

CLARIFICATION ON THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN E-COMMERCE:

CHANGES TO THE COMMENTARY ON ARTICLE 5

Introduction

1. This document contains the changes to the Commentary on the OECD Model Tax Convention adopted by the Committee on Fiscal Affairs on 22 December 2000 concerning the issue of the application of the current definition of permanent establishment in the context of e-commerce. It follows two previous drafts which were released for comments by Working Party No. 1¹ in October 1999 and March 2000.

2. The Committee wishes to thank the individuals, organizations and non-member countries that have sent comments on the previous drafts. These comments have helped the Working Party to draft the changes to the Commentary on Article 5 which are included in this document. The comments that were received from non-member countries lead the Committee to believe that these changes reflect interpretations that have wide support both among OECD and non-OECD countries.

3. The conclusions reflected in this document have been reached after a thorough analysis of the various conditions underlying the current treaty definition of permanent establishment having regard to work done over the last few years by the Working Group on Permanent Establishments. When drafting the changes included in this document, the Working Party has taken care to ensure that its interpretation of these conditions in the context of e-commerce remained fully consistent with the views of its Member countries on the application of these conditions to more traditional business operations.

4. The Committee wishes to stress that the changes included in this document deal exclusively with the permanent establishment definition as it currently appears in Article 5 of the OECD Model Tax Convention. The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits in the Context of Electronic Commerce has been given the general mandate “to examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules.” The Committee looks forward to receiving the views of the TAG on the more important issue of whether any changes should be made to that definition or whether the permanent establishment concept should be abandoned. The work of that group will assist the Committee in deciding whether changes need to be made to the Model Tax Convention to address this broader issue.

5. The Committee also looks forward to receiving the views of that TAG and the conclusions of the Working Party No. 6 on the Taxation of Multinational Enterprises on the issue of how much income should be attributed to electronic commerce operations carried on through computer equipment in circumstances where there would be a permanent establishment.

6. As this document shows, the Committee has been able to reach a consensus on the various issues concerning the application of the current definition of permanent establishment in the context of e-commerce (subject to the two dissenting views described at the end of this paragraph and of paragraph 14 below). This consensus includes the important views that a web site cannot, in itself, constitute a

1. Working Party No. 1 on Tax Conventions and Related Questions is a subsidiary body of the OECD Committee on Fiscal Affairs and is responsible for drafting changes to the OECD Model Tax Convention.

permanent establishment, that a web site hosting arrangement typically does not result in a permanent establishment for the enterprise that carries on business through that web site and that an ISP will not, except in very unusual circumstances, constitute a dependent agent of another enterprise so as to constitute a permanent establishment of that enterprise. However, Spain and Portugal do not consider that physical presence is a requirement for a permanent establishment to exist in the context of e-commerce, and therefore, they also consider that, in some circumstances, an enterprise carrying on business in a State through a web site could be treated as having a permanent establishment in that State. That is the reason why Spain and Portugal look forward to the results of the work of the TAG on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits in the Context of Electronic Commerce (see paragraph 4) as regards the issue of whether changes to the definition of permanent establishment should be made to deal with e-commerce.

7. As a number of commentators and delegates have noted, it is unlikely that much tax revenues depend on the issue of whether or not computer equipment at a given location constitutes a permanent establishment. In many cases, the ability to relocate computer equipment should reduce the risks that taxpayers in e-commerce operations be found to have permanent establishments where they did not intend to. Also, in circumstances where a taxpayer would want to have income attributed to a country where its computer equipment is located, that result can be achieved through the use of a subsidiary even if no permanent establishment is considered to exist. It is crucial, however, that taxpayers and tax authorities know where the borderlines are and that taxpayers not be put in a position to have a permanent establishment in a country without knowing that they have a business presence in that country (a result that is avoided by the conclusion that a web site cannot, in itself, constitute a permanent establishment).

8. Since a large part of the draft released in March 2000 discussed a minority view that some human intervention was required for a permanent establishment to exist and since many commentators have argued that this was the case, the Committee wishes to explain the position reached on that issue and reflected in the changes that have been adopted.

9. Having further examination of the issue, the conclusion has been reached that human intervention is not a requirement for the existence of a permanent establishment.

10. There is no specific reference to human intervention in paragraph 1 of Article 5 but it has been argued that the Commentary on Article 5, in particular paragraphs 2 and 10 thereof, imply that there is a requirement of human intervention for a permanent establishment to exist. The Committee concluded, however, that the Commentary does not support this view.

11. The relevant part of paragraph 2 reads as follows:

"The definition, therefore, contains the following conditions:

[...]

the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated."

12. Although electronic commerce is developing rapidly, this statement is still accurate, i.e. usually, enterprises that have fixed places of business carry on their business through personnel. This, however, does not, and was not intended to, rule out that a business may be at least partly carried on without personnel.

13. The same applies as regards to paragraph 10. According to the Committee, the example provided in that paragraph clearly supports the conclusion that no human intervention is required for a permanent

establishment to exist. Also, the first sentence ("The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel)") is still an accurate statement of how business operates but, again, does not rule out that a business may be at least partly carried on without personnel. Finally, the Committee believes that a requirement of human intervention could mean that, outside the e-commerce environment, important and essential business functions could be performed through fixed automated equipment located permanently at a given location without a permanent establishment being found to exist, a result that would be contrary to the object and purpose of Article 5.

14. The changes to the Commentary on Article 5 which appear below make it clear that, in many cases, the issue of whether computer equipment at a given location constitutes a permanent establishment will depend on whether the functions performed through that equipment exceed the preparatory or auxiliary threshold, something that can only be decided on a case-by-case analysis. Some countries did not like that outcome and the uncertainty that may result from it. They suggested that, in the case of e-tailers, it would have been better to simply conclude that a server cannot, by itself, constitute a permanent establishment. In order to reach a consensus, however, most of these countries have accepted the view expressed above, noting that they will take into account the need to provide a clear and certain rule in their own appreciation of what are preparatory or auxiliary activities for an e-tailer. The United Kingdom, however, has taken the view that in no circumstances do servers, of themselves or together with web sites, constitute permanent establishments of e-tailers and intends to make an observation to that effect when the changes to the Commentary on Article 5 are included in the Model Tax Convention.

15. In order to illustrate that it is possible for functions performed through computer equipment to go beyond what is preparatory or auxiliary, an example has been included in the last sentence of paragraph 42.9. It was noted during the discussion that this example is merely illustrative and should not be considered to determine the point at which the preparatory or auxiliary threshold is exceeded since many countries consider that this could be the case even if only some of the functions described in that example are performed through the equipment.

CHANGES TO THE COMMENTARY ON ARTICLE 5

Add the following heading and paragraphs 42.1 to 42.10 immediately after paragraph 42 of the Commentary on Article 5

'Electronic commerce

42.1 There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

42.2 Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated (see below), a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" (see paragraph 2 above) as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.

42.3 The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise (see paragraph 4 above), even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.

42.4 Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

42.5. Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on

through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

42.6 Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources.

42.7 Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include:

- providing a communications link – much like a telephone line – between suppliers and customers;
- advertising of goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.

42.8 Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 42.2 to 42.6 above), there would be a permanent establishment.

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an "e-tailer") that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet (for example, the location is used to operate a server that hosts a web site which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), paragraph 4 will apply and the location will not constitute a permanent establishment. If, however, the typical functions related to a sale are

performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary.

42.10 A last issue is whether paragraph 5 may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 may apply to deem such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISP. While this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the web sites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises. It is also clear that since the web site through which an enterprise carries on its business is not itself a "person" as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph."