

Uneasy Application of Permanent Establishment Rule in a Digital Era:

Comments on Recent Work Undertaken by OECD

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I. Introduction: PE as a distributive rule

Ever since its first appearance in the 1899 double taxation treaty between Prussia and Austria-Hungary, the concept of Permanent Establishment (PE) has assumed great significance in international tax practice. The existence of PE has now been the decisive condition for the taxation of income from business activities and of capital pertaining to such activities. ² Under this rule, the host state may have priority in taxing the profits derived by an enterprise of the other contracting State only to the extent that the enterprise carries on business through a permanent establishment situated in the first-mentioned state and only insofar as the profits are attributable to such a permanent establishment. In other words, permanent establishment is the threshold requirement for the host state to exercise its tax right over cross-border business profits and all other business activities below this threshold will only be taxed by the resident state. This effective function of PE as a distributive rule of tax rights between source states and resident states makes it the best candidate to settle jurisdictional conflicts regarding cross-border business income. That is also the reason why over 3000 existing double taxation conventions adopted this rule.

To be specifically, the PE rule consists of two parts, the determination of PE governed by Art 5 of OECD Model Tax convention or UN Model and the profit attribution of PE addressed by Art.7 of these two models.³

II. Application of PE in electronic commerce: challenges and policy options

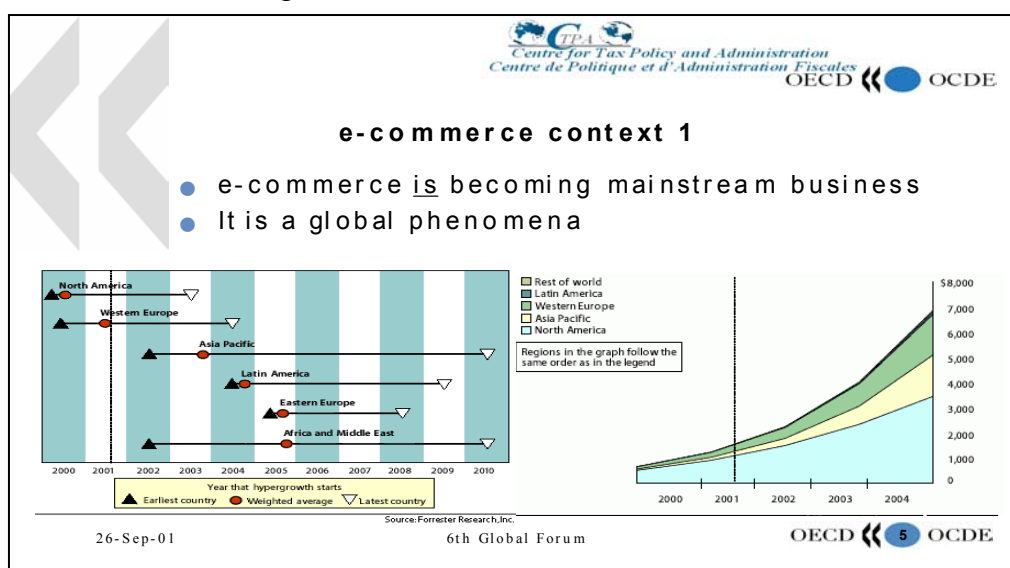
The fast advance of information and communication technologies (ICT) has offered global business unprecedented opportunities. Even small businesses wherever they are located could sell their products and services to a customer in a remote place around the clock. The so called electronic commerce ,although not precisely defined

¹ I have been engaged in the research of international tax issue of Electronic Commerce and Cyber law under the supervision of Prof. Liao since 1998 when I was an undergraduate student. Some of my research papers have been published in established core journals, such as International Taxation, Journal of International Economic Law of China, etc. However, it needs to be mentioned that my article here is not meant to be an in-depth analysis of this issue, but rather an informational summary and comments on the very recent progress made in this field. Any comments and suggestions are very welcome. Please mail to lawbig@vip.sina.com.

² Klaus Vogel, on Double Taxation Conventions, Kluwer Law International, Third Edition,1997, p280.

³ UN Model Tax Convention has adopted a broader definition of the term “permanent establishment” than OECD Model Tax Convention does. For the purpose of reference, the author uses OECD Model as the basis of analysis in this article. And since OECD has been frequently updated over the years ,unless otherwise indicated, all reference is made to 2002 OECD Model as amended, which is available at <http://www.oecd.org/daf/fa>

or defined varyingly, involves the application of new ICT to a broad range of production and distribution activities being conducted on a global scale through channels which are digital and permit to do business interactively at any time, at any place. The basic characteristics of Electronic commerce are: simultaneous, dismantling geographical difference, lack of central control, global, anonymous, untraceable, etc. These characteristics have their tax implications and explain why so many are concerned about tax issues of the internet, why the most fundamental income tax challenges of e commerce is jurisdictional. One element adds to the complexity of this problem is that e commerce is still growing rapidly and becomes mainstream business in a global scale. See the Chart below.



Note: The largest impacts yet to be felt. Most of the world is still on the bottom of the S curve.

The 2000 market correction (.com to .bomb) merely slowed the growth of e-commerce from unbelievably fast to exceptionally rapid.

Concerns over the possible erosion of tax base by international electronic commerce have inspired numerous literatures and discuss papers since the first release of US Treasury Paper *Selected Tax Policy Implications of Global Electronic Commerce*. National governments, international organizations and tax experts reached a Consensus that it would not be easy to apply current PE rule in electronic commerce which it is not designed for. The difficulties are : the website is by itself combination of software and digital data stored in the server and does not amount to the place of business,⁴ the visibility of website will no lead to the existence of PE,⁵ the location of servers are too easy to be manipulated to be fixed, the automation of website and server normally does not constitute carrying business activities, websites are hosted

⁴ OECD, Changes to Commentary on Article 5, first visited on January 18, 2001, <http://www.oecd.org/daf/treaties/clari-e.pdf>

⁵ Helmut Becker, Taxation of Electronic Business in a Globalizing World—Ten Demands for an Adaption, Intertax, VOL26, Issue 12, 1998, p.410. see also, Gary Sprague and Rachel Hersay, Letter to OECD re Electronic Commerce, Intertax, VOL27, Issue 2, 1999, p40.

by Internet Services Provider and the business does not have at its disposal the server and the location of the server, the telecoms company and ISP provides only internet access, data storage, transit or other auxiliary services and could not be an agency PE of the foreign vendor.⁶

Some commentator describes the process of applying current treaty notions to electronic commerce as the story of Cinderella, trying various shoes on one foot. But what if the foot is what the shoe makers did not envisage? Current PE rule is designed in a traditional environment and attaches great importance to physical presence such as place of business and agents. The strong market penetration effects of electronic commerce are not what it has or ought to have contemplated.

In view of the ineffectiveness of PE rule in the electronic commerce context, international communities have proposed a variety of policy options to address this issue. Depending on the extent to which these policy options deviate from the existing PE rule, they are classified as revolutionary or conservative. Revolutionary approaches include new taxes such as BIT tax advocated by Canadian tax expert A.Cordell, withholding tax proposal by R L Doernberg and the so called *abandonment of PE*. In contrast, some commentators are rather conservative in even proposing a possible solution to this problem. To them, good taxes are old taxes. A status quo or hands-off approach would be the best way to deal with the challenges by international electronic commerce which merely represents the natural evolution of conventional channels to conduct business. A compromise between these two extremes, namely virtual PE, is advocated by Professor L.Hinneken, University of Antwerp.⁷

Not surprisingly, current discussion mainly focuses on the determination of PE in the electronic context. The profit allocation issues are mentioned only incidentally. Since the profits allocation issues arise only if and when a PE is found to exist, which rarely occurs in an electronic environment.

III. OECD as international forum in the taxation of electronic commerce

(i) The appropriate forum to address the challenges

OECD has been playing an important role in the process of re-evaluation and monitoring of the current international business with a view to establishing a tax framework that enables such business to develop to its full potential while protecting the tax revenue basis of the concerned States. It offers the appropriate forum in conjunction with the contribution of other international organization such as European

⁶ For a summary of these difficulties, please consult the author's article *Inquire into the Determination of Permanent Establishment in the Context of Electronic Commerce*, published in *Peking University International and Comparative Law Review*, VOL 1, 2002, also, *Application of PE Rule in Electronic Commerce*, to be published in *Journal of International Economic Law*, VOL 5, Law Press, 2002.

