A research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce specialising in Taxation.

FLEXIBILITY OF THE PERMANENT ESTABLISHMENT CONCEPT TOWARDS E-COMMERCE AS ENDORSED BY THE OECD.

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Declaration

I declare that this research report is my own work. It is submitted for the degree of Master of Commerce specialising in Taxation in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.

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ABSTRACT

According to article 7 of Organisation for Economic Co-operation and Development (OECD) Model Tax Convention, profits of an enterprise of a contracting state will be taxable only in that state, unless the enterprise carries on business in the other contracting state through a permanent establishment (PE) situated there (OECD 2017: 33). Article 5 of the OECD Model Tax Convention defines a PE as a 'fixed place of business through which the business of an enterprise is wholly or partly carried on' (OECD 2017: 31). Current PE rules (source rules) are strongly territorial based (Azam 2007: par 19). Territorial taxation is based on international enterprises being subject to tax on income only in the source jurisdiction (Kobetsky 2011: 35). The challenge of taxing business income without a PE has been exacerbated by the advent of electronic commerce (e-commerce) (Michielse and Thuronyi 2015: 170). E-commerce challenges territorial concepts as e-commerce businesses can be located anywhere and conduct business everywhere (Azam 2007: par 20). The rise of e-commerce has opened source-based principles of taxation for re-examination (Doernberg, Hinnekens, Hellerstein and Li 2001: 169).

This research examines the current PE concept as endorsed by the OECD, whether it is flexible enough to handle challenges presented by e-commerce. This research will examine the evolution of the PE concept, how the previously identified e-commerce challenges have been addressed in the current PE concept as endorsed by the OECD, the contribution of the OECD towards the PE concept and lastly to analyse recent court cases on the PE concept regarding e-commerce.

Key words: international taxation, OECD, non-resident, e-commerce taxation, permanent establishment concept. flexibility principle.

CHAPTER 1 Introduction

1.1 Background

The PE concept was first used in a bilateral tax treaty between the Austro-Hungarian empire and Prussia signed in 1899 to prevent double taxation and to facilitate cross border trade (Kobetsky 2011: 110). Under this treaty, business profits made were to be taxed in the country in which a permanent establishment was located (Kobetsky 2011: 110). As a result, tax treaties use the “PE” concept to determine a source of business income (Cockfield, Hellerstein, Millar and Waerzeggers 2013: 47). The primary objective of a treaty is to resolve the problem of overlapping tax jurisdictions by allocating taxing rights over income between contracting countries (Kobetsky 2011: 1). The PE concept was designed in a physical economy and it connected to the structure of “bricks and mortar” at a geographic location in a territory of the taxing state. The PE concept requires a fixed physical location and a recognizable business activity in the source state. As businesses became more mobile and technology became more advanced, these requirements became increasingly restrictive. (Doernberg and Hinnekens 1999: 309)

E-commerce, since its emergence, has threatened to upset the tax balance which exist between importing and exporting states, and this tax base which appears to be eroding is based on traditional international tax notions (Doernberg and Hinnekens 1999: 312, 315). E-commerce is described as a process of buying and selling or exchanging of products, services, and information via the internet and this became possible in 1999 when internet was opened to commercial use (Mourya and Gupta 2015: 1.2, 1.3). The challenge now is finding a basis for allocating taxing rights between residence and source states which satisfies both e-commerce importing and exporting states (Doernberg and Hinnekens 1999: 312). Some members of the Business Profits Technical Advisory Group (TAG) have argued that an enterprise can participate to a significant degree, in the economic life of a country without the need for a human or physical presence which would result in a PE (OECD 2004: par 51).

This means that source countries will lose source generated taxable income if international tax rules insist on the physical presence requirement as these intermediaries have often constituted permanent establishment under tax treaties, triggering source-based taxation (Chetcuti 2002). In Ottawa in October 1998, there were five broad taxation principles agreed upon which should apply to e-commerce: those principles included 'flexibility' (OECD 2001: 10). Flexibility principle suggests that 'taxation systems should be flexible and dynamic to ensure they keep pace with technological and commercial development' (OECD 2001: 10). It follows that, the Committee of Fiscal Affairs adopted these principles as they are reflected in the taxation framework conditions, suggesting that taxation principles which guide conventional commerce should also guide e-commerce. These principles should be structured to maintain fiscal sovereignty between countries and to achieve fair sharing of the tax base from e-commerce to avoid double taxation. (OECD 2001: 11)

According to the Boston Consulting Group (BCG), analysis for western European markets, e-commerce will become the dominant channel in most categories, with online channel leading for domestic and cross border sales, once e-commerce is fully developed (meaning when barriers to cross border e-commerce have fallen) (Van Heel, Lukic, and Leeuwis 2014: 1). E-commerce market revenue is expected to grow from USD 320 billion to more than 900 billion between 2015 and 2021, for business to consumer (B2C) e-commerce in the Association of Southeast Asian Nations (ASEAN), India and China regions. This is because B2C e-commerce sales are projected to grow much higher than traditional retail sales (OECD 2018a: 82). Although global e-commerce markets are still relatively small compared to traditional commerce, e-commerce is evolving and growing quickly (OECD 2018a: 82). One of the factors affecting the growth of cross border e-commerce is the legal and regulatory environment which includes taxation as an important matter which can be complicated by cross border e-commerce (OECD 2018a: 91, 92).

Some members of the Business Profits Technical Advisory Group (TAG) which was set up by the OECD Committee on Fiscal Affairs in January 1999, argued for changing the current PE rules while others argued for maintaining the current PE rules. Those in favour of maintaining current PE rules stated that:

> existing rules are sufficiently flexible to accommodate the development of the “new” economy business models and capable to adaptation where specific aspects of the rules need to be revisited considering developments (OECD 2004: par 88).

Those proposing changes took a different view regarding the capacity of existing rules to adapt to e-commerce as it no longer complemented the business model of today and tomorrow (OECD 2004: par 92, 98). There were also several alternatives suggested to the OECD, such as virtual permanent establishment, virtual agencies and virtual fixed place of business which would apply to electronic commerce operations but none of these alternatives was approved by the OECD as they were not perceived to justify a dramatic departure from the current PE rules (OECD 2015a: 156).

The purpose of this research is to examine the current PE concept as endorsed by the OECD and investigate whether it is flexible enough to handle challenges presented by e-commerce. The examination of the current PE concept in relation to being flexible would assist in order to ascertain whether, having one PE concept for both traditional and e-commerce, is still appropriate or relevant in these completely different business models. This research will examine the evolution of the PE concept, how the previously identified e-commerce challenges have been addressed in the current PE concept as endorsed by the OECD, the contribution of the OECD towards the PE concept and, lastly, analyse recent court cases on concept, regarding e-commerce.

1.2 Research problem

1.2.1 The statement of the problem

This research examines whether the current PE concept is flexible enough to handle challenges presented by e-commerce**.** The OECD has served as a starting point for almost over 3,000 bilateral tax treaties among countries in the world (Michielse and Thuronyi 2015: 164).

1.2.2 The sub-problems

1.2.2.1 The first sub-problem is to understand what e-commerce is.
1.2.2.2 The second sub-problem is to examine the history and the significance of the PE concept and how it has evolved to address challenges presented by e-commerce.
1.2.2.3 The third sub-problem is to analyze how the previously identified e-commerce challenges have been addressed by the OECD.
1.2.2.4 The fourth sub-problem is to analyze recent court cases on the PE concept regarding e-commerce.
1.2.2.5 The fifth sub-problem is to understand the role of the OECD and its contribution towards amending the PE concept to address challenges presented by e-commerce.

1.3 Research methodology

The research conducted is qualitative in nature: it examines and analyses the available information on the research topic. The research will entail the use and analysis of the following resources in the research:

- Books,
- Electronic resources,
- Internet,
- Case law,
- Journals,
- Publications,
- Technical and conference papers, and
- Statutes.

1.4 Scope and limitations

This research will focus on the PE concept as endorsed by the OECD, since the OECD has served as a starting point for almost over 3,000 bilateral tax treaties among countries in the world (Michielse and Thuronyi 2015: 164). It focuses (specifically) on how flexible the concept accommodates e-commerce from time to time as this concept is found in domestic tax law and tax treaties of contracting states for the purpose of allocating taxing rights to the source country if a non-resident taxpayer has a PE in the source country. Although tax challenges which have been previously identified were classified into nexus, data and characterisation (OECD 2015a: 99), this research will concentrate on the PE concept and not on measurement of profit to be attributable to PE.

Further examination of the PE concept in relation to domestic tax law and tax treaties will be limited to France, India and Spain because of the latest PE concept court cases which have been concluded in France, India and Spain so these court cases will be discussed in chapter 5 of this research.

1.5 Chapter outline for the research

Chapter 1: Introduction

This introductory chapter will introduce the background and significance of the research, the problems and sub-problems identified, and the research methodology used.

Chapter 2: Electronic commerce

The purpose of this chapter is to provide an understanding of what constitutes e-commerce, what business models are involved in e-commerce and how e-commerce has evolved since its emergence in comparison to conventional commerce.

Chapter 3: Evolution of PE Concept.

The purpose of this chapter is to set out the history and significance of the PE concept on international taxation as endorsed by the OECD. This chapter will also focus on how the PE concept has evolved to accommodate the significant changes which have been caused by e-commerce.

Chapter 4: Analysis of previously identified e-commerce challenges on the current PE concept as endorsed by OECD.

The purpose of this chapter is to analyse how the previously identified e-commerce challenges have been addressed by the OECD and how the potential options have been incorporated in the current PE concept. This chapter will also analyse whether these potential options have been incorporated in domestic laws and under tax treaty provisions by relevant countries (where applicable).

Chapter 5: Analysing recent court cases on the PE concept.

The purpose of this chapter is to analyze the recent court cases on the PE concept regarding e-commerce. This chapter will evaluate the facts of some relevant court case, the court findings and conclusions reached by the relevant court. Four major cases will be analysed in this chapter which includes, *Google Ireland v French Tax Authorities*, *Value Click International v French Tax Authorities*, *ITO v Rights Florists Pvt Ltd and Spain v. Dell case*. Lastly, the chapter will focus on action taken by relevant tax authorities in terms of their domestic tax laws after court cases have been concluded.

Chapter 6: Role of OECD and its contribution to the PE concept.

The purpose of this chapter is to set out the role, approach and contribution of the OECD in addressing international taxation issues, such as, amending the PE concept to address challenges presented by e-commerce. The chapter will also examine how the commentary to the article for the PE concept applies.

Chapter 7: Conclusion

This chapter will conclude on whether the current PE concept is flexible enough to handle challenges presented by e-commerce and will also propose areas requiring further research.

Chapter 2: Electronic commerce

2.1 Background

E-commerce began in the early 1970s with electronic fund transfer (EFT) which was mainly used by financial institutions and large enterprises to exchange account information over protected networks (Turban, Lee, King and Chung 2000: 13). Then electronic data interchange (EDI) came into existence in the 1980s guaranteeing enterprises that they would be able to transmit computer readable transactions with one another reliably (Mourya and Gupta 2015: 1.3). When internet was opened for commercial use in the early 1990s, the term e-commerce was invented and its application expanded rapidly (Turban, Lee, King and Chung 2000: 13). As digital transformation has grown more quickly , the e-commerce environment has become progressively dynamic, new players are entering as some barriers have fallen especially for businesses, individuals and at cross-border level businesses, while new obstacles have emerged (OECD 2019d: 32). The fast development of e-commerce is changing how the society engages in commercial transactions as more transactions are conducted through the internet (OECD 2018a: 80).

Small and medium enterprises (SMEs) have also increased their participation in e-commerce market, resulting in an increased share of enterprises which trade online (OECD 2019d: 39). Three major e-commerce business models which have been transformative include, (i) online platforms which act as both retailers and providers of online marketplaces bringing buyers and sellers together, (ii) online subscription services such as Netflix streaming services and (iii) online-offline business models such as grocery stores which combine online ordering with offline distribution (OECD 2019d: 75, 86). Association of Southeast Asian Nations (ASEAN), India and China regions, e-commerce market revenue is expected to grow from USD 320 billion to more than USD 900 billion from 2015 to 2021 for B2C as e-commerce sales between B2C are projected to grow more than conventional retail sales. Although global e-commerce markets are still relatively small compared with traditional commerce, e-commerce is still evolving and growing quickly. (OECD 2018a: 81, 82)

The purpose of this chapter is to obtain understanding of what e-commerce is. What business models are involved in e-commerce. lastly, to obtain understanding of how e-commerce has changed the way business is conducted.

2.2 What is e-commerce?

E-commerce is defined by a number of authors in different contexts. According to Azam, e-commerce refers to any commercial transaction concluded wholly or partly through the use of the internet (Azam 2013: 7). E-commerce disregards the territorial boundaries. Azam further states that all e-commerce is virtual, including tangible, intangible and services as they occur within the internet and their physical existence outside the internet is very limited (Azam 2012: 648). Internet (i**nte**rconnected **net**works) refers to a number of interconnected logical networks that connect a number of computers globally. It refers to logical connection among computers and it does not refer to physical connections. (Doernberg, Hinnekens, Hellerstein and Li 2001: 10). The OECD defines e-commerce as a sale or purchase of goods or services through the use of computer networks designed to place or receive orders. Qualifying a commercial transaction as an e-commerce transaction is determined by the means used to place an order (OECD 2019d: 14).

