THE "FIXED PLACE OF BUSINESS" IN THE CONTEXT OF ELECTRONIC COMMERCE

Cristián Gárate

Introduction

The aim of this document is to analyze in a synthetically way the present discussions available in the field of international income tax law for the treatment of Electronic Commerce in cross border electronic transactions. First, the analysis starts with a brief examination of the traditional conditions set down in the OECD Model and its Commentary for the existence of a permanent establishment, with special attention to the "fixed place of business". Second, this paper examines the new conditions set forth in paragraphs 42.1 to 42.10 of Article 5 of the OECD Commentary for the treatment of Electronic Commerce. Third, this document addresses some problems that arise in relation to the new paragraphs in application to practical cases of electronic commerce and tries to envisage possible solutions under the present stage of development of international tax law.

I. Permanent Establishment

1. Permanent Establishment Concept

Traditional concepts related to permanent establishment were drafted during the Old Economic Era. Theoretically, the concepts designed an abstract notion of permanent establishment in order to determine the taxability of economical activities carried in the territory of another sovereign state[1]. The core of the theory was to define the subjective and objective elements that made taxation applicable to material or physical transactions[2]. Within the traditional economic context of this theory a material or physical transaction took place if a natural or juridical person developed tangible economical activities in a certain territory for a minimum period of time[3]. Consequently, if traditional economic activities met the conditions set forth in the notion of permanent establishment tax revenues could be allocated to the respective sovereign state were these activities were carried on.

In an international context, all states describe the scope of income over which they exert taxing jurisdiction through different tax allocating rules[4]. In accordance to conventional ways in which economic activities are developed, the principal rules in which most tax regimes base their tax allocation have a territorial base. These rules are grounded on the

[1] R.S.J. Martha, *The Jurisdiction to Tax in International Law*, Kluwer (1989), p 22. Also, Luc Hinnekens, *De territorialiteit van de inkomstenbelasting op nieuwe wegen en grondslagen*, Kluwer (1993), pp 28 et seq.
[2] Eric. C.C.M. Kemmeren, *Principle of Origin in Tax Conventions a Rethinking of Models*, Pijneburg (2001), pp34 et seq.
[3] Geoffrey Jones, *The Evolution of International Business: An Introduction*, Routledge (1996), p 25.

"place of residence" of a physical person and on the "place of source" of economical activities[5]. According to Article 4 of the OECD Model a resident of a State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. Thus, the original notion of residence is territorially linked. In case an individual is considered to be a resident in two tax jurisdictions, according to paragraph 2 of Article 4 of the OECD Model, specific Tie Breaker Rules are provided to determine the strongest territorial connection to a state[6]. Furthermore, if a legal person is considered to be resident of two tax jurisdictions, under paragraph 3 of Article 4 of the OECD Model, it is deemed to be resident only in the state in which the place of effective management of the company is situated. Hence, profits of an enterprise are taxable only in the territory of a state were the company is physically present through its headquarters. However, if the profits or part of them could be attributed to a permanent establishment situated in the territory of another country, then this other state is allowed to tax the profits attributable to that permanent establishment. Therefore, the concept of permanent establishment is the key that allows a contracting state, bound by a Double Taxation Treaty based on the OECD Model, to extend its tax jurisdiction to the profits of an enterprise of other contracting state, which carries on its business through a permanent establishment situated in its territory[7]. Moreover, in case of conflict between two distinct states who claim taxing rights over a specific economical activity the OECD Model provides in Articles 23 A and B a credit method or an exemption method for taxes paid in the other state[8]. Consequently, Double Taxation Treaties drafted under the OECD Model do not impose income taxes on foreign businesses, unless these economic activities surpass the international agreed *de minimis* threshold, which is to maintain a material or physical presence within its territory in the form of a permanent establishment.