⁷ For a comprehensive review of these approaches, see Luc Hinneken, *Looking for an Appropriate Jurisdictional Framework for International Electronic Commerce in the Twenty-first Century*, *Intertax*, VOL 26, Issue 6-7, 1998. see also, the author's article on the same issue, which has been inspired by Professor Hinneken but has its own standpoint in elaborate on the diversity in characterizing the challenges of electronic commerce, *supra* note.

Community to coordinate government response to this tax challenge.⁸ OECD Turku Report envisages this process as follows: ‘This plan institutes a virtual organization by drawing on the strength of existing organizations while avoiding the creation of a new supervisory body. In essence, this approach mirrors that undertaken in Member States where various departments and ministers come together to forge international or regional policies. The horizontal nature and speed of electronic commerce necessitate a similar strategy at the international level.’⁹

The OECD ministerial conference in Ottawa (1998) “*A Borderless World: Realising the Potential of Electronic Commerce*” has produced fruitful results. Among them is the most desirable consensus, namely, ‘Taxation Framework Conditions’ which establishes the basic principles that should guide the e-commerce taxation. These principles include neutrality, efficiency, certainty, simplicity, effectiveness, fairness, and flexibility.¹⁰

In order to implement the Ottawa Framework Conditions, the Committee of Fiscal Affairs set up five Technical Advisory Groups (TAGs) with a mandate to take the coordination process forward with the involvement of the business sector and non-member countries so as to come up with globally acceptable well-considered solutions. Of particular relevance to our discussion is the TAG on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits in the context of Electronic Commerce. (Hereinafter referred to as Business Profits TAG). This TAG has as its mandate to examine the application and clarification of, and assessment of the alternatives to existing treaty key concepts relating in particular to:

- the concept of ‘place of effective management’
- the concept of a permanent establishment (PE);
- the attribution of profit to a server-PE, and
- transfer pricing issues.

The Business Profits TAG would provide their input into the deliberations of Working Party No.1 on Tax Conventions and Related Questions.¹¹

(ii) Recent work under taken by OECD

Following two previous drafts which were released for comments by Working Party No. 1 in October 1999 and March 2000, CFA adopted the changes to the Commentary on the OECD Model Tax Convention concerning the issue of the

⁸ Hinckens, How OECD Proposes to Apply Existing Criteria of Jurisdictional to Tax Profits Arising from Cross-border Electronic Commerce, *Intertax*, VOL29, Issue 10, 2001, p322.

⁹ Ibid.

¹⁰ OECD, *Electronic Commerce: Taxation Framework Conditions*, 1998, <http://www.oecd.org>

¹¹ The mandate of these five TAG was originally two years and elapsed in 2001, however their mandate has been extended to put the work forward. 1. Working Party No. 1 on Tax Conventions and Related Questions is a subsidiary body of the OECD Committee on Fiscal Affairs and is responsible for drafting changes to the OECD Model Tax Convention.

application of the current definition of permanent establishment in the context of e-commerce on 22 December 2000.¹² The changes draws a distinction between businesses that operate the server (usually ISPs) and those carries on business via website (usually vendors) in that the latter do not have at their disposal the server and the location of the server since the latter's websites are normally hosted by the first. Therefore, vendors in general will not constitute a PE. The changes also clarify what the preparatory or auxiliary activities would be in e-commerce context. Generally, the provision of communication links between supplier and customer, advertisements for goods or service and gathering market information for the business would be treated as the exceptional activities, unless these activities or combination of these activities amount to an essential and significant part of the business. In addition, an agency PE will also be unlikely to arise.

Now that the threshold question has been settled, at least in respect of the application of the existing rules, attention turns naturally to what profits can be attributed to e-commerce activities that have passed the threshold of Article 5 so that a permanent establishment is held to exist. The Business Profits TAG then attempts to explore the interpretation and application of Article 7 of a PE in digital environment and publishes a discussion paper entitled Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions for public comments prior to 30 June 2001.¹³ Although the discussion deals with only the case of e-retailing model, it performs a factual and functional analysis and distinguishes different variations depending on the nature and scope of functions performed and the number of server PE's involved. For example, a stand-alone server processes on line transactions with consumers and delivers to them digitized products by means of automated functions without intervention of personnel in the PE. The server-PE thus performs only routine functions and relies on other parts of the enterprise to provide the intangible assets necessary to perform its functions (mostly software, hardware and marketing intangibles). Theses limited functions, under the working hypothesis employed in this report, are comparable to those of a 'contract service provider' arrangements which leaves assets and risks with the head office and attributes to the PE only the profit associated with the physical operation of a computer server¹⁴. As not CUP's may be available, an arm's length fee would be determined under the Transfer Pricing Guidelines according to the cost plus method applied to the direct and indirect costs incurred by the provider-PE. Based on this variation, the report also examines other variations which perform more functions or involve more servers (multi-server). The methodology prevails in this report is an analogical application of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax

¹² OECD, Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5, December 22,2000, <http://www.oecd.org/daf/fa>

¹³ OECD, Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions, February 2001,

¹⁴ For detailed discussion, see OECD, *supra* note.

Administrations.¹⁵

IV . Comments

The changes to Commentary of Article 5 recognized the possibility of a PE in the context of e-commerce but it seems to be exception other than the norm. The report has been filled with restrictive wording such as ‘only in exceptional cases’, ‘in very unusual circumstances’ (is a PE likely to exist.) or it would be that in order to constitute a PE in e-commerce, a number of strict criteria need to be met.(in a typical e-commerce case, these tests are not likely to be met in the meantime)

Regarding the profit allocation issues, the role and profit of the server-PE has been reduced to that of a service provider entitled to the cost plus which a contract service provider would earn or an independent service provider, whose fee is ultimately not much better as it is to be reduced by an arm’s length charges for the use of the intangibles of which the head office is the economic owner. TAG thus denies the PE any mainstream trading function and related profit margin. This minimalistic approach to the function and corresponding arm’s length profit attribution to the PE may not properly reflect the activities of the PE and its effective penetration of the market via the new channels. The value created with the help of website has exceeded that of a simply communication tool, but contribute substantially to the company’s commercial and residual profits.¹⁶

In summary, it could be seen that OECD takes an approach that seems to fall into the conservative category. Those Conservative firmly believe that good taxes are old taxes. Moreover, current PE rule has proved its effectiveness since its first appearance in international arena and has formed part of international consensus and should be clarified and adapted to characteristics of the new medium rather than be abandoned. The principle of neutrality is frequently cited as one of the arguments for such an approach. It seems, to them, e-commerce is mere acceleration of natural evolution of commercial channels. Similar conservative attitudes are also shared by national governments such the United States, the Netherlands and Canada.¹⁷

Underlying such a proposal is a motive for geo-political interests. The conservative approach will ,in practice, lead to one effect—further the shifting of the right to tax e-commerce profits from the source state to the residence state. When the flows of capital investments and trade are in balance, the shift does make sense because it only changes the direction of taxation and simplifies the taxation by reducing the source taxation. However, if the flows are in imbalance, the result would

¹⁵ OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 1999. Its Chinese Translations have been done by my colleagues and I, edited by Prof. Liao, to be published by Peking University Press,2002.

¹⁶ Some arguments have also been raised against the validity of the analogical use of TPG .see, Hinnekens, supra note 8.

¹⁷ US Treasury, Selected Tax Policy Implications of Global Electronic Commerce, Intertax, VOL25, Issue 4,1997. Advisory Committee on Electronic Commerce of Canada, Electronic Commerce and Canada’s Tax Administration, <http://www.rc.gc.ca/ecommm>, 1998.

be that the residence state unilaterally benefits from such a shift. That exactly explains why e-commerce net exporting countries such as the United States have held so conservative attitude towards taxation of e-commerce.

However, in order to implement the policy goal, that is, to provide a fiscal climate within which electronic commerce can flourish, weighed against the obligation to operate a fair and predictable taxation system that provides the revenue required to meet the legitimate expectations of citizens for publicly provided services¹⁸, an international consensus shall be above all the most important. As is recognized by OECD in its reports, the consensus is more important than the rule itself. Any solution thus must produce a fair sharing of the tax revenue arising from cross-border e-commerce among concerning states, especially between source States and resident States. From this standpoint, the conservative approach is by no means the proper one to such an effect.

It should be also noted that, Business Profits TAG is now in its working project on examining the application of current treaty notions to e-commerce. It will explore the possibility of considering alternatives to these notions. It still remains to be seen what approach and attitude the Business Profits TAG will possibly take in its future work.

¹⁸ OECD, , Electronic Commerce: Taxation Framework Conditions, 1998,<http://www.oecd.org>