E-commerce definition provided by the OECD include online platforms and it specifically exclude orders placed through manually typed email, phone calls, short messaging system (SMS) or through social media networks, as these are normally used in an informal economy (OECD 2019d: 17). According to Oguttu and van der Merwe, e-commerce refers to varied commercial transactions conducted through electronic means which facilitate trade without the limits of geographic boundaries (Oguttu and van der Merwe 2005: 305, 306). Therefore, e-commerce enterprises can sell goods or services to any specific client's country with limited physical presence or without the use of agents as they can directly contact clients globally through use of the internet (Azam 2012: 676). E-commerce enterprises can either use (i) indirect e-commerce which facilitates ordering of tangible products or services and delivery is performed through traditional channels or (ii) direct e-commerce which facilitates ordering and delivery of intangible products online (OECD 2014: 74).

2.3 Types of business model used by e-commerce

According to Mourya and Gupta, there are six types of e-commerce which are usually accepted: Business to business (B2B), Business to Consumer (B2C), Consumer to Consumer (C2C), Government to Government (G2G), Consumer to Business (C2B) and Business to Employee (B2E) (Mourya and Gupta 2015: 2.2). OECD refers to three types of e-commerce, B2B, B2C and C2C (OECD 2014: 74, 75). For purpose of this research, only B2B and B2C will be discussed below.

2.3.1 Business to business (B2B) model

B2B refers to businesses which sell goods or services to other businesses through e-commerce and this can also include supplies of goods or services to support other business (OECD 2014: 74). Following are examples of how business support other businesses:

> *(i)* logistics services such as transportation, warehousing, and distribution; *(ii)* application service providers offering deployment, hosting, and management of packaged software from a central facility; *(iii)* outsourcing of support functions for e-commerce, such as web-hosting, security, and customer care solutions; *(iv)* auction solutions services for the operation and maintenance of real-time auctions via the Internet; *(v)* content management services, for the facilitation of website content management and delivery; and *(vi)* web-based commerce enablers that provide automated online purchasing capabilities. (OECD 2014: 74)

B2B e-commerce relies heavily on electronic data interchange (EDI) which is useful for maintaining a one-on-one relationship between a single buyer and single seller (Laudon and Traver 2014: 340). According to Laudon and Traver, the major business model used under B2B are defined as follows:

(1) E-distributor: an enterprise which offers goods and services directly to individual businesses.
(2) E-procurement: enterprises which create and sell access to digital electronic marketplaces through the use of “value chain management” software.
(3) Exchange refers to an independent vertical digital electronic market where suppliers meet a small number of large buyers for the purpose of increasing access to buyers, while buyers meet sellers for the purpose of keeping up-to-date with latest developments.

(4) Industry consortia refers to industry-owned vertical markets which supply a small number of enterprises with goods and services of their specific interest industry such as automobile, aerospace and chemical industries. (Laudon and Traver 2014: 341,342)

2.3.2 Business to consumer model (B2C)

B2C refers to online businesses which sell to individual customers. Li includes among the examples of the earliest B2C models (i) Online version of traditional shops, online service providers such as Google, digital content providers such as music, transaction brokers, market creators and social networks, such as Facebook (Li 2014: 11). According to Laudon and Traver the above business models are defined as follows:

(1) E-tailers refers to online retail stores similar to "brick and mortar" storefront, except that customers make use of an internet or mobile device to place an order. Some e-tailers have existing physical stores, while others only operate in a virtual world with no physical location.

(2) Content providers provide online content such a digital videos, music, photos, text, online newspapers and magazines.

(3) Transaction brokers process online transaction which would usually be handled in person by a customer, such as travel services and job placement services.

(4) Market creator refers to online enterprises which build a digital electronic environment where buyers and sellers can meet and transact with one another.

(5) Service providers refers to enterprises which offer services online such as Google maps, Gmail, travel recommendation and online medical bill management.

(6) Portals, such as Google, Yahoo, Msn, they do not seem to be selling anything in particular, but they provide powerful search tools, news, shopping, music and video streaming etc.

(7) Community providers create an online environment for the purpose of linking people with similar interest in order to buy or sell products, photos and videos. Example includes social networks such as Facebook and LinkedIn. (Laudon and Traver 2014: 332, 339).

2.4 Unique features of e-commerce

1. Potentially virtual presence of a non-resident enterprise in a source country may be solely based on hosting of a website on a computer server located there (Chetcuti 2002). “E-commerce does not seem to be occurring in the physical location but instead it takes place in the world of cyberspace” (Cockfield, Hellerstein, Millar and Waerzeggers 2013: 27).
2. Disintermediation and less labour intensive, non-resident enterprises, no longer requires intermediaries in the source countries in order to trade there. E-business activities require less human intervention than conventional businesses (Chetcuti 2002). Internet has removed a need for certain physical intermediaries traditionally required to facilitate transactions, for example, traditional bookshops are no longer vital for the sale of books, since online bookshops can replace traditional bookshops and sell e-books as well as hard copies (Cockfield, Hellerstein, Millar and Waerzeggers 2013: 27).
3. Globally, the scope of market penetration is limitless (Choudhary 2011: 38). E-commerce enterprises can be located anywhere in the world and their clients will not be interested in where these enterprises are located (Cockfield, Hellerstein, Millar and Waerzeggers 2013: 27). According to Laudon and Traver, e-commerce allows commercial transactions to cross cultures, regions and state borders. As a result, the ‘potential market size of e-commerce enterprises is roughly equal to the size of the world’s online population’. (Laudon and Traver 2014: 53, 54)
4. Anonymity: internet has made it very difficult to uncover the identity or physical location of buyers and sellers, especially in B2C business models of e-commerce (Cockfield, Hellerstein, Millar and Waerzeggers 2013: 31). Since e-commerce transactions are conducted over the internet, economic participants such as buyers and sellers may not know one another since their details are at least partially anonymous (Choudhary 2011: 38).

2.5 Revenue streams earned by e-commerce enterprises

Major business models utilised under B2C and B2B models on e-commerce such as e-tailers, digital content providers, market creators, portals, service providers, transaction brokers and e-distributors etc. generate their revenue based on different revenue models and, according to the OECD, the most common revenue models are:

- Advertising based revenues: This category includes search engines which primarily charges advertisers for ad placements (Laudon and Traver 2014: 334). Other models rely on providing advertising through mobile devices (OECD 2014: 83).
- Digital content purchases or rental: customers are charged per digital content downloaded, for example, if a customer downloads an e-book, videos, games and music etc. (OECD 2014: 83).
- Sale of goods (including virtual items): this category includes e-tailers such as virtual retailer, bricks and clicks, catalogue retailer and manufacturer direct (Laudon and Traver 2014: 331). This category also covers online gaming which could be provided for free or at discounted prices as introduction products (OECD 2014: 83).
- Subscription based revenues: this category includes community providers such as Facebook and LinkedIn, digital content providers such as CNN.com and ESPN.com and portals such as Google, Bing, Yahoo (Laudon and Traver 2014: 331). According to OECD examples include annual or monthly subscription payments for digital content such as music, video streaming and also regular payments for software services (OECD 2014: 83).
- Sales of services: this revenue model is utilised by online enterprises offering users a service, rather than a product. Examples will include financial services, travel agencies, and enterprises which provide internet access and also act as intermediaries, such as web hosting and domain registration (OECD 2014: 83).

2.6 Conclusion

It clear that e-commerce is still evolving and growing although it still small in comparison with conventional commerce (OECD 2018a: 81, 82). E-commerce potentially takes place in a virtual world as it does not seem to occur in a physical location like conventional commerce. According to Cockfield the introduction of e-commerce has changed the way business is being conducted: in the past MNEs have relied on having physical presence in foreign country in order to perform significant business activities (Cockfield 2001: 1183). E-commerce has resulted in the removal of conventional intermediaries (including human intermediaries) and created new online intermediaries. According to Cockfield, introduction of e-commerce resulted in a term called "reintermediation", which refers to a creation of new online intermediaries which facilitates business transactions through the internet and these online intermediaries do not require a physical place to conduct business in the foreign country.(Cockfield 2001: 1184) Conventional retailers in the past have relied on setting up sales offices in the foreign country in order to facilitate advertising and promotion of sales but with the development of internet, these business activities can be achieved through a website (Cockfield 2001: 1183). Lastly, e-commerce has resulted in the generation of additional revenue models which could have not been possible through conventional commerce.

Chapter 3: Evolution of the PE concept.

3.1 Background

The PE concept was first used in a tax treaty between German states in 1899 in order to prevent double taxation among Prussian municipalities (Kobetsky 2011: 110). During this time the PE concept, was not developed into Prussian tax legislation: originally it was not a tax concept until the passing of the German Double Taxation Act of 1909 (Skaar 1991: 73, 74). The tax treaty prevented double taxation by allocating taxing rights among the source country and residence country (Kobetsky 2011: 107). According to Seligman there are two different categories of double taxation: the first double taxation is caused by the competing jurisdictions or authorities and the second it is caused by the same jurisdiction or authority (Seligman 1931: 99). Seligman further justifies the above two categories of double taxation by providing the following explanation:

> The first is essentially geographical in character. A man living in one state and owning property in another state may be taxed on the same property by both states, because they compete in claiming jurisdiction over that property. Not only is this true as between foreign countries, but it is equally true, and in fact of far greater importance, as between conflicting authorities in the same country (Seligman 1931: 99).

According to Doernberg, “double taxation” refers to “juridical double taxation” which is caused by overlapping claims of tax jurisdiction because of concurrent application of residence and source-based taxation (Doernberg, Hinnekens, Hellerstein and Li 2001: 85). Generally the tax treaty resolves overlapping jurisdictional claims between residence and source state by granting the taxing right to a source state, provided that the taxpayer’s nexus with a source state is sufficiently strong, i.e. using the PE concept (Doernberg and Hinnekens 1999: 19, 20).

3.2 Source and residence-based taxation

According to Hellerstein, there are two bases on which states may claim to tax business income, namely residence and source (Hellerstein 2003: 4).

3.2.1 Source-based taxation

The power to tax income based on source depends on the relationship between taxing state and the location of property or activities that produce income in that state (Cockfield, Hellerstein, Millar and Waerzeggers 2013: 43). To prevent double taxation, League of Nations of 1923 tasked four economists to prepare a report on the matter of double taxation and one of the terms of reference given to four economists was:

> Can any general principles be formulated as the basis of an international convention to remove the evil consequences of double taxation, or should conventions be made between countries, limited to their own immediate requirements? In the latter, can such conventions be so framed as to be capable ultimately of being embodied in the general convention? (Bruins, Einaudi, Seligman and Stamp 1923: 2(4006))

The four economists identified a doctrine of economic allegiance, which had four criteria namely, origin of wealth or income, situs of wealth or income, enforceability of wealth or income and domicile of the person entitled to dispose of wealth or income (Bruins, Einaudi, Seligman and Stamp 1923: 27(4031)). Economic allegiance uses these four criteria as a measure of existence and the degree of economic relationship between a state and the wealth or income of a person to be taxed. In concluding, four economists indicated that it would be necessary to apportion economic allegiance as between origin (source) and domicile (residence), namely (i), all corporeal, immovables and tangible movables except money, jewellery and furniture should be assigned, mostly, if not wholly to origin (source) and (ii) intangible wealth should be assigned, mostly, if not wholly to domicile (residence). (Bruins, Einaudi, Seligman and Stamp 1923: 39(4043)).

Since there are two sources of international tax, namely domestic tax law and tax treaty. Domestic tax law usually define source of business income as a place of carrying on business, contract and location of certain business activities, while the tax treaty uses the “PE” concept to determine the source of business income (Doernberg, Hinnekens, Hellerstein and Li 2001: 79).

