engage in cross border investment and licensing transactions which would previously have taken place through these traditional intermediaries, tax administrations will not be able to rely on and utilize these institutions for tax compliance to the same extent as before, if at all. Disintermediation refers to the elimination of these traditional intermediaries.

Even if there is no intentional tax evasion, parties to these international transactions may not be familiar with the withholding provisions and with information reporting requirements. This, combined with the increased anonymity of the taxpayer, could lead to significant revenue loss. Information reporting plays an important role in tax administration and it may also be necessary to integrate these transactions into an electronic system of reporting.

## Conclusion

The purpose of this section has been to highlight some of the many problems raised by electronic commerce. Although there are many unanswered questions and many unresolved issues, there are certain technological developments related to the Internet, which appear to possibly hold the answer some of these question and issues. Right now, however, the international fiscal world is in a planning phase, in which the way forward for electronic commerce and the regulation of this business form from a fiscal perspective will be mapped out for the future. This phase and the policy making phase which is sure to follow are critical, as electronic commerce is possibly the biggest commercial revolution in the history of man, and the promotion thereof is essential to future world economic growth and prosperity.

The OECD is at the forefront of this planning phase, and it may well be through the various forums of the OECD that many of the issues are solved. In closing, I have therefore elected to set down the highlights which flowed from the Turku conference in the form of the OECD's summary of the responses of Governments to the electronic commerce issued raised during the conference. While this does not present the answers to the many questions and issues, it does give us an insight into how the international fiscal community plans on approaching the problem.

#### IV. THE RESPONSE OF GOVERNMENTS<sup>1</sup>

136. The response of governments to the developments described in this paper has been one of caution. No government to-date has issued new laws or regulations or instructions on how to apply existing concepts to activities carried out on the Internet. The position of governments has generally been one of "lets learn more about how the net functions" and lets discuss the issues in such international fora as the OECD before taking any action. More than twelve OECD countries now have Commissions, Committees or Ad hoc Groups looking at the tax implications of the Net. The US and Australia have issued discussion papers. The CFA has initiated a series of study projects The International Fiscal Association has launched an international research project.

137. This cautions approach may dismay the private sector which is looking for greater certainty in this area, but the Committee feels that this is the right approach at the moment. Because of the global nature of the Internet, and the rapid pace of technological change, it is essential that globally accepted principles of taxation are agreed upon on how to tax the transactions and income from activities carried out over the Internet. Such an agreement will only be reached once tax policymakers and administrators have:

- (1) come to a common understanding of how the net functions;
- (2) agreed upon which existing tax arrangements need to be reviewed;
- (3) agreed upon the process by which any of existing arrangements will be changed and
- (4) agreed upon the nature of these changes.

Throughout this process the dialogue must include all parts of the government and those parts of the private sector which have an interest in the Internet and electronic commerce. Only then will a stable tax environment be achieved which will enable the Internet to develop its full potential but at the same time protect the revenue base. The work being carried out by the CFA is intended to provide such a stable environment and to encourage a closer co-operation between tax authorities and other agencies in government.

---

<sup>1</sup> Electronic Commerce: The Challenges to Tax Authorities and Taxpayers – An Informal Round Table Discussion Between Business and Government at page 32.

**(a) Criteria by which to evaluate any reform proposals**

138. In setting out proposals on how to deal with the issues discussed in this Report, the Committee found it useful to identify a number of criteria that governments can use in their search for the appropriate ways to tax activities on the Internet and global electronic commerce:

- (i) The system should be equitable. Taxpayers in similar situations which carry out similar transactions should be taxed in the same way;
- (ii) The system should be simple. Administrative costs for the tax authorities and compliance costs for taxpayers should be minimized as far as possible;
- (iii) The rules should provide certainty for the taxpayer so that he or she knows in advance of a transaction what will be the tax consequences. Taxpayers should know what is to be taxed and when and where the tax is to be accounted for;
- (iv) Any system adopted should be effective. It should produce the right amount of tax at the right time. The potential for evasion and avoidance should be minimized;
- (v) Economic distortions should be avoided. Corporate decision-makers should be motivated by commercial rather than tax considerations. This applies to both domestic and international transactions;
- (vi) The systems need to be sufficiently flexible and dynamic to ensure that the tax rules keep pace with technological and commercial developments;
- (vii) Any tax arrangements adopted domestically and any changes to existing international taxation principles should be structured to ensure a fair sharing of the Internet tax base between countries; and
- (viii) Initially the focus should be on adapting existing tax arrangements to the Internet rather than examining the introduction of new forms of taxation.

139. The CFA recognizes that these criteria will conflict. A simple system may not be equitable and may not be sufficiently robust to be effective in protecting the revenue base. All involve an element of judgement. Views on what is a fair

distribution of the revenue base, for example. Governments and businesses are likely to take different views on what the tradeoffs should be where conflicts do arise. But most would agree on the criteria listed above. The Committee emphasizes, in particular, that maintaining an international consensus is the key to enable the internet to develop its full capacity and at the same time enabling tax authorities to protect their revenue base. This consensus could, in practice, be more important than decisions on the actual rules.

**(b) Options being examined by the Committee on Fiscal Affairs**

140. Whilst it is too early to put forward solutions to many of the issues identified in this Report, the work carried out by the CFA's subsidiary bodies has identified a number of options that governments can consider, individually and collectively. The following paragraphs set these options. The CFA looks forward to having a lively discussion of these proposals with the business community.
- .....

**(ii) Dealing with the consequences for tax treaties**

145. First results of this work are expected in 1998. A Working Group of WP1 on Tax Treaties is currently examining the permanent establishment issues attached to the Internet and Electronic Commerce. The Group is working at two levels. First to see how the existing concepts used in the OECD Model can be applied to these new ways of doing business. Secondly, to examine the longer-run implications of these developments for the Permanent Establishment concept and the concept of Royalties. A report on the first part of the work is expected early in 1998.
- .....

**(iv) Dealing with the compliance issues**

149. A special group is examining the threats and opportunities electronic commerce may have on tax compliance (basic compliance issues as well as avoidance/evasion issues). The work is focusing on:

- (i) the review of the steps businesses and monetary authorities are taking to minimize the risks of fraud they face and an analysis of how far these can be adapted to meet tax administration's needs (e.g. concerning security, encryption, e-money, registration of domain names);
- (ii) the identification of additional requirements to ensure compliance with tax laws where the tools being developed for business purposes do not meet, or conflict, with the needs of tax administrators;
- (iii) the design of Internet business models to help develop understanding the risks challenges that tax administrations face from electronic commerce, and how far these can be mitigated through domestic and/or internationally co-ordinated responses;
- (vi) developing a set of best practices which harness the opportunities presented by new technologies to improve customer service and administrative practice;
- (v) examining the implications of electronic payment systems within the mandate of WP8; and
- (vi) developing a menu of practical approaches to support effective tax administration in relation to cyberspace for discussion within the OECD and appropriate elements of the public and private sector.<sup>1</sup>

---

<sup>1</sup> OECD Electronic Commerce *supra* at 32 (136)