2. Permanent Establishment in the Traditional Economy

According to the basic rules of the OECD Model, contained in paragraphs 1, 2 and 4 of Article 5 for a permanent establishment to exist certain objective and subjective elements must be met. The concept is defined in paragraph 1 of Article 5 as "a fixed place of business

[4] Gary D. Sprague and Michael P. Boyle, General Report, *Taxation of Income derived from Electronic Commerce*, Cahiers de Droit Fiscal International, Volume LXXXVIa, 200, pp 29 et seq; Piergiorgio Valente e Franco Roccatagliata, *Aspetti Guiridici e Fiscali del Commercio Elettronico*, Il Fisco (1999), pp. 87 et seq.
[5] Manuel Pires, *International Juridical Double Taxation of Income,* Kluwer (1989), pp. 109 et seq.
[6] Robert Couzin, *Corporate Residence and International Taxation*, IBFD (2002), p. 6 et seq.
[7] Article 7 (1), OECD Model.
[8] Article 23 A and 23 B, OECD Model.

through which the business of an enterprise is wholly or partly carried on"[9]. A permanent establishment is deemed to exist in certain cases included in the positive list contained in letters a) to e) of paragraph 2 of this same Article. Further, the concept of permanent establishment includes the case of businesses carried through dependent agents who act on behalf of an enterprise, with powers to conclude contracts, as provided in paragraph 5 of Article 5 of the OECD Model.

In synthesis, paragraph 1 of Article 5 of the OECD Model lists a number of conditions that must be satisfied in order to qualify as a permanent establishment:

a) there must be a fixed place of business (*situs test*);
b) the fixed place of business must be located at certain territorial area (*locus test*);
c) the use of the fixed place of business must last for a certain period of time (*tempus test*);
d) the taxpayer must have a certain right of use the fixed place of business (*ius test*); and
e) the activities performed through the fixed place of business must be of a business character, as defined in the treaty law and in the domestic tax laws (*business activity test*)

In the traditional economy the basic conditions of a permanent establishment are related to the question of existence of a "fixed place of business"[10]. The qualification of the place of business and the fixed element comprise three fundamental aspects: *situs, locus et tempus*. According to doctrine and commentators, in order to determine the existence of a fixed place of business it is necessary to comply with the "place of business test", the "location test" and the "permanence test". Although the other elements described under the "right of use test" and the "business activity test" are relevant, their analysis present a lower level of complexity as the former ones at an international tax level[11]. As for the fulfillment of the requisites contained in paragraph 3, of Article 5, namely the "negative list test" and paragraph 5 of Article 5, namely the "agency test", this article will not focus on the discussion of their underlying principles and problems.

Due to the fact that the term "fixed place of business" is not defined in the OECD Model, from its inception it has been modeled according to legal doctrine, case law and the revised OECD Commentary. These legal sources have allowed the terminology to gain flexibility in order to adapt to business changes occurred during the traditional economy; but as conventional business evolved to automated economic transactions and later to electronic commerce transactions the new facts have produced hermeneutic confusion.

[9] Article 5 (1), OECD Model.
[10] Arvid A. Skaar, *Erosion of a Tax Treaty Principle*, Kluwer (1991), pp 75 et seq.
[11] Alessandro Caridi, *Proposed Changes to the OECD Commentary on Article 5: Part I –The Physical PE Notion*, IBFD (2003),ET p. 9.

With regards to the *situs test*, the existence of a place of business is determined by the existence of a material place where activities are carried out, such as premises, facilities or as further development in certain instances, to machinery or even substantial equipment. With regards to the *locus test*, the original sense given is that there must be a link between the place where the business is developed and a specific geographical point in the territory of a state. Therefore, the facilities, premises, machinery or substantial equipment constituting the place of business have to be actually fixed, in the sense that they remain on a specific location within a geographical site. With regards to the *tempus test* it flows that, since the place of business must be fixed, the permanent establishment can only exist if the place of business has a certain degree of permanency in time and is not merely temporarily (*de minimis tempus*). The period of time depends on the nature of the activity or the circumstances in which the economic activity is developed. Finally, in the original concept, normally the business of an enterprise is carried out by individuals, such as the owner personally or through its employees or dependent personnel. In other cases, the business could be carried through agents acting on behalf of the enterprise with powers to negotiate and close contracts[12].

Due to the development of traditional economic activities from manual relations to automated relations the "fixed place of business" and the tests that describe its content suffered an enlargement from its basic features. This was achieved with a relativization of the fundamental concepts by way of legal dynamic interpretation. Thus, in relation to the *situs test* in doctrine and case law it was further agreed that any substantial physical equipment, movable or fixed, which was suitable for a commercial activity could qualify as a place of business. Also, the *locus test* acquired a wider sense in order to embrace the possibility of ambulatory economical activities within a certain geographical area, which led to a larger spatial delimitation approach[13]. Moreover, the *tempus test* also relaxed to comprehend the possibility of very short term economical activities with a principle of time relativity being applied in practice by tax administrations and courts on a case by case basis[14]. As a consequence of automatization, one of the most crucial enlargement criterion was that a permanent establishment may exist if the business of the enterprise is carried through

[12] OECD Commentary, Article 5. See also: Vogel, *On Double Tax Conventions*[3] (1996) Article 5; Arvid Aage Skaar, *Commentary on Article 5 of the OECD Model Treaty*: *The concept of Permanent Establishment*, IBDF (1994); Francisco Alfredo Garcia Prats, *El Establecimiento Permanente*, Tecnos (1996), p 124 et seq.
[13] OECD Commentary, Article 5, paragraph 3 N° 18.
[14] Barry Larking, *The Importance of Being Permanent*, IBFD, (1998) p. 185; OECD Commentary, Article 5, paragraph 1 N° 6.

automatic equipment, the activities of the personnel being restricted only to setting up, operating, controlling and maintaining such equipment[15].

These further applications showed conformity from the point of view of the primary concepts, since a permanent establishment maintained the character of being relatively fixed, physical or tangible in nature, comprising permanent businesses and developed with intervention of natural persons. From an economical point of view, the development pattern showed that the business activities tended to be performed with relatively fixed or substantial movable equipment; within a relatively stationary or ambulatory spatial delimitation; within permanent operations or relatively durable operations or with a minimum of temporality; and utilizing semi manual or automated equipment, which was totally or partially human activated or controlled.

3. Permanent Establishment in the Automated Economy

The aforementioned changes to the notion of permanent establishment respond to legal doctrinal discussions and landmark case law, which forced to rethink the original criteria in spite of the development of traditional economy with the introduction of new technologies of telecommunication from manual to automated businesses. Thus, physical and material objects, which are necessary to conform a permanent establishment in a certain site or position within a territory, changed with the appearance of smaller, portable equipment, which also proved commercial suitable to serve as the basis of a business activity[16]. These developments made conclude that one economical activity not necessarily needs to be fixed to a certain geographical and economical point, but may be totally peripatetic, through distinct taxing jurisdictions. As an example of the adaptation process, the concept resulted in the "coherent whole economically and geographically" actually in use by the OECD Commentary[17].

Also, automated economical activities developed in a way that they could be performed independent of human intervention. However, in this latter case it had been argued that the definition comprised in Article 5 of the OECD Model still could be supported, since its wording does not require the presence of individuals to carry out a business[18]. Therefore, automatic gaming and vending machines, fully automated pumping stations, drilling platforms, portable equipment for obtaining data, fishing equipment and other similar objects

[15] OECD Commentary, Article 5, paragraph 1, N° 10.
[16] Arvid Aage Skaar, Commentary on Article 5 of the OECD Model Treaty: *The concept of Permanent Establishment*, IBDF, (1994).
[17] OECD Commentary, Article 5, paragraph, 3 N° 18.
[18] Eric Tomsett, *Tax Planning in International E-Commerce*, Volume 3, N° 2, (2001) p. 30.

were likely to be considered permanent establishments[19]. Moreover, as from the decision of the Bundesfinanzhof in the German Pipeline Case, it was accepted that in case of distribution of physical goods by means of a transboundary pipeline a fixed place of business could be generated[20]. Nevertheless, until this stage the main conditions were that, in the automated economy, the place of business still must be grounded on tangible objects, attached to a certain geographical point during some minimal period of time.

4. Permanent Establishment in the Electronic Commerce

The next stage of economic development goes from automated economical activities to the use of electronic commerce. This phase is characterized by the use of computer networks to facilitate transactions involving the production, distribution, sale and delivery of goods and services in the marketplace[21]. The operations of electronic commerce refer to consume and business trade conducted over a network that uses computers and telecommunications. Of those networks the Internet is the most relevant with respect to coverage of business traders and consumers. Electronic commerce covers principally transactions business to business (B2B), as well as business to consumers (B2C). It involves multinational enterprises as well as small enterprises. Transmission Control Protocols (TCP) and Internet Protocols (IP) allow Internet users to interact with any person also linked to the net. Each participant of the network is allowed to have a web site or e-mail address, but such address cannot be referred to a certain geographical location[22]. Thus, the concept of physical presence of the permanent establishment looses its relevance, since business transactions start to operate within the bits and bytes of the network[23]. As a corollary, the direct link between the taxing jurisdiction and the economical activity is no longer available, since transactions occur in Cyberspace: this has been called the disappearing of the taxpayer in Cyberspace[24].