3.2.2 Residence based taxation

According to Hellerstein, ‘a state has substantive jurisdiction to tax business income on the basis of residence’. This simply means that a country where an enterprise is a residence, that country has the power to tax business income of the enterprise, without having regards to the source of business income (Hellerstein 2003: 5). Countries generally tax enterprises based on residence, which is determined with reference to commercial domicile, place of incorporation, location of enterprises headquarters or place of "effective" management. According to the OECD model article 4, a resident of contracting country is defined as any person who is liable for tax in that country solely by the reason of his domicile, residence, place of management, or any other criterion of similar nature. However, this term does not include a person who is liable to tax on income in that country only by reason of income being from that source country. (OECD 2017: M-15)

3.3 Origins of the PE concept:

The Prussian municipal regulations used in the Eastern part of Prussia (German states) proposed that standing operations/business (stehendes Gewerbe/Betrieb) be taxed in the municipality where located, even if the owner did not live in that municipality. Then a tax treaty was signed between Prussia and Saxony which stipulated the conditions of taxing the standing operation/business (stehendes Gewerbe/Betrieb).(Skaar 1991: 72, 73) The standing operation concept had two conditions which became the core element of a PE concept: (i) There must be a fixed physical location in the other municipality and (ii) Intention to continue performing business activities in the location of that municipality should not be temporary (Skaar 1991: 73). The first-time the general definition of the PE concept became legislation in 1909 through German Double Taxation Act to prevent double taxation within German municipalities and the PE concept remained unchanged until it was amended for the first time in 1977 (Kobetsky 2011: 110). According to Professor Traversa and Dr. Sanghavi' s presentation, Double Taxation Act of 1909 states that:

> A permanent establishment within the meaning of this Act is any fixed facility or establishment, for the purpose of exercise a permanent (or fixed) business. Apart from the headquarters of company, the following are to be treated as permanent establishments, branches, manufacturing plants, sales establishments: and distribution offices (…) (Traversa and Sanghavi 2018: 4)

The PE concept was first used on international tax treaties in 1899 between the governments of Austria-Hungary and Prussia, which simply stipulated that business profits generated through a PE in the other country should be taxed in that other country (Skaar 1991: 75). According to the League of Nations draft Double Taxation of 1928, the PE concept was defined as:

> The real centres of management, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bonafide agent of independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country. (League of Nations 1928: 2)

Work done by the League of Nations regarding the PE concept from 1927 to 1946, was taken over by OEEC which later became known as the OECD from 1958 until today, OEEC was instructed to draft Double Taxation Convention in 1958, which led to development of the OECD model tax treaty of 1963, which provided the general definition of the PE concept for the first-time in history, under article 5(1) (Skaar 1991: 96). The general definition of the PE concept is defined under article 5(1) of 1963 as follows:

> For the purposes of this Convention, the term "PE" means a fixed place of business in which the business of the enterprise is wholly or partly carried on (OECD 1963: 43).

According to article 5(1) of the OECD commentary paragraph 2 of the Double Taxation Convention of 1977, the general definition of the PE concept includes three conditions: The “place of business" must exist, the place of business must be "fixed", and, lastly, the business of an enterprise must be carried through the fixed place of business (OECD 1977: 59). These three conditions will be discussed below in detail, from point 3.3.1 to 3.3.3.

The OECD draft Double Taxation Convention of 1963 introduced a list of items which fall specifically within the term “PE” under article 5(2) as follows:

> a) a place of management;
>
> p) 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.

When comparing the League of Nations draft Double Taxation Convention of 1928 with the OECD Double Taxation Conventions of 1963, agencies are no longer reflected under a basic PE rule (article 5(1) and 5(2)) in the OECD draft Double Taxation Convention of 1963. They were disclosed separately under article 5(4) for dependent agent and under article 5(5) for independent agent. This is well explained by Skaar who states that an agency is an alternate test for the location test for the "place of business" (Skaar 1991: 97).

3.3.1 The "place of business" must exist

According to the OECD model Tax Treaty Convention the "place of business" incorporates any premises, facilities or installations used to carry out business (OECD 1977: 59). Therefore, a place of business will only exist where these premises, facilities or installations are physically present in a source country (Olivier 2002: 871). A place of business may also exist even where no premises are available in a source country as long as the enterprise has access to an amount of space at its disposal (OECD 1977: 59). Items specifically included as a place of business under article 5(2) of OECD Tax Convention are partly because of the premises and partly because of the type of activities performed there (Skaar 1991: 116).

3.3.2 The place of business must be fixed

The place of business to be considered fixed, there must be a connection between a place of business and the specific geographic point in a source country (OECD 1977: 60). In the early German court practices, place of business had to be attached to the ground for them to be considered fixed but this has changed as the place of business may even be in an open-air space (Skaar 1991: 126). Equipment which qualifies as a place of business does not necessarily need to be attached to the soil to be considered fixed; as long it is located in a site, it will be considered as fixed (OECD 1977: 60). The place of business must also have an element of permanence to be considered fixed, meaning operations must be carried out on a regular basis with the intention of carrying on using the place of business on an ongoing basis. Activity itself does not need to have an element of permanence but a place of business needs to be structured with an element of permanence. (Olivier 2002: 872)

3.3.3 The business of an enterprise must be carried through the fixed place of business

For a place of business to constitute a PE, the business of an enterprise must be conducted from that place of business in the source country, either wholly or partly (OECD 1977: 60). Business of an enterprise that is carried on mainly using automatic machines may create a PE, even if the activities of people the employed by the enterprise are only restricted to setting up, operating, controlling and maintaining the enterprise (OECD 1977: 61).

3.3.4 Activities excluded from article 5(4) of the PE concept prior to BEPS action 7

According to the OECD article 5(4), the following activities are excluded from the PE concept, even if they are conducted through a fixed place of business, as they are preparatory or auxiliary in nature:

> 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 subparagraphs 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. (OECD 2015b: M-16)

What may be considered preparatory or auxiliary activity for one enterprise may not qualify to be preparatory or auxiliary activity for another enterprise (Olivier 2002: 874). A fixed place of business, the general objective of which is the same as the objective of the enterprise, activities are not considered preparatory or auxiliary activities (OECD 2015b: par 24).

3.3.5 Agents PE prior to BEPS action 7

According to article 5(5), a dependent agent who acts on behalf on an enterprise in the source country and habitually exercises authority to conclude contracts in the name of the enterprise, that enterprise is deemed to have a PE in the source country where the dependent agent is performing the activities, unless those activities are of preparatory or auxiliary in nature (OECD 2015b: 17). Agency PE does not require the enterprise to comply with conditions of the basic PE rule provisions stipulated on article 5(1) and 5(2), so agency PE provides an alternate test to the basic PE rules. If an enterprise has a PE in a source country through article 5(5), it is not necessary to show that enterprise would fall under article 5(1) and 5(2). (OECD 2015b: par 31) Under an agency PE, individuals and companies are considered to be a place of business. Therefore, agency PE does not require a fixed place of business in the source country as the physical connection is replaced by personal connection. (Skaar 1991: 464, 465)

3.4 PE concepts since the emergence of e-commerce

What is evident in the OECD draft Double Taxation Convention of 1963 and of 1977, the general definition of the PE concept and its commentaries, did not incorporate any provisions or commentaries to address e-commerce. The internet was only available for commercial transactions with customers from 1991 (Mourya and Gupta 2015: 1.3). Since the emergence of e-commerce, the OECD amended the PE concept in January 2003 by only updating the commentaries of article 5 and the PE concept from article 5(1) to 5(6) has remain unchanged. The general definition of the PE concept under article 5(1) has remained unchanged and still refers to the traditional economy. The reason for amending the PE concept by only updating commentaries was to incorporate paragraphs 42.1 to 42.10 which specifically addresses e-commerce in order to keep up with latest technological developments. (OECD 2003: 102, 105)

The development of e-commerce necessitates the revision of the traditional economy threshold and tests embraced in the original PE concept such as place of business must exist, must be fixed to a specific geographic point in the source country and must have element of permanence (Garate 2002 : 8). In the past, transnational corporations required physical presence in order to be involved significantly in the foreign markets; with emergence of e-commerce physical locations are no longer required to participate in a foreign market since e-commerce transactions are conducted through internet (Oguttu 2009: 216). Below we examine how the PE concept has accommodated e-commerce technologies such as websites and servers.

3.4.1 Website

An e-commerce website is defined as a central location where software and electronic data are stored on and run by server (Chetcuti 2002). As a result, a website it an intangible property (OECD 2003: 102). According to the OECD commentaries to article 5 paragraph 123, a website cannot result in a creation of the PE as far as the software and electronic data are concerned, since there is no “place of business” as there is no location for the website. According to paragraph 124 of article 5, if the website is hosted on a server of an Internet Service Provider (ISP), there is no “place of business” at the disposal of the enterprise (OECD 2017: C(5)-49, C(5)-50). Skaar elaborates that a “place of business” refers to tangible objects which serve as a base for business activity such as premises, computer equipment and machines and so a software is not considered a “place of business” (Skaar 1991: 123). Even if the enterprise carries out business through the website on the server it owns or leases, this cannot result into the PE but PE may be created through a location of a server at the disposal of the enterprise (OECD 2017: C(5)-50).

3.4.2 Servers

According to Chetcuti definition of servers:

> An internet server consists of tangible computer equipment networked to the internet. A server is usually dedicated to the storage and internet accessibility of web sites, email accounts and databases and software programs resident on the server can automatically administer the electronic transmission of digitalised e-commerce products or services to end consumers. (Chetcuti 2002).

According to the OECD commentaries on article 5 paragraph 125, a server may constitute a PE if it is accessed through computer equipment which has a physical “fixed place of business” (OECD 2017: C(5)-50). a place where a server is physically located may constitute a PE of the enterprise, provided all requirement of article 5(1) are met (OECD 2017: C(5)-50).

The presence of the personnel in the location of a server is not necessary in order to consider the location of a server as a fixed place of business. This applies to e-commerce the same way it applies to equipment automatically operated such as automatic pumping equipment. (OECD 2017: C(5)-50) Activities generally considered as preparatory or auxiliary activities for e-commerce operations would be, providing a communication link like a telephone line between suppliers and customers, online advertising of goods and services, supply of information, collecting market data for the enterprise and transmitting the information through a mirror computer equipment for security and efficiency purposes (OECD 2017: C(5)-51).

Lastly, an Internet Service Provider (ISP) may not create a PE by performing a hosting arrangement for an enterprise. As a result, article 5(5) will generally not be applicable to ISP's because ISP's will not usually have authority to conclude contracts or play principal role leading to conclusion of contracts in the name of enterprise so ISP's would not be a dependent agent. (OECD 2017: C(5)-52) According to article 3(1)(a), the term "persons" includes individuals, companies, any other body of persons and this term does not cover website that is used to carry on business by an enterprise (OECD 2017: M-10). Therefore article 5(5), cannot deem a PE to exist by virtue of a website as an agent (OECD 2017: C(5)-52).

3.5 Modification to PE concept as a result of action 7 of BEPS project of 2015.

3.5.1 Modification of article 5(5) and 5(6) to prevent artificial avoidance of a PE status.

The OECD considered it was necessary to amend the dependent agent PE definition under article 5(5) and independent agent definition under article 5(6), in an attempt to prevent artificial avoidance of a PE status through commissionaire arrangements (OECD 2015c: 9). The OECD loosely define a commissionaire arrangement as an arrangement where an enterprise sells products in a source country in its own name but on behalf of a non-resident enterprise that is the owner of these products (OECD 2015c: 9). The OECD noted the following issues in its final report on BEPS action plan 7 of 2015, (i) A non-resident enterprise that uses a commissionaire arrangement is able to avoid the creation of a PE in a source country under article 5(5) of the OECD model convention since contracts finalised by commissionaire are not binding to non-resident enterprise since contracts were not concluded in the name of non-resident enterprise; (ii) contracts were significantly negotiated in the source country but are finalised by a non-resident enterprise in the foreign country and (iii) a person considered as an independent agent to which exception article 5(6) applies qualified even through the person is closely related to the non-resident enterprise acting on its behalf. (OECD 2015c: 10)

Amended article 5(5) requires that an enterprise, acting on behalf of a non-resident enterprise or that habitually play a principal role of non-resident enterprise to finalise contracts without material modification and those contracts are in the name of or for the transfer of ownership or for provisions of services of a non-resident enterprise. If all these conditions are met, a non-resident enterprise would be deemed to have a dependent agent PE in source country provided that article 5(4) does not apply. (OECD 2017: M-20) If an enterprise that acts exclusively on behalf for a non-resident enterprise that is closely related to, that enterprise would not qualify to be given independent agent status under article 5(6), so the enterprise would be classified as a dependent agent, provided article 5(5) conditions are all met. (OECD 2017: M-20)

3.5.2 Modification of article 5(4) to prevent artificial avoidance of PE status through specific exceptions

One of the key concerns expressed by the OECD was that MNEs are able to change their business structures by fragmenting cohesive business operations into several small business operations that end up qualifying as "preparatory or auxiliary" activities under article 5(4). As a result, the OECD agreed to modify article 5(4) and provided additional commentaries to clarify what is meant by the expression, "preparatory or auxiliary" (OECD 2015c: par 12). However, the OECD went a step further by introducing an anti-fragmented rule, paragraph 4.1 of article 5 specifically designed to deal with fragmentation of activities by the same enterprise or between closely related parties (OECD 2015c: par 13). Article 5 (4.1) specifically states that exceptions under article 5(4) will not apply to a fixed place of business maintained by the enterprise if the same enterprise or closely related enterprise conducts business activities in the same location or another location within the same contracting states, provided that the activities performed by these enterprises or closely related parties are considered complementary functions which form part of a cohesive business operation (OECD 2017: M-19, -20). Article 5(4.1) is directed at digital enterprises which split their value chains across several enterprises and jurisdictions (Olbert and Spengel 2017: 14).

3.6 Conclusion

This chapter has demonstrated that the PE concept found under article 5 of the OECD model which was developed during the era of traditional economy, has been modified a number of times in order to keep up with the ongoing development of business activities and the emergence of complex businesses at the international level. As a result, the PE concept has demonstrated its ability of being flexible, up until e-commerce emerged. When e-commerce emerged, the OECD added paragraph 42.2 to 42.10 commentaries to article 5 to accommodate e-commerce without changing the general definition of the PE concept under article 5(1). These paragraphs to the commentaries of article 5 clarify two things, (i) website cannot result into the creation of PE in the source country and (ii) server may result into creation of PE in source country provided all requirement of article 5(1) are met. According to Oguttu, the development of the commentaries to article 5 paragraph 42.2 to 42.10 that was meant to address the PE concept in the context of e-commerce was guided by traditional principles in determining whether a website or server qualifies as a PE (Oguttu 2009: 217).

This was done even after the fact that emergence of e-commerce has removed the need for physical location in order to engage in significant commercial activities in foreign countries (Oguttu 2009: 216). According to the Oxford dictionary, “flexibility” of tax system refers to its capacity to be easily modified or adapted to respond to new circumstances. Although modification of the PE concept has been achieved by adding paragraphs 42.2 to 42.10 of the commentaries to article 5 but they do not seem to have responded to the true nature of e-commerce. Lastly, significant modification achieved by the OECD to the PE concept under article 5(4), 5(4.1), 5(5) and 5(6), relate to BEPS action 7 project (OECD 2016: par 8). However, the BEPS Monitoring Group (BMG), stated that issues addressed by BEPS action 7 relate to old issues which date back to the 1928 (before e-commerce emerged) and the aim was to patch up the existing tax rules as they were not able to resolve the central problem of allocating profits to where value is created (BMG 2017: 1, 4). According to Avi-Yonah and Xu it is unfortunate that many of the old principles have been preserved and included in the BEPS project (Avi-Yonah and Xu 2017: 6). This confirms that to some extent, challenges brought by e-commerce remain unaddressed in the PE concept.

<u>Chapter 4: Analysis of previously identified e-commerce challenges to the current PE concept as endorsed by the OECD.</u>

4.1 Background

This chapter focuses on action plan 1 of Base Erosion and Profit Shifting (BEPS), addressing tax challenges created by the digital economy (OECD 2015a: 1). Modification of the PE concept as a result of action plan 7 of BEPS project has been discussed under chapter 3 of this report. Action plan 1 of the BEPS report of the OECD 2015, does not define what digital economy is but it defines e-commerce as a process of buying and selling goods or services through computer networks and can also be used to facilitate the ordering of goods or services (OECD 2015a: par 117). Digital economy is a term which is used primarily in markets where digital technologies are used to facilitate buying or selling of goods or services or information through e-commerce (OECD 2012: 5). E-commerce is also defined as process of buying and selling or exchange of products, services and information using internet (Mourya and Gupta 2015: 1.2, 1.3). Therefore, e-commerce and digital economy will be used interchangeably in this research as e-commerce forms part of the three components which comprise digital economy (Mesenbourg 2001: 2, 3).

According to action plan 1 of BEPS, tax challenges created by digital economy were classified into three broad categories, namely, nexus, data and characterisation of income (OECD 2015a: par 248). According to the OECD, the main issue on data is how to 'attribute value created from the generation of data from digital goods or services and how to characterise the person or enterprise that provides data for tax purposes' (OECD 2015a: par 248). The increasing use of data has raised the question about the appropriateness of current nexus rules about whether any business profit generated through remote gathering of data by an enterprise should be taxable in the country where data are obtained (OECD 2015a: par 262). New business models have raised question as to how to characterise certain payments as royalties or fees for technical services or business profit under domestic law and tax treaty law (OECD 2015a: par 269). The issue of characterisation has wider implications for nexus rules in terms of allocating taxing rights to the source country for taxation purposes (OECD

2015a: par 272). For the purpose of this research, the tax challenge to be discussed is nexus since all these three broad categories may overlap with the nexus issue.

4.2 Action taken to address the nexus issue through proposals about virtual PE and significant digital presence.

4.2.1 Nexus issues

In tax treaties, in order to tax the business profit of a non-resident enterprise in a source country, the PE concept is used as a basic rule to determine the taxing right for the source country (OECD 2004: par 13). Article 5(1) of OECD define the term "permanent establishment" as a ''fixed place of business through which the business of an enterprise is wholly or partly carried on''(OECD 2017: M-19). The PE concept requires that there must be a fixed physical place of business in the territory of a source country and it should not be temporary in nature (OECD 2017: C(5)-3). Emergence of e-commerce has enabled non-resident enterprises to engage in geographically distant markets in source countries without establishing any physical presence that is required by article 5(1) of the OECD (OECD 2004: par 51). Non-resident enterprises achieve significant economic participation in source country, using automated functions which do not require human intervention or physical presence (OECD 2004: par 51). In the e-commerce environment, it is challenging to determine location where e-commerce transactions are undertaken (OECD 2004: par 78).

Another problem that e-commerce raises is whether activities which were classified as preparatory or auxiliary in terms of article 5(4) of the OECD under conventional commerce, are still appropriately to classified under e-commerce, since e-commerce is capable of changing these activities into a significant part of a business (OECD 2015a: par 260). All these questions are raised by e-commerce on the nexus rule, specifically challenging the definition of the PE concept about whether it is flexible enough to handle e-commerce (OECD 2015a: par 256). In January 2003, the OECD included paragraph 42.2 to 42.10 (now renumbered from 122 to 131) as part of the article 5 commentary to deal specifically with issues created by e-commerce (OECD 2003: 102-105). Paragraph 123 states that a website cannot result in creation of the PE, even if hosted by an ISP (OECD 2017: C(5)-49). Paragraph 125 states that a server may result in creation of the PE if accessed through computer equipment which has a fixed physical place of business (OECD 2017: C(5)-50).

This new category of the PE was criticised by some authors since it was not accurate in connecting the geographical location with activities producing the income (Vaca 2016: 93). Cockfield pointed out several policy arguments against servers being considered as nexus for international taxation. A server is a computer connected to internet and there can be a million servers in the world potentially resulting in the PE, this may be difficult to enforce. Cockfield further argued that the real test about a server, is the software within the server and a problem with the software is that it can be moved to any server in the world so no connection exist between the location of the software and the jurisdiction where value is created. He also argued that servers being used to determine nexus may result in BEPS if servers are in low- or no-income tax territories. (Cockfield 2006: 172) To address the nexus issue, a proposal made adds a new nexus for "electronic (virtual) permanent establishment", which will be used as an alternate nexus, specifically addressing e-commerce (OECD 2004: par 322).

4.2.2 Virtual PE

The proposal suggested that an alternate nexus would require the modification of the PE concept's definition in three ways: the definition will be extended to cover, "virtual fixed place of business" through which a business of the enterprise is carried on, "virtual agency" which is an electronic equivalent dependent agent of a PE and, lastly, "on-site business presence" (OECD 2004: par 322). A "virtual fixed place of business PE" will be created if a non-resident enterprise carries out business through a website hosted by another enterprise in the source country. This effectively removes a need for a non-resident enterprise to have at its disposal a tangible property or facilities in the source country. All other characteristics of a conventional PE would be retained, such as, there must be a place within a source country and this place of business should not be temporary in nature. (OECD 2004: par 323) A "virtual agency PE" refers to an electronic dependent agency PE, which would cover situations where contracts are habitually concluded on behalf of a non-resident enterprise with persons located in the source country (through technological means) (OECD 2004: par 324).

This simply means that contracts which are binding to non-resident enterprises which are habitually completed through the use of a website, might result in the creation of electronic dependent agency PE, regardless of the location of a server where the website is hosted (OECD 2004: par 324). The last alternative is “on-site business presence”, which looks at the economic presence of a non-resident enterprise providing on-site services to a customer through a computer or phone interaction. This alternative does not require a fixed place of business to be at the disposal of a non-resident enterprise or the conventional view that business activity should take place within the source country. Under this alternative, minimum threshold needs to be specified, such as time period during which a non-resident enterprise regularly operates within the source country, monetary threshold or limitation on types of activities covered to ensure that the source country taxation is applied, only when there is a significant level of economic activity. (OECD 2004: par 325)

When all three alternatives were evaluated against the flexibility principle, it was noted that “virtual fixed place of business” would only make sense to the extent that a server is maintained by the enterprise in the source country (OECD 2004: par 343). Supporters of “virtual agency PE” and “on-site business presence PE” argued that these alternatives do provide flexibility to the PE concept since “virtual agency PE” removes the need for conventional human intervention while “on-site business presence” focuses on economic activity regardless of the means used to perform the activity (OECD 2004:par 344). The OECD reached a conclusion that this alternative nexus regarding e-commerce “virtual permanent establishment” does not justify departure from the current PE concept because of lack of evidence of losses of tax revenues for capital importing because of e-commerce. Secondly, business TAG indicated that these alternatives should only be acted upon if they proved to be superior more than the existing rules. Therefore, the OECD did not approve the alternate nexus for e-commerce which is “virtual permanent establishment” (OECD 2004: par 350, 351).

4.2.3 A new nexus based on significant digital presence PE

The OECD in 2005 reached the conclusion that “virtual permanent establishment” was not an appropriate alternative at that time since there was inadequate evidence to justify departure from the existing PE concept (OECD 2004: par 350). Under BEPS action 1, “virtual permanent establishment” is not discussed but, rather, a new nexus alternative based on significant digital presence, is proposed as a possible alternative (OECD 2014: 143). A non-resident enterprise involved in “fully dematerialised digital activities” in a source country can be deemed to have a taxable presence provided they maintained “significant digital presence”, in this way creating a PE, provided that certain threshold are exceeded (OECD 2014: 144). BEPS action 1 of OECD 2014 classify the following activities as part of “fully dematerialised digital activities”:

(a) Core business relies entirely or substantially on providing digital goods or services.

(b) No physical activities are involved in the creation of actual goods or services.

(c) Contracts are generally finalised through internet or by telephone.

(d) Entering the relationship with a non-resident enterprise is only through a website.

(e) The majority of non-resident enterprise profit is attributable to digital goods or services.

(f) No physical presence is required for the actual use of a digital goods or services, other than the means of accessing the digital goods or services. (OECD 2014: 144)

“Significant digital presence” would be deemed to exist in the source country where for example, (i) a significant number of contracts for digital goods or services are concluded between non-resident enterprise and the customer which is a tax resident in the source country, (ii) substantial payments made to a non-resident enterprise relate to the main line of business which is to provide digital goods or services and branches of non-resident enterprise provides only secondary activities to the source country customers. (OECD 2014: 145) On the final report of BEPS action 1 of 2015, it was indicated that “significant digital presence”, would be determined based on factors which evidence a purposeful and sustainable interaction with the economy of the source country through technology or automated equipment (OECD 2015a: par 277).

Those factors used to determine significant digital presence according to OECD are discussed below:

4.2.3.1 Revenue based factors

Revenue earned on a sustainable basis in the source country can be considered as a basic indicator for the existence of significant digital presence. Revenue factors will not be considered sufficient on their own to create nexus in the source country but when combined with other factors, nexus may be created in the form of significant digital presence. (OECD 2015a: par 278) One of the technical issues relating to revenue factors is the determination of level of threshold which may be based on gross revenue generated from remote digital transactions but this threshold should be determined in absolute terms and in local currency of the source country to avoid manipulation (OECD 2015a: par 278).

4.2.3.2 Digital factors

Digital factors to be used as part of the test to determine significant digital presence in the source country will include local domain name, local digital platform and local payment options. Non-resident enterprises are likely to use a localized domain name in the source country to enable local customers to find the local site, but it is not certain whether local domain name method will remain the main method in the future. Non-resident enterprises generally establish local website and platforms in a source country in order to facilitate interaction (easily) with local customers regarding website content, services and functions. Lastly, incorporating a local form of payment in a website is considered the most complicated task not generally undertake by a non-resident enterprise which does not intend to participate purposefully in the source country's economy. (OECD 2015a: 279)

4.2.3.3 User-based factors

According to the OECD, user base and data input are considered important indicators for a purposefully and sustainable interaction with the economy of another country; such factors include monthly active users (MAU), online contract conclusion and data collection. All these factors can be used to measure the level of economic participation in a country, such as MAU, which measures the number of users who generally visit the enterprise website within a 30-day period. Another important factor is the online conclusion of contracts, which refers to contracts concluded by non-resident enterprise with customers using digital platform. This factor specifically addresses the "dependent agent" test under article 5(5) of the OECD by indicating that an online conclusion of a contract between a non-resident enterprise and customers of the source country can be considered appropriate to indicate the level of economic participation of a non-resident enterprise in another country. Lastly, data collected through a digital platform are another important factor to be considered but data collected will not only be limited to personal data but will also cover content created by the user, reviews of products and search engine history. (OECD 2015a: par 280)

4.2.3.4 Possible combination of the revenue factor with digital or user-based factors.

Total revenue which exceeds the revenue threshold will be a good indicator of existence of significant digital presence of a non-resident enterprise in the source country but, for the non-resident enterprise to be considered to be participating in the economic life of source country, other factors such as digital or user-based, need to be considered. Consideration of other factors will be driven by the unique features and economic elements offered by each market (OECD 2015a: par 281, 282). This concept is demonstrated as follows:

> If a non-resident enterprise generates gross revenues above the threshold from transactions with in-country customers, concluded electronically through a localised digital platform where the customer is required to create a personalised account and utilise the local payment options offered on the site to execute the purchase, it could be considered that there is a link between the revenue generated from that country and the digital and/or user-based factors evidencing a significant economic presence in that country. (OECD 2015a: par 283)

4.3 Action taken on proposals of withholding tax on digital transactions and equalisation levy as back-up mechanism to the PE concept.