The use of this new commercial platform changes the nature of businesses (now called "e-business") and the economical activities embraced in the term "New Economy". In essence, Internet creates an almost instantaneous interactivity that is virtual (non physical), global (borderless), anonymous (difficult to track), non intermediated (impersonal), closely

[19] Arvid A. Skaar, *Erosion of a Tax Treaty Principle*, Kluwer (1991), p 120.
[20] German Tax Supreme Court, BFH 30.10.1996, III R 12/92, BStBl II 1997, 12.
[21] Richard Doernberg and Luc Hineekens, *Electronic Commerce and Internatinonal Taxation*, Kluwer (1999 p. 45; Tanja Utescher, *Internet und Steuern*, *Electronic Commerce und Telearbeit*, IDW Verlag GMBH, 1999 pp 49 et seq.
[22] Björn Westberg, *Cross-Border Taxation of E-Commerce*, IBFD (2002), pp 4 et seq.
[23] Gary D. Sprague and Michael P. Boyle, General Report, *Taxation of Income derived from Electronic Commerce*, Cahiers de Droit Fiscal International, Volume LXXXVIa (2001), pp 23 et seq.
[24] Prof. Luc Hinnekens, *Income Taxation of Electronic Commerce and other Cross Border Business Coordinated by the OECD,* European Taxation, IBFD (2001), pp 299 et seq.

integrated and specialized across borders; it is an alternative to business conducted through traditional channels.

Confronted to this stage of development electronic commerce poses major problems of applications to be resolved with the traditional rules governing existing international tax treaty law. Hence, appears the urgent necessity to revise the traditional legal thresholds and tests comprised in the original definition of permanent establishment. Consequently, the *situs test* needs to be revised to include the new technological *situs* in the forms of a server and web sites. The *locus test* needs to be reconsidered to comprise new locations named Networks in the form of Intranets, Extranets and the Internet. The *tempus test* needs to be analyzed to support economic operations that are performed instantaneously between several parties. Likewise, human intervention comprised in the original concept of permanent establishment needs to be revised in the light of fully electronic equipment that performs instructions with a code or program denominated Software[25]. Further, the possibility of accessing such information through the Network needs the intervention of an Internet Service Provider (ISP), which is not in analogy to any concept of the original definition of permanent establishment. Finally, these new digital processes may operate with an appropriate Software, which may be adapted to specific commercial functions of the whole business, in order to achieve a split and minimization of core activities and extension of auxiliary or preparatory functions if necessary between different taxing jurisdictions. The concepts are elementary, but the application is difficult, since in the original definition of permanent establishment the taxing rights of each sovereign state depended on a certain level of tangible presence, which in the new economy is not found[26]. Thus, the traditional permanent establishment concepts need to be adapted to the technological means of the new economy or else must be abandoned[27].

At this point, it is noticeable how case law, doctrine and tax administrations reacted. The German Tax Court Decision on Pipeline Case broadened the definition of permanent establishment. But in doing so, the Court had to revise all the precedents and jurisprudence relating to the concept of permanent establishment found in Section 12 AO, which contains the German Concept of a permanent establishment, comparable to 5 (1) of the OECD Model[28]. German fiscal authorities later had to step back and issue guidance principles

[25] Massimiliano Sammarco, Guillermo Domingo Pérez, Espana: *Puente Europeo Hacia Latinoamerica, El Comercio Electrónico en el Marco de la Fiscalidad Actual*, J.M. Bosch, pp 243 et seq.
[26] Frances M.Horner, Jeffrey Owens, *Taxes and the WEB: New Technology Old Problems*, IBFD (1996) pp 385 et seq.
[27] Jacques Sasseville, *Die Zufunft des Internationalen Steuerrechts*, Linde (1999) p. 46.
[28] Richard Doenerberg, Luc Hinnekens, Walter Hellerstein and Jinyan Li, Kluwer, *Electronic Commerce and Multijurisdictional Taxation,* Kluwer (2001), pp. 215 et seq. See Also: Marc Lampe, *Broadening the Definition of a Permanent Establishment: The Pipeline Decision*", European Taxation, IBFD (1998), p 69.

clarifying that the criteria developed in this jurisprudence did not extend to the question whether an internet server constituted a permanent establishment in the case of transboundary businesses[29]. Furthermore, tax authorities did not address the aspect of a fixed place of business; instead they argued on the basis that the activities performed by an internet server abroad would have a preparatory character and should not constitute a permanent establishment according to paragraph 4 of Article 5 of the OECD Model [30].

Contemporaneously, technical explanations to the US Model also focused on the need for a specific geographical location and a degree of permanence for the permanent establishment to exist. Nevertheless, the IRS had taken position in published rulings that a permanent establishment does not need to be fixed within the meaning of the word. Therefore, the activity does not need to be attached to one physical location. This was the criteria followed in case of a non resident who was present in the United States for a period of time of 2 years to demonstrate and sell equipment in different areas, where there was no warehouse or other type of fixed premise or building from which he worked[31].

Furthermore, in case law Piedras Negras Broadcasting Co v. Commissioner the US court determined that the productive activity, consistent in providing advertising by a radio transmitter situated in Mexico to listeners in Texas, occurred at the place where the capital and labor inputs that directly contribute to the production of the income are located and not at the location of the US payer[32]. Therefore, the court decided that advertising as an income producing service had its source at the *situs* of the performance of the service. Thus, advertisement income was considered foreign source income[33]. These considerations are relevant, since the case dealt with a situation directly comparable with the use of electronic commerce: here, information programmed on a server and connected with the Internet is transboundary and may be downloaded or revised by target consumers abroad. As consequence, according to this judicial interpretation an advertisement placed on a Web page

[29] Regional Financie Office of Karlsruhe, Decree 11 November 1998, IstR 1999, at 439; F.E. Hey, *German tax authorities rule that server does not constitute PE*, Tax Notes International, (1999), pp 636 et seq.
[30] Handbook on the 1989 Double Taxation Convention Between the Federal Republic Germany and the United States of America, *International Tax Aspects of Permanent Establishments*, IBDF (2002), GUS Supp. No. 17 August 2000.
[31] Revenue Ruling 56-165, 1956-1 C.B. 849, Article III (1) (a) of the 1951 United States- Switzerland Income Tax Treaty on International Tax Aspects of Permanent Establishments, IBDF, 2002.
[32] Richard Doenerberg, Luc Hinnekens, Walter Hellerstein and Jinyan Li, *Electronic Commerce and Multijurisdictional Taxation*, Kluwer (2001), p. 239.
[33] National Reporters, Brendan Surgrue and Gary Tober, *United States Taxation of Income Derived from Electronic Commerce*, Cahiers de Droit Fiscal International, Volume LXXXVIa, 2001, p. 727; Piedras Negras Broadcasting Co. V Comm´r, 43 B.T.A. 297 (1941), nonacq., 1941-2 C.B. 22, aff´d, 127 F. Fd 260 5 Cir. 1942.

could be situated in the Internet, with no physical presence in the country where customers are located[34].

Conversely, other jurisdictions had shown different approaches, such as in France, where the court reasoned in accordance to the "complete commercial cycle doctrine". In this country, it was understood that a non-resident broadcaster situated in Monaco with no physical presence in France was taxable[35].

As noted, contradictions appear between taxing jurisdictions and the concept of permanent establishment seems to be departing too much from its point of origin to be reconciled with the new forms of digital business[36]. This tension between established legal doctrines, case law, international tax treaty law and the new economic world leaded by the industrialized nations is crucial for understanding the changes proposed to the OECD Model in the form of commentaries added to Article 5.

5. Necessity of New Guidelines?

With the introduction of new technologies the recognition of a permanent establishment becomes arduous. The notions of place of business, location, permanency and temporality lack of consistency and have to be reconciled in order to be applicable to the new digital reality. If the concept of permanent establishment cannot be sustained in this new digital realm, then overall taxation of electronic economical activities could be the next step and this would impede technological and commercial development of industrialized nations[37]. On the other extreme, since electronic commerce has the ability to produce income with little or no physical presence, the most certain effect to fear is an unequal division of tax revenues between residence states (manufacturing and technologically - based) and source states (customer - based). The aforementioned, since patterns of electronic commerce could potentially produce that residence States of multinationals are able to sell their manufactured products with no material presence in other consuming non developed countries within the means of electronic commerce and with very low marketing and selling costs. In principle, electronic commerce allows the on-line ordering and off-line delivery of goods, which is the case where the supplier delivers to the customer through traditional channels; the same is