A task force on digital economy (TFDE) considered introducing withholding tax on payments by resident to non-resident enterprises for goods or services purchased online by residents. Withholding tax can either be applied on final gross withholding tax or on net-basis taxation based on "significant economic presence" in the source country. (OECD 2015a: par 292) However, an approach which was more viable was withholding tax on net-basis taxation based on “significant economic presence” and is considered to be a back-up mechanism (OECD 2015a: par 301). Equalisation levy was considered as an alternative which could be applied with the intention to tax foreign enterprise in the source country who have “significant economic presence” (OECD 2015a: 302). Levy would be charged to all transactions finalised remotely with source country customers by non-resident enterprises (OECD 2015a: par 303). India is an example of a country which has already introduced equalisation levy, a separate tax based on gross revenue generated from online advertisings by non-residents. According to the OECD report, there are revenues reported by the Indian government based on equalisation levy. (OECD 2018: 142)

A task force on digital economy (TFDE) evaluated all options proposed to address tax challenges in the digital economy, included the new nexus in the form of significant digital presence, withholding tax and equalization levy. All these options were evaluated based on neutrality, efficiency, certainty and simplicity, effectiveness and fairness**, flexibility**, sustainability, proportionality and it was further agreed that no principle is better than another principle. (OECD 2015a: par 356) TFDE concluded by not recommending the new nexus based on significant digital presence and other two options. The reasons were that it would require significant key changes to be made in the international tax standard and this would require further work. Several countries were concerned about such changes as it was still uncertain whether they would be able to deal with changes brought by e-commerce on an ongoing basis. (OECD 2015a: par 357)

However, TFDE suggested that countries may adopt into their domestic laws or tax treaties, any of the options which were not recommended by TFDE, provided that they oblige to the existing tax treaties they have with other countries. To adopt this suggestion, countries would be required to provide additional clarity to ensure consistency of the existing international legal obligations. (OECD 2015a: par 357) Because of lack of agreement among countries regarding the options not recommended by the TFDE, some countries have decided to explore these unilateral measures by introducing alternate PE threshold based on “significant economic presence” (OECD 2018b: par 346). These unilateral measures are aimed at lessening the requirement of permanence and physical presence in the source country to establish nexus (OECD 2018b: 349). Two countries, Israel and India, have already modified the PE threshold based on "digital" or "online" presence: the new nexus rule is based on the "significant economic presence" test for these countries (OECD 2018b: 351). Israel and India PE threshold will be discussed further below.

4.4 Unilateral action taken by India and Israel to modify the PE threshold based on new nexus rule of "significant economic presence".

4.4.1 Israel's PE threshold

According to Israel's tax authorities, a non-resident enterprise involved in providing online services to customers through a remote location outside Israel may create a taxable presence if these activities constitute "significant economic presence" . These activities are defined by referring to the "digital presence" factors which include, online contract conclusion, localised website, use of digital products and services and multi-sided business model. These "digital presence" factors can be applied individually or combined without considering revenue-based factors. However, the "significant economic presence" test applies only to non-resident enterprises of countries which do not have double tax agreements with Israel. (OECD 2018b: 137) No tax revenue has been reported regarding this as there are ongoing tax audits being performed (OECD 2018b: par 352) and when there are conflicts between significant economic presence measures and current statute law, the matter will be resolved favouring the statute (OECD 2018b: par 351).

4.4.2 India's PE threshold

According to India, a non-resident enterprise business's profits would be taxed in India, provided there is a significant economic presence, regardless of physical presence of the non-resident enterprise in India. The significant economic presence threshold will be based on the threshold of local revenue and on the number of local users of digital services. India also took a similar approach to Israel by stating that any conflict will be resolved by following the PE definition under the double tax treaty, not the domestic nexus rule which include significant economic presence. The significant economic presence measure only applies to circumstances not covered by tax treaty. (OECD 2018b: 138)

4.5 Action taken to address additional tax challenges presented by the digitalised economy in the interim report of 2018

Extending the work from BEPS action 1 of 2015, according to the interim report of 2018, the OECD observed that there were three salient characteristics found in highly digitalised enterprises business model which present more tax challenges to the current international tax system, especially for multinational enterprises (OECD 2018b: par 383). These features include cross-jurisdictional scale without masses, heavy reliance on intangible assets and the importance of data and participation by the user. “Scale without masses” reduces the number of countries which have taxing rights over business profit of multinational enterprises because of business profit not being taxed in that market jurisdiction, even when non-resident enterprise has an important economic presence. (OECD 2018b: par 384) Although there is no consensus among members of the inclusion framework, some members of the group expressed the view that the features of highly digitalised enterprises (specifically user participation) may lead to misalignment of the location where business profit is taxed and the location where the value is created by the enterprises (OECD 2018b: par 389).

This means that the current PE concept is failing to link the location where business profit of highly digitalised enterprise is taxed and where value is generated (OECD 2018b: par 389). The second group expressed the view that an ongoing digital transformation presents a challenge on the nexus issue because of the ability of highly digitalised enterprises participating in the economic life of a source country with minimal or no taxable presence, while the existing PE concept still determines nexus based on “fixed place of business”. The last group is still satisfied with the existing PE concept and do not see a need to change this. (OECD 2018b: par 392, 394) Since there is no agreement regarding the need for interim measures to address tax challenges the interim report did not make any recommendations (OECD 2018b: par 514).

4.6 Status on secretariat proposals for “unified approach” under pillar 1.

In January 2019, the Inclusive Framework on BEPS approved a policy note to propose a way forward by agreeing to examine a proposal based on two pillars in an attempt to reach an agreement. The first pillar focuses on broad tax challenges of the digitalised economy and on allocating taxing rights (i.e. PE concept) and the second pillar focuses on addressing the unresolved BEPS issues (OECD 2019a: par 1.2). In March 2019, a public consultation was held in Paris (France) by the Inclusive Framework members for the purpose of presenting proposals to address such tax challenges presented and to obtain comments from stakeholders. However, the proposals presented were not the views of Inclusive Framework, Committee of Fiscal Affairs (CFA) or its subsidiary body: they were intended to provide stakeholders with substantive proposals for their analysis and comments. (OECD 2019b: 3) In an attempt to address tax challenges presented in three characteristics of highly digitalised business model in the interim report of 2018, three proposals were developed to focus on pillar one: these include “user-participation”, “marketing intangibles” and “significant economic presence”. The user-participation proposal focused on highly digitalised businesses which create value through engaged and active users by obtaining data and content which contribute to the creation of value for digitalised business (OECD 2019b: par 17).

Value created through user participation is most significant for businesses involved in social media platforms, search engines and online marketplaces (OECD 2019b: par 19).Currently the PE concept does not allocate any taxing rights to user jurisdiction where value is created through user-participation so the PE concept will need to be revised so that user jurisdiction has taxing right over business profits (OECD 2019b: par 20,21). The “marketing intangibles” proposal focuses on multinational enterprises which reach jurisdiction remotely or through limited local presence to develop a customer base (OECD 2019b: par 30). This creates an essential link between marketing intangibles and market jurisdiction. The result of this proposal is that it gives taxing right to market jurisdiction, even in the absence of taxable presence, similar to the user participation proposal (OECD 2019b: par 32). Lastly, the “significant economic presence” proposal focuses on creating taxable presence in a jurisdiction; when a foreign enterprise has significant economic presence based on factors which provide evidence of a deliberate and continued interaction in the jurisdiction through digital technology (OECD 2019b: par 51).

Interested parties were invited to provide comments for the public consultation document on addressing tax challenges presented by digital economy no later than 6 March 2019 and this document had four questions which required comments: (1) what is your general view regarding the proposals? (2) To what extent do you think enterprises as result of digitalisation of economy, are able to participate (actively) or have presence in the jurisdiction not covered by the current nexus rule? (3) In developing the new nexus rule in line with the proposals, what will be the most important design consideration? and (4) what could be the best approach to ensure tax certainty and avoid disputes among jurisdictions? (OECD 2019b: par 87) After comments received were analysed, it was noted, under the secretariat proposal of "unified approach" that all three proposals under pillar one have significant commonalities. These include, (i) all proposals would reallocate taxing rights to user/market jurisdiction and (ii) all proposals envisage a new nexus rule that will not rely on physical presence in the user/market jurisdiction (OECD 2019c: par 10). Based on the significant commonalities among three proposals under pillar one, the secretariat developed a new approach which will provide a solution supported by all members of the Inclusive Framework (OECD 2019c: par 13,14).

The secretariat proposal on a unified approach which was sent to the public to provide comments includes a proposal for a new nexus that does not rely on physical presence but largely on sales (OECD 2019c: par 15). The secretariat's proposal intends to grant new taxing rights to countries where the users of highly digitalised business are located (OECD 2019c: par 17). What is interesting about the proposal is that it will be introduced as a separate rule, in addition to the PE concept to avoid any unintended effect on other existing rules (OECD 2019c: par 22). This means that the current existing PE concept is no longer appropriate to ensure a fair allocation of taxing rights among countries in an increasingly globalised world (OECD 2019c: par 16). Comments in relation to public consultation of the secretariat's proposal for unified approach have already been received and possibly by the end of January 2020 agreement will be reached by members of inclusive framework as previously agreed.

4.7 Conclusion

According to Skaar the future will probably demonstrate that the PE concept has lost it strength for new and mobile industries, whether bilateral tax treaties are renegotiated for this objective or not. Skaar specifically suggests that, the “fixed place of business test” should be abandoned as a leading requirement for tax jurisdiction. Non-resident enterprises’ physical connection to a source country is no longer reliable evidence of economic allegiance. (Skaar 1991: 573) What has been found is that all the alternate new nexus being proposed although not recommended by the OECD, they are trying to move away from the PE concept leading requirement of “fixed place of business” to a virtual world which is more aligned to e-commerce. The main reasons why the OECD is not recommending all the alternate new nexus include (i) there is no proof of revenue losses due to e-commerce, (ii) proposals have not proven to be superior to the existing PE concept principles and (iii) proposals will require a significant changes to the current PE concept (OECD 2004: 350, 351). Although alternate new nexus proposals were not recommended by OECD, countries were encouraged to take unilateral action as a back-up mechanism in case the current PE concept does not accommodate the forever evolving e-commerce (OECD 2015a: par 357).

However, these back up mechanisms apply mainly where a tax treaty does not exist. Lastly, on secretariat “unified approach” under pillar 1, all proposals had significant commonalities, which include reallocating taxing rights to user/market jurisdiction and envisaging new nexus rules, which would be a stand-alone from PE concept and it would not rely on the physical presence in user/market jurisdiction (OECD 2019c: par 10). As is demonstrated in this chapter, the PE concept is facing significant challenges in addressing/accommodating issues created by e-commerce, especially under action plan 1 of the OECD. BEPS monitoring group has stated in their submission that they have ‘not managed to resolve the central challenge of how business profits should be allocated according to where “economic activities occur, and value is created”’ (BMG 2017: 1). Nevertheless, there has been modification to the PE concept under action plan 7 of the BEPS project (which have been discussed in greater detail in chapter 3 of this report).

Chapter 5: Analysing recent court cases concerning the PE concept on e-commerce.

5.1 Background

Linderfalk and Hilling stated in their study that courts use the OECD commentaries to express their arguments about the proper understanding of bilateral tax treaties (Linderfalk and Hilling 2015: 41). Therefore, evaluating court cases for the PE concept concerning e-commerce will provide us with understanding of the PE concept in relation to e-commerce. Although Kobetsky stated that courts use the OECD commentaries to interpret the PE concept included in the bilateral tax treaty, there is always confusion about which version to be used between static or ambulatory approach (Kobetsky 2011: 157). Cockfield tried to illustrate in his study how the 'attempt by regulators to transpose the "real world" international tax principles (the need for physical presence in source countries) into the virtual world replicates (a server as a PE) will often fail' (Cockfield 2001: 1192, 1193). According to Cockfield, servers are very mobile, and servers do not need to be physically connected to income producing activity in a country where customers are based (Cockfield 2001: 1193).

Cockfield further states that a server is merely a box and what is of significance is the servers software, which allows business to perform several e-commerce functions, including acting as a DNS server which can identify the location of the server by simply converting the domain name to internet protocol (IP) address (Cockfield 2001: 1193). Cockfield noted that the Treasury Department in 1996 reviewed the server PE and concluded that servers would not likely constitute a PE under the traditional tax principles, and they would be best addressed by residence-based taxation (Cockfield 2006: 172). Analysing how courts have reached their conclusion will assist in determining whether the correct approach was followed by courts, an approach which will enable this study to conclude on the flexibility of the PE concept. Lastly, chapter 5 will also focus on action taken by relevant tax authorities where applicable, in terms of their domestic tax laws after court cases have been concluded.

5.2 *France v Google, case no.17PA03065*

5.2.1 Summary of the facts of the case

Google France and Google Ireland Ltd are subsidiaries of Google Incorporation Group, a U.S. based company (Falcao 2019: 535). Google Ireland provides advertising services to clients. Google Ireland entered into a marketing and services agreement (MSA) with Google France in order to reach the French market since Google Ireland does not have offices in France. Google France act as a service provider to Google Ireland and in terms of the MSA, Google France is remunerated at 8% cost plus basis. MSA further stipulate that Google France has no authority to bind or to sign contracts or any agreement on behalf of Google Ireland. (Hermant 2018) To understand this case, it is best first to understand the Google business model regarding AdWords and Ad Servers. Google is more than just a search engine; it generates most of its revenues from automated advertising services. Google uses its free search engine to create an appropriate target audience by analysing their search activities so that can be used in targeted advertising. However, it should be noted that Google's income is not directly from these search engines target users but from using search engines as an advertising space for advertisers. (Kofler, Mayr and Schlager 2017: 523)

The advertising network of Google is made up of two main products, "AdWords" and "AdSense": AdWords allows companies and salespersons to advertise on Google's networks, while AdSense enables publishers to reserve a space for AdWords advertisement on their websites (Kofler, Mayr and Schlager 2017: 523). Advertisers pay Google to display content to targeted web users, then Google allow the content to pop-up on the screen of a targeted web user. Google is paid each time a targeted web user clicks on the online advertisement content. (Falcao 2019: 534) According to the court, Google provides AdWords services in two forms: (i) Online Sales Organisation (OSO) which is the cheapest form of advertising, since the account is managed by the advertiser independently and (ii) Direct Sales Organisation (DSO) which provides the client with assistance regarding advertising activities and management of the account. Therefore, Google's case directly relates to the DSO option (Falcao 2019: 534).

5.2.2 Approach by French tax authorities

French tax authority's main argument was that Google Ireland was selling online advertisement through a dependent agent of Google France in terms of article 2(9)(c) or Google Ireland has a PE in France, in terms of article 4(1) of the France-Ireland double tax treaty. According to the France- Ireland double tax treaty, which follows the OECD model, article 2(9)(c) and article 4(1), respectively state that:

> A person acting in a Contracting State on behalf of an enterprise of the other Contracting State, other than an agent of an independent status to whom subparagraph (d) applies, shall be deemed to be a permanent establishment in the first-mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise. (France-Ireland double tax treaty 1968: 4)

> The industrial and commercial 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, tax may be imposed in the other State on the profits of the enterprise but only on so much of them as is attributable to that permanent establishment. (France-Ireland double tax treaty 1968: 6)

During the audit by French tax authorities, it appeared that some of the employees of Google France were tasked with recruiting potential clients with an intention to improve turnover; others were responsible for managing customers portfolios, some were responsible for negotiating contracts, for sales or referred to as sellers and, lastly, Google France has recruited a fulltime lawyer responsible for advising on negotiations and drafting contracts with French customers (Falcao 2019: 535).

5.2.3 Court conclusion on the matter

According to the administrative Tribunal in Paris, it was held that no PE was created by Google Ireland in terms of Article 2(9)(c) of France- Ireland double tax treaty. The administrative Tribunal noted that, although there is no subsidiary-parent relationship specifically between Google France and Google Ireland other than that both companies are subsidiaries of U.S. Google Group Inc., (based on MSA) it was concluded that it prevented Google France from being independent of Google Ireland. (Falcao 2019: 535) The main reason which influenced the court decision was based on MSA which the parties had signed which specifically expressed that Google France does not have power to bind Google Ireland or to conclude or sign contracts in the name of Google Ireland (Falcao 2019: 535). The court further examined the final online advertising contracts signed with customers and noted that: (i) the advertising contracts were between a customer and Google Ireland, (ii) there was no evidence that suggested that terms of contracts were not developed by Google Ireland and, lastly, the advertisement could only be posted online once Google Ireland has provided final authorisation (Hermant 2018).

5.2.4 Analysis of whether the court conclusion on the PE concept is consistent with OECD model

It should be noted that the court in reaching its decision only focused on the legal approach which focused on MSA and the signed contracts between the customer and Google Ireland (Hermant 2018). For an enterprise to be classified as dependent agent of a non-resident enterprise that result into a deemed a PE; article 5(5) of the OECD model requires an enterprise to act on behalf of a non-resident and habitually exercises authority to conclude contracts in the name of a non-resident enterprise. Activities performed by the enterprise should not fall within article 5(4) of the OECD model and, lastly the enterprise should not have an independent status in terms of article 5(6) of the OECD model (OECD 2014a: M-17). The Tribunal/court decision that Google France was not a dependent agent of Google Ireland is consistent with article 5(5) of OECD model since Google France was not authorised to bind or conclude advertising contracts on behalf of Google Ireland as indicated in the MSA and this was further proven by the online advertising contracts signed by the customer and Google Ireland.

As a result, no dependent agent existed in terms of the France-Ireland tax treaty article 2(9)(c). Article 5(6) of the OECD model will not be applicable as the Tribunal noted that the obligations indicated in MSA prevented Google France from being independent of Google Ireland, even if there was no direct control between Google France and Ireland (Falcao 2019: 535). Although a fixed place of business was not the main focus of the Google case, commentary on article 5 paragraph 42.2 of OECD model website cannot result in creation of PE as far as software and data are concerned, mainly because software and data are not tangible so cannot be a place of business since there is no location. However, a server where a website is stored and accessible through a tangible piece of equipment has a physical location and the location may be a “fixed place of business” (OECD 2014a: C(5)-24, -25).

5.3 *ITO v Rights Florists Pvt Ltd (ITAT Kolkata).*

5.3.1 Summary of the facts of the case

The Assessee is Rights Florist Pvt Ltd, an online florist, which goes online to generate business income using search engines such as Google and Yahoo. The Assessee has made expenditure payments of Rs 30,44,166 for online advertisement to Google Ireland Limited and Yahoo USA during the 2005-2006 years of assessments and no tax was withheld from these expenditure payments. When the income tax return filed by the Assessee was examined by the Assessing Officer the Assessee was required to prove as to why these expenditure payments should not be disallowed as deduction under section 40(a)(i) of the Income Tax Act of 1961 in the determination of income. One of the reasons provided by the Assessee was that these expenditure payments were made to non-resident corporations which did not have a PE in India.

5.3.2 Approach by India tax authorities

These claims by the Assessee were rejected by the Assessing Officer on the ground that they were not substantiated and there was no establishment whether these non-resident corporations were party to any tax treaty with India. Therefore, the Assessing Officer disallowed the deduction of expenditure payments under section 40(a)(1) which prohibits deduction of expenditure payments made to non-resident corporations in determination of income, when the Assessee has failed to withhold tax on such payments.

5.3.3 Court conclusion on the matter

The most important question the Tribunal had to address was to determine whether payments made by the Assessee for online advertisement services to non-resident corporations (Google Ireland and Yahoo USA) were taxable in India through a PE. For the purpose of a PE in India, business profits are examined for taxability in terms of section 5(2)(b), which state that only a portion of such income accruing or arises to a non-resident corporation is attributable to its business carried out in India, through its branches, offices, factory's or sales outlets is taxable in India through that PE. Firstly, the Tribunal concluded that the nature of these payments to non-residents amounted to business profits. The Tribunal, to address the PE concept, referred to Australia's tax treaties which are in line with the OECD Model of Tax Convention. The Tribunal concluded that there was no place of business in India since Google Ireland and Yahoo USA are search engines and a search engine's presence is only located on the internet or by way of a website, which is not a form of physical presence in India. The Tribunal further agreed that Google Ireland is only present in India through a website which cannot result in a creation of a PE in terms of the domestic laws of India.

5.3.4 Analysis of whether the court conclusion on the PE concept is consistent with the OECD model

This decision is consistent with paragraph 42.2 of the OECD commentary to article 5 which state that an internet website which is a combination of software and electronic data, constitutes intangible property (OECD 2015b: C(5)-24, -25). If so, it does not have physical location which can be considered a place of business in the absence of premises or machinery or equipment so no PE may be created as far as the software and electronic data are concerned. However, a web server where a website is stored and accessible through a tangible piece of equipment that has a physical location, that location may be a "fixed place of business" (OECD 2015b: C(5)-24, -25). Another important factor which the court looked into was the reservation made by India on the commentary of article 5 paragraph 42.2, where India has indicated that they do not agree with the interpretation as they are of the view that a website may result in PE under certain circumstances and the court concluded that a reservation about commentary of OECD has no role in the judicial analysis. (*ITO v Rights Pvt ltd* 2013 :par 18)

5.4 *Spain v Dell case no.1475/2016*

5.4.1 Summary of the facts of the case

Dell Ireland an entity of the Dell Group. Dell Group had 17 commissionaire subsidiaries in European states, of which Dell Spain was one. Dell Spain changed from being a distributor of Dell Group to commissionaire after 1995. Client portfolios were transferred to Dell Ireland and this included all risks associated with inventory, clients and guarantees. (Jimenez 2016: 462) Dell Ireland made sales through Dell

Spain (which acted as commissionaire agent) to explicit clients and through a web page of Dell Ireland to other clients in order to serve the Spanish Market. Dell Spain provided one employee who was responsible for maintenance of web page content for the Spanish market although the web page was hosted by servers located outside Spain. (Vaca 2016: 97)

5.4.2 Approach by Spain’s tax authorities

The tax administration concluded that Dell Ireland had a PE in Spain under article 5(1) of the Ireland-Spain tax treaty of 1994. The Ireland-Spain tax treaty of 1994 article 5(1) state that, the term “permanent establishment means a fixed place of business through which an enterprise is wholly or partly carried on’’. In reaching this conclusion, the tax administration’s reasoning was that the web page gave rise to the virtual PE, considering all the activities being carried out by Dell Group in Spain through Dell Spain, even though the servers were located outside source country (Spain) (Jimenez 2016: 462).

5.4.3 Court conclusion on the matter

The tax administration reasoning was supported by the Tribunal Eco-nomico Adminstrativo Central (TEAC) of Spain; this is an administrative body which is part of the Ministry of Treasury of Spain (Vaca 2016: 97). However, when the matter was referred to Audiencia Nacional (National court of Spain, AN), AN corrected the decision taken by TEAC regarding the web page creating a virtual PE in Spain, by stating that a web page is a combination of software and electronic data, which are intangible property, therefore, it cannot have a fixed place of business (Jimenez 2016: 465).

5.4.4 Analysis of whether the court conclusion on the PE concept is consistent with the OECD model

The conclusion of AN was consistent with paragraph 42.2 of the commentary to article 5 of OECD which state that a website cannot result in creation of PE as far as software and electronic data are concerned since there is no place of business as there is no facility or premises for the website (OECD 2014a: C(5)-24, -25).

5.5 *France v Valueclick Ltd, case no. 17PA01538*

5.5.1 Summary of the facts of the case

SARL Valueclick France is a subsidiary of Valueclick International, located in Ireland. Valueclick France's sole purpose is to promote Valueclick Group's services within the French market. There is an intra-group service contract which governs relationships between Valueclick France and Valueclick Ireland. In terms of intra-group service contract, Valueclick France was required to render the marketing services to Valueclick Ireland by: (1) providing marketing and sales support which included searching and finding potential clients for Valueclick Ireland; (2) provide continued management services, back office support and administrative assistance in the area of accounting, human resources, cash management and information technology. (Wilhelm 2018) The intra-group service agreement specifically stated that Valueclick France and Valueclick Ireland were independent and that the intra-group service agreement does not create an agency relationship or a relationship for partners who are in joint venture business. It was also stated that no party has a right to represent the other party, as this would result in one party binding the other party to agreements with third parties, and Valueclick France was also denied the right to authorize or sign contracts in the name of Valueclick Ireland. Valueclick France was reimbursed by Valueclick Ireland for providing marketing services at fixed rate of 8% cost plus basis. (Falcao 2019: 536)

5.5.2 Approach by French tax authorities

The French tax authorities considered that Valueclick has a PE in France through having a fixed place of business and is a dependent agent in terms of France-Ireland tax treaty of 1968. French tax authorities provided reasons to support their claim, that Valueclick France had the necessary staff to operate the full range of marketing operations to promote the Valueclick group's products in the French market; they had the necessary resources to provide management support services to Valueclick Ireland. Valueclick France was negotiating the terms of the advertising contracts and drafting certain key clauses in the contracts. (Gelin and Billard-Moalic 2018: 30) The French tax authorities further stated that, in fact, Valueclick employees had power to conclude contracts on behalf of Valueclick Ireland since Valueclick Ireland's authorisation was a mere automatic validation, as the work of negotiating, drafting of contracts, setting up and monitoring of advertisements was performed by employees of Valueclick France (Hermant 2018).

5.5.3 Court conclusions on the matter

The Court concluded that there was no fixed place of business within the meaning of the France-Ireland tax treaty of 1968 in France as the equipment necessary for the implementation of technical services was not located in France (Gelin and Billard-Moalic 2018: 30). Valueclick France did not provide services beyond its mandate as indicated in the intra-group service agreement which could have resulted in creation of a PE (Falcao 2019: 535, 536). Therefore, marketing and management support services were not likely to correspond with activities which creates PE (Hermant 2018). Regarding a dependent agent, the court concluded that Valueclick France was not a dependent agent of Valueclick Ireland, as Valueclick France did not have power to bind Valueclick Ireland and no contract could be finalised without the signature of Valueclick Ireland (Hermant 2018). Valueclick France employees were not legally empowered to act in the name of and on behalf of Valueclick Ireland (Gelin and Billard-Moalic 2018: 30). Therefore, the court overlooked the findings of the investigation by French tax authorities and concluded, based on legal reading which focused on whether Valueclick France had powers to bind Valueclick Ireland (legally) as per intra-group service contract (Falcao 2019: 536).

5.5.4 Analysis of whether the court conclusion on the PE concept is consistent with the OECD model

According to the France-Ireland tax treaty article 4(1), industrial and commercial profits of a non-resident enterprise are only taxable in France if that non-resident enterprise carries on business through a PE in France (France-Ireland taxa treaty 1968: 4). Article 2(9) of the same tax treaty defines "PE" as a 'fixed place of business in which a business of an enterprise is wholly or partly carried on' and this definition is in line with article 5(1) of OECD model (France-Ireland tax treaty 1968: 2).

Article 5(5) of OECD model 2014 required that the enterprise with no independent agent status, acting on behalf of the non-resident enterprise and has exercised or habitually exercises in the source country an authority to conclude contracts in the name of the non-resident enterprise, that non-resident enterprise will be deemed to have a PE in the source country, provided that, activities performed by the enterprise are not of preparatory or auxiliary in nature as indicated by article 5(4) (OECD 2014a: M-17).

The court decision seems to be consistent with article 5(5) of the OECD model because Valueclick France was denied the right to authorise or sign contracts on behalf of Valueclick Ireland as per the intra-group service agreement so Valueclick France is not a dependent agent (Hermant 2018). Regarding a fixed place of business, commentary to article 5 paragraph 42.2 of the OECD model, a website cannot result in the creation of a PE as far as software and data are concerned, mainly because software and data are not tangible so cannot be a place of business since there is no location. However, a server where a website is stored and accessible through a tangible piece of equipment which has a physical location may be a "fixed place of business" (OECD 2015b: C(5)-24, -25). The court conclusion that there was no "fixed place of business" seemed to be in line with paragraph 42.3 since hardware necessary to implement technical services were located outside France (Gelin and Billard-Moalic 2018: 30).

5.6 Action taken by relevant authorities in the source country after court cases have been concluded.

France introduced and adopted a Digital Services Tax (DST) as from 1 January 2019 and DST covers the following supply of services:

- The supply, by electronic means, of a digital interface which allows users to contact and interact with other users, including for the delivery of goods or services directly between those users.
- Services provided to advertisers or their agents enabling them to purchase advertising space located on a digital interface accessible by electronic means in order to display targeted advertisements to users located in France, based on data provided by such users.

These services include, among others, the buying, stocking and diffusion of advertising messages and the management and communication of users data.(Boksenbaum 2019)

This DST will affect French enterprises and non-resident enterprises as long as their gross revenues for the group exceed a threshold of, (i) •€ 750 million for taxable digital services supplied worldwide and (ii) •€ 25 million for taxable digital services supplied in France . The DST is imposed at the fixed rate of 3% on gross revenues generated by taxable digital services of which French users are deemed to have played a major role in value creation. The reason for introducing DST is to align the mismatch between location where digital service profits are taxed and location where the value is created. However, it should be noted that DST is temporary, and France has agreed that once the OECD has found a credible long-term solution, they will withdraw DST. (Hôo, Mazevet and Seroin 2019) The Spanish government also approved DST on 18 January 2019. DST will be charged at 3% for the digital services such as (i) online advertising services, (ii) online intermediation services and (iii) data transfer services. However, it should be noted that the DST falls outside the scope of bilateral tax treaties which have been concluded by Spain. (Turu 2019) Although DST for Spain was initially approved, it has not yet been enacted because the Spanish government was dissolved and it is not clear whether the new government will continue with this proposal (Gracia, Viñas, Galante and García-Borregón 2019).

5.7 Overall conclusion for all court cases

All the cases which were analysed in this chapter specifically deal with non-resident enterprises which conduct their business operations in other countries through e-commerce. The common finding about these non-resident enterprises is that no PE was found in the source country either through the application of article 5(1) or 5(5) of the OECD models prior to BEPS project and, even after considering commentaries to article 5 paragraph 42.2 to 42.10 which were specifically designed to accommodate e-commerce (website and servers). These common findings are confirming what Cockfield indicated in his study when he stated, ‘an attempt by regulators to transpose real world to virtual world by replicating a server as a PE would often fail’ (Cockfield 2001: 1192, 1193). Cockfield concluded his study by stating that taxing business profits generated by servers will prove to be difficult to accept because neither the software within the servers nor the servers themselves necessarily have any physical connection with income-producing activities (Cockfield 2001: 1265). Through observation of paragraph 42.2 of the OECD commentaries to article 5, it clear that the main reason a website was not considered a place of business because it is an intangible object so it does not have location according to the OECD (OECD 2014: C(5)-24, -25). According to Skaar a fixed place of business only refers to tangible objects (Skaar 1991: 123). Lastly courts rely on the legal approach when addressing the PE concept.

It should be noted that court cases discussed in this chapter were concluded based on the OECD model (article 5 and its commentaries) prior to implementation of action plan 7 BEPS initiatives, such as modification of dependent agent under article 5(5) and independent agent 5(6). The reason for using the OECD model prior to action plan 7 BEPS, modification to article 5(5), 5(6) and commentaries are only reflected in the OECD model, full version as it reads on 21 November 2017 (OECD 2017) and the multilateral instrument to modify the PE concept in the existing bilateral tax treaty was only signed by these countries (France, Spain, Ireland and India) in July 2017 and these modifications in the existing tax treaty only came into force on 1 January 2019 for France. Spain has made the declaration and no date has been reflected yet; 1 October 2019 for India and 1 May 2019 for Ireland (OECD 2020: 1, 4). As a result , Post BEPS action plan 7 initiatives came into force after these court cases have been concluded.

Chapter 6: Role of the OECD and its contribution to the PE concept.

6.1 Background

The OECD model has served as a starting point for over 3 000 bilateral tax treaties between countries worldwide since 1963 after replacing the League of Nations (Michielse and Thuronyi 2015: 164). These tax treaties use the “PE” concept to determine the source of business income generated by non-resident enterprise (Cockfield, Hellerstein, Millar and Waerzeggers 2013: 47). The history of the PE concept dates back to the period of 1869 where it was first seen in a tax treaty among German states and in the International Tax Treaty in 1899: this was before the emergence of e-commerce which only came into being in 1991. During 1963 when the Committee of Fiscal Affairs of the OECD presented its report, it foresaw that draft Double Tax Convention which includes the PE concept would need to be reconsidered and amended to reflect the ongoing development of business activities and the emergence of complex businesses at an international level (Kobetsky 2011: 156, 157). As a result, it is not surprising that, when e-commerce emerged, it was agreed in Ottawa in 1998 that the same taxation principles which applied under traditional economy should also apply under e-commerce.

One of the five taxation principles agreed upon in Ottawa, on which this research report focuses, is “flexibility”, which simply means that the tax system should be flexible and dynamic to keep pace with technological and commercial development (OECD 2001: 10). According to the Oxford dictionary, “flexibility” in relation to a tax system refers to its capacity to be easily modified or adapted to respond to new circumstances. Although it has been argued in the past by some members that the PE concept is flexible enough to handle challenges presented by e-commerce (OECD 2004: par 88). The concept has encountered a number of challenges since the emergence of e-commerce, which brought the question about whether it is still appropriate for e-commerce (OECD 2004: par 88). The purpose of this chapter of the research report is to understand the role and influence of the OECD model on the PE concept found in tax treaties since the OECD has served as a starting point for over 3 000 tax treaties. How does the OECD modify, amend and reconsider the PE concept to keep up with e-commerce developments where applicable? What approach does OECD take in interpreting the PE concept as this understanding may assist in determining whether the PE concept is flexible or not, especially under circumstances where only commentaries are modified and not provisions of article 5?

6.2 The role and influence of the OECD model on the PE concept

The OECD uses its model, commentary and reports on specific topics, to guide the tax treaty system (Kobetsky 2011: 152)**.** The main aim of the OECD model is to provide a uniform means of resolving the most common problems which arise among taxpayers because of international juridical double taxation (OECD 2012: par 3). The OECD member countries when concluding bilateral tax treaties are obliged to follow the OECD model as interpreted by commentaries, having regard for reservations they have expressed. Tax authorities are also required to follow the same commentaries which are changed from time to time when applying and interpreting the bilateral tax treaty provisions based on the OECD model (OECD 2012: par 3). The OECD model could be followed back to the work of the League of Nations of 1928 which resulted in the development of the first bilateral tax treaty in 1928 and the last final two bilateral tax treaties which were not widely accepted in 1943 and 1946 (Kobetsky 2011: 154). The OEEC Fiscal Committee (OEEC later known as OECD) which was instructed by council to prepare a draft Double Taxation Convention in 1958, submitted a report in 1958 which included a definition of the PE concept (Skaar 1991: 96).

The OEEC Fiscal Committee's reports resulted in the draft OECD Double Tax Convention of 1963 which was a final breakthrough for creating a uniform bilateral tax treaty. The draft OECD Double Tax Conventions of 1963 signified a similar trend as the one of the League of Nations of 1928. Although the basic PE concept remained unchanged, an entirely new text was added with a number of innovations. It was for the very first time that the OECD Fiscal Committee became successful in creating a general definition for the PE concept, as reflected in article 5(1) of 1963 as a "fixed place of business in which the business of an enterprise is wholly or partly carried on". (Skaar 1991: 96, 97) Other important innovations made in the draft text related to the agency PE clause which was explained in greater detail in commentaries in the model and seek to provide a general criterion for defining agency PE rather than to use examples to describe it (Skaar 1991: 96, 97).

The draft OECD Double Tax Convention and its commentaries of 1963 were revised for a first time in 1977 to accommodate the changing economic conditions (OECD 2012: par 8). Because of continued pressure from globalisation and liberalisation, the Committee of Fiscal Affairs ended up issuing several reports recommending the amendment of 1977 OECD model including the commentaries (OECD 2012: par 8). In 1991 the Committee of Fiscal Affairs realised that changes to the OECD model and commentaries had become a continuing process so the concept of ambulatory model tax treaty was adopted requiring periodic and timely amendments (OECD 2012: par 9). In 1992 the committee started publishing the OECD model and its commentaries in a loose-leaf format as part of an ongoing process of amending the model regularly in response to developments (Kobetsky 2011: 157). Since the 1992 publication of loose-leaf format, changes have been made almost every two to three years: 1994, 1995, 1997, 2000, 2003, 2005, 2008, 2010 and 2014. Although commentaries are being revised regularly, the provisions of the OECD model and bilateral tax treaties were not changed regularly since it takes longer to negotiate bilateral tax treaties (Linderfalk and Hilling 2015: 41).

The loose-leaf format of 2003 is of importance for the purpose of this research since it incorporated, for the first time, commentaries relating to e-commerce and were later incorporated in the condensed version published in 2010 under paragraphs 42.2 to 42.10 (OECD 2012: C(5)-24, C(5)-27). Before any modifications are made to the OECD model tax treaty or its commentaries, OECD member countries are provided with an opportunity to deliberate on the proposed treaty changes, reach an agreement and, if need be, make observations or reservations within the commentaries of the tax treaty (Cockfield 2006: 142). Since 1963, the OECD model has influenced negotiations, applications and interpretation of bilateral tax treaties for both OECD member countries and non-OECD countries (OECD 2012: par 12). The OECD model influence went beyond its member countries; the committee then decided to extend the invitation to non-OECD countries to participate in the process of amending the OECD model which covers the PE concept (OECD 2012: par 9).

6.3 The role of the OECD commentaries in the interpretation of the PE concept in tax treaties.

According to the OECD, detailed commentaries included under article 5of the OECD model for the PE concept are intended to demonstrate or interpret article 5 provisions (OECD 2012: par 28). According to the OECD, tax authorities and courts use the commentaries under article 5 to interpret the PE concept included under tax treaties. The Committee of Fiscal Affairs indicated that the OECD commentaries have been used in a number of published court decisions where it has been widely quoted, studied and played key role in the court proceedings (OECD 2012: par 29.1, 29.3). Enterprises use commentaries under article 5 provisions to guide and direct their business transactions and investment (OECD 2012: par 29.2). The OECD commentaries are also viewed as an important interpretative reference as they go beyond a simple explanation of the terms: they provide background to the article's provisions and explain why they were considered essential (Linderfalk and Hilling 2015: 34). It clear that the OECD model and commentaries carry a significant weight to its member countries and non-OECD countries who choose to follow the wording of OECD in their bilateral tax treaties (Lang and Brugger 2008: 100).

Although OECD commentaries are a significant source of interpretation of articles of the bilateral tax treaty, it expresses an individual opinion and so is not binding to contracting states which follow the OECD model (Vogel 1986: 41). According to Linderfalk and Hilling, state that international law experts find it difficult to understand how the OECD commentaries can provide any insight to interpreters regarding the common intention of parties in a bilateral tax treaty if those commentaries did not existed during the time treaty was signed (Linderfalk and Hilling 2015: 34). However, a bilateral tax treaty is an international agreement which administers contracting states and so it a binding agreement which needs to be interpreted in accordance with the Vienna Convention Law of Treaties (VCLT) laid down in article 31-33 of 1969 (Linderfalk and Hilling 2015: 34). The key question asked regarding non-binding OECD commentaries with regard to interpretation of a tax treaty is 'how can the use of the OECD commentaries be justified based on article 31-33 of VCLT?' (Linderfalk and Hilling 2015: 43).

In article 31 of VCLT, a general rule of interpretation states that:

> 1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
>
> 2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
>
> (a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
>
> (b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
>
> 3. There shall be taken into account, together with the context:
>
> (a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
>
> (b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
>
> (c) Any relevant rules of international law applicable in the relations between the parties.
>
> 4. A special meaning shall be given to a term if it is established that the parties so intended. (VCLT 1969: 340)

According to Linderfalk and Hilling, the use of the OECD commentaries when interpreting a bilateral tax treaty are justified as follows: (i) they may assist in determining the "ordinary meaning", "object and purpose" of the term such as the PE concept in the bilateral tax treaty in a sense of article 31(1) VCLT; (ii) may fall within the scope of article 31(3)(b) VCLT which requires that any subsequent practice in application be taken into account when interpreting the bilateral tax treaty, and (iii) may form part of "circumstances of it conclusion" in a sense of article 32 VCLT (Linderfalk and Hilling 2015: 43).

In order to interpret the PE concept found in tax treaties (article 5 of OECD model), the OECD Committee stated that existing agreements should be interpreted in the spirit of the revised commentaries even though those provisions of agreement did not include the exact wording when they were concluded in the previous versions (OECD 2012: par 33). Changes or additions to the OECD commentaries are generally applicable to the interpretation of agreements signed before their adoption as they represent a general agreement to the proper interpretation of the existing provisions (OECD 2012: par 33).

According to Linderfalk and Hilling, under an ambulatory approach, the ‘interpreter accepts the relevance of any subsequently adopted commentaries’, while under the static approach, an interpreter will ‘limit the use of the OECD commentaries to those that existed at the time bilateral tax treaty was concluded’ (Linderfalk and Hilling 2015: 34). Paragraphs 42.2 to 42.10 of the OECD commentaries provide clarity or guidance about when a PE may be created in a source country when an enterprise applies e-commerce to operate its business. To be specific, according to OECD commentaries to article 5 paragraph 42.2, a website cannot result into a creation of a PE as far the software and electronic data are concerned, since there is no “place of business” as there is no location for the website (OECD 2003: 102). Paragraph 42.3 state that, even if the enterprise carries out business through a website on the server it owns or leases, a website cannot result in the PE but PE may be created through a location of a server at the disposal of the enterprise (OECD 2003: 103). According to the OECD commentaries to article 5 paragraph 42.4, a server may constitute a PE if it is accessed through a computer equipment which has a physical “fixed place of business” (OECD 2003: 103).

The OECD Committee indicated that tax authorities regularly obtain guidance from the OECD commentaries in order to interpret their double tax agreements and they give the OECD commentaries a greater weight (OECD 2012: par 29.1). According to Lang and Brugger:

> If tax authorities of both contracting states consistently apply an interpretation introduced through commentary amendment, as suggested by the OECD Commentary, such a Commentary amendment may become relevant through “subsequent practice” in the application of the treaty which establishes the agreement of the parties regarding its interpretation” under Article 31 (3) (b) VCLT. (Lang and Brugger 2008: 103)

This view was also supported by Linderfalk and Hilling who stated that evidence demonstrated through practice may create an agreement under article 31(3)(b) of the VCLT even though it does not require any legal obligation to understand a bilateral tax treaty in any particular way (Linderfalk and Hilling 2015: 46). It follows that ‘subsequent practice forms part of general rule of interpretation’ (Lang and Brugger 2008: 103). Therefore, the OECD commentaries to article 5 paragraph 42.2 to 42.10 are relevant as “subsequent practice” in the application of a PE concept found in a bilateral tax treaty which creates an agreement of the parties regarding its interpretation under article 31(3)(b) of VCLT of 1969. Courts are progressively using the OECD commentaries to reach their decisions (Steenkamp 2017: 86). Cockfield stated that, ‘ the OECD model tax treaty or its commentaries are recognised by courts as a secondary source of authority which assists with tax treaty interpretation’ (Cockfield 2006: 142). According to Kobetsky, the OECD commentaries are also used by US courts, Canadian courts and Australian courts in the interpretation of bilateral tax treaties, although there are uncertainties about which approach to apply, static or ambulatory (Kobetsky 2011: 176).

According to Brauner, ‘the changes to the OECD model and commentaries do not dynamically amend the obligations of states in their tax treaties to adapt to changes in circumstances’ (Brauner 2020: 34). Although the OECD specifically states that existing tax treaties should be interpreted in light of the revised commentaries, Ault in his study states that if changes to commentaries are provided for the purpose of clarification or elaboration without amending the treaty provision language, the ambulatory approach will be appropriate in interpreting the existing tax treaty. However, if changes to commentaries result in amendment to tax treaty provision without actually changing the existing treaty provision language, then static approach will be appropriate in such circumstances. Ault further states that if the aim is to change the operative result of tax treaty provision, it will be more appropriate to change both tax treaty provision language and its commentary so that an ambulatory approach can be followed in interpreting the previously concluded tax treaties. (Ault 1994: 148)

According to the League of Nations (LN) of 1928, agencies were included as part of a positive list that created a PE, except a bona-fide agency of independent status (LN 1928: 4162). The OECD Committee of Fiscal Affairs then drafted 1963 Double Tax Convention which did not include agencies as part of a positive list under article 5(2) and then agency (excluding agency of independent status) was included as a separate provision under article 5(4) (OECD 1963: 43, 44). According to Skaar although it was not obviously stated, it was clear that agency does not need to have a place of business in the source country in order to constitute an agency PE under the OECD draft Tax Convention of 1963 (Skaar 1991: 97) .

The OECD model of 1963 has successfully clarified that a “personal connection test” for an agency is an alternative to the location test for the “place of business”(Skaar 1991: 97). The OECD commentaries to article 5(5) paragraph 30 were redrafted in 1977 in order to clarify the intention of the corresponding provisions in the 1963 draft. From the OECD model Double Tax Convention of 1977 commentaries to article 5(5) paragraph 30, it clear now that even if the enterprise does not have a fixed place of business under article 5(1) or 5(2), it may create a PE under article 5(5). (OECD 1977: par 30) Lastly, action plan 7 of the BEPS project, resulted in modification of article 5(5) which deals with a dependent agent, article 5(6) which deals with an independent agent and commentaries on these articles (OECD 2017: C(5)-49, C(5)-52). Therefore, interpretation of these tax treaty provisions in future will be aligned with the OECD which recommends an ambulatory approach. This will also be in harmony with Ault’s suggestion that; in order to change the operative result of tax treaty provision, both tax treaty provision and its commentary should be changed so that an ambulatory approach can be followed (Ault 1994: 148).

6.4 Conclusion

The OECD’s most important modification efforts are recognised in the OECD model Tax Treaty provisions and its commentaries which are used to assist with interpretation of tax treaty provisions (Cockfield 2006: 142). As a result, the OECD either revise the tax treaty provisions of article 5 or add/modify the OECD commentaries of article 5 to keep up with latest developments like e-commerce. When e-commerce emerged, the OECD only added paragraph 42.2 to 42.10 as commentaries to article 5, without amending article 5(1) which is a general definition of the PE concept. These commentaries to article 5 were added to clarify or elaborate how a PE may be created when dealing with e-commerce enterprises. What is challenging with this clarification or elaboration, is that the general definition of the PE concept remained unchanged and it clear from the definition that e-commerce was never anticipated when the general definition was developed. E-commerce does not require a “fixed place of business” to be located in the source country as it is required by the general definition of the PE concept.

The OECD should have amended both; article 5(1) which is a general definition for the PE concept and its commentaries, to ensure the PE concept keep up with e-commerce development so that an ambulatory approach can be applied effectively. Although the OECD recommend that the general definition of the PE concept under article 5(1) should be interpreted in the spirit the revised commentaries (paragraphs 42.2 to 42.10 of article 5), this does not seem to be useful when dealing with e-commerce. All court cases relating to e-commerce which were examined in chapter 5 of this research report, did not result in a creation of a PE, even though an ambulatory approach was followed by the courts . Even if the static approach were followed, it would have not resulted in a creation of a PE in a source country because of the leading requirement of the general definition of a PE ("fixed place of business") as it would have not been met by e-commerce enterprises whose servers are located outside source country and have no dependent agents in the source country. Regardless of the approach followed, static or ambulatory, the outcome is the same. This means, adding paragraphs 42.2 to 42.10 to the commentaries of article 5 did not achieve the original objection of keeping up with e-commerce development and no flexibility of the PE concept has been demonstrated by adding these commentaries to article 5.

Chapter 7: Conclusion

The PE concept has served the international community very well since its inception in 1899: it has been able to grant taxing rights to source countries where significant economic activities are performed by non-resident enterprises physically located in a source country. The PE concept has been diluted a number of times, either through national case law (Skaar 1991: 572) or as result of changes to technological and business development anticipated when the OECD developed the draft model tax convention of 1963 by modifying article 5 provisions or commentaries (Kobetsky 2011: 157). Two achievement of the 1963 OECD draft model Tax Convention noted by Skaar in his book are: (i) the OECD being able to produce a generally accepted PE definition under article 5(1) and (ii) removed agencies under article 5(2) positive list and clarified "personnel connection test" for an agency as an alternative test to location test for the "place of business" (Skaar 1991: 97).

Modification through case law have been demonstrated in this research report, prior to BEPS action 7, agent PE under article 5(5) of the OECD required a dependent agent to act on behalf of and habitually exercise authority to conclude contracts in the name of a non-resident enterprise. The Google France case discussed in chapter 5 of this research report, based on MSA, made it clear that Google France does not have the power to bind or sign contracts on behalf Google Ireland (Falcao 2019: 535). Although French tax authorities indicated that signing by Google Ireland was just an automatic validation of contracts, which have been concluded by Google France. When the court concluded it was clear that there was no agent PE under article 5(5) solely because courts used a legal approach (not considering economic approach) about who has power to sign contracts and who actually signed the contracts. Cases like Google France have resulted in the OECD amending the wording of article 5(5) through BEPS action 7 so it now requires a dependent agent to act on behalf or habitually play principal role to finalise contracts without material modification (OECD 2017: M-20).

When e-commerce emerged in 1991 the OECD attempted to address tax challenges brought by e-commerce by adding commentaries to article 5 in January 2003 (paragraph 42.2 to 42.10) to clarify that a website cannot result in a PE and a server may create a PE provided all requirements are met (OECD 2003: 102, 105). A number of authors have raised concerns regarding these commentaries to article 5 to address e-commerce: Oguttu stated that commentaries were guided by traditional principles to decide whether a website or a server may create a PE (Oguttu 2009: 217). Cockfield stated that 'transposing real world international tax principles to the virtual world by replicating server as a PE will often fail' (Cockfield 2001: 1192, 1193). Chapter 5 of this research report has confirmed Cockfield's view as no PE was found in all those court cases involving non-resident enterprises which conduct business through e-commerce.

Although the PE concept has been modified to accommodate e-commerce, it does not seem to provide any solution. For the PE concept to be considered flexible towards commerce, it should go beyond modification: the concept should be able to respond in order to keep up with technological changes. The OECD has been looking into a number of proposals, without success, to ensure that the PE concept keeps up with technological changes, proposing alternate new nexus such as virtual PE and significant economic presence. Even back-up mechanism such as withholding digital tax and equalisation levy were not recommended by the OECD. Interestingly, under secretariat proposals "unified approach" pillar 1, countries require a new nexus rule, which would be a standalone PE concept (OECD 2019c: 22), which does not rely on physical presence in market jurisdiction (OECD 2019c: para 10).

Current PE concepts in relation to e-commerce have reached their limits as they are unable to address challenges presented by e-commerce and cannot keep up with technological development. Challenges faced by the PE concept are forcing states to apply unilateral measures as back-up mechanisms in an attempt to protect their revenue base. Skaar stated that the future will prove that the PE concept has lost it force even if bilateral tax treaties are renegotiated and it seems as if the future has arrived (Skaar 1991: 573). Skaar further suggested that the "fixed place of business" as a PE leading requirement should be removed (Skaar 1991: 573). Even the BEPS monitoring group have indicated that they have not been able to resolve the issue of ensuring that business profits are taxed where value is created (BMG 2017: 1). The PE concept in relation to e-commerce is not flexible because the PE leading condition still requires a “fixed place of business” while e-commerce enterprises have demonstrated they can participate in a source country without physical presence. A separate PE concept is required for e-commerce as suggested in the secretariat proposal “unified approach” under pillar 1 and this should not be viewed as ring fencing e-commerce. Tax challenges presented by different business models should be addressed, based on their own unique features.

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