[34] Richard A. Westin, *International Taxation of E-Commerce*, Kluwer (2000), pp 347 et seq.
[35] Rapporteurs Nationaux, Thierry Pons et Stepáne Gelin, Cahiers de Droit Fiscal International, Volume LXXXVIa, 2001, p 387. See also, Conseild D´Etat, 13 Juilliet 1968, N° 66 503, Dupont 1968, p. 447 ; Marcellin Mbwa-Mboma, Tax Notes International, (2002), Volume 26 N° 9.
[36] Michael St. J R Butler, Victor T.Chew, Roger H. Epstein, Ian J. Gamble, Pieter L. de Ridder, Eirc N. Roose and Neil A. Russ, *International Taxation of Global E-Commerce*, IBFD, Asia- Pacific Bulletin (2000). Also, Prof. Luc Hinnekens, *Taxation of Electronic Commerce and other Cross Border Business Coordinated by the OECD", European Taxation*, IBFD, (2001), p 299. Also
[37] Barry Larking, *The Importance of Being Permanent*, IBFD (1998) p 185.

applicable to services. Further, electronic commerce permits the on-line ordering and on-line delivery of virtual goods and services, which can be downloaded over the internet in digital form. In this later case, delivery of goods and services is done digitally, no physical presence of the supplier is needed and payments are made on-line, with no possibility for tax administrations to enforce their taxing jurisdiction over this intangible transactions[38].

It seems remarkable that, as a result of court decisions and reactions, it was demonstrated that countries facing new technological realities tend to interpret their domestic tax laws and international tax treaties in a rather liberal manner. As described, jurisdictional hermeneutics was approaching to aggressively the possibility to tax Internet business activities in the country were goods and services are consumed. In this sense, the German Pipeline case is crucial for electronic commerce. It demonstrates how the German courts resolved a case applying the concept of permanent establishment expansively to technology that did not exist when the concept was originally drafted. As a result, this dynamic interpretation increased the risk that a server, a web site, an ISP or telecommunication companies that use electronic equipment or a servers could qualify as having a permanent establishment in other tax consuming jurisdictions[39]. This direction would probable lead to taxation around the world of tax telecommunications companies and internet service providers. Thus, proposals to tax e-commerce should be understood as a premature reaction to the increasing utilization of Internet based businesses, which was likely to produce a significant shift from source-state to residence-state taxation. In this scenario, developed export economies counteracted taking action against the possibility of further dynamic interpretation and stopped to promote a broad concept of permanent establishment that had been conceived and nurtured in their own taxing jurisdictions[40]. At a business level, this is exemplified in the general consensus of USA industry representatives, as expressed by a special Letter sent to the OECD by the Software Coalition, requiring specific guidance on the question of whether a server my constitute a permanent establishment. Curiously, many of the points recommended were considered in the OECD Commentary[41]. Moreover, at a governmental level this is illustrated by the cutting statements of the Director of the Inland

[38] Richard L. Donenberg, *Electronic Commerce: Changing Tax Treaty Principles Bit by Bit?*, Tax Planning In International E –Commerce, Volume 3, N° 3 (2001) p 7.
[39] Richard A. Westin, *International Taxation of E-Commerce*, Kluwer (2000), pp 353 et seq.
[40] Marc Lampe, *Broadening the Definition of a Permanent Establishment: The Pipeline Decision*. European Taxation. IBFD, 1998, p 69.
[41] Gary Sprague and Rache Hersey, Gaker McKenzie, *Software Coalition to Mr. Jeffrey Owens, OECD Head of Committee on Fiscal Affairs*, Intertax, Volume 27 (1999), pp. 40 et seq. The request was for the Commentary to clarify that: "i) the visibility of a web site in a jurisdiction never establishes a PE and ii) the location of a server in a jurisdiction, including any personnel needed to operate and maintain the equipment, generally does not constitute a permanent establishment".

Revenues International Division at a conference in Lisbon, in relation to the application of the permanent establishment article in United Kingdoms tax treaties, in the context of electronic commerce[42]. Notwithstanding, other countries that rely on source taxation had shown preoccupation for the disappearing or the erosion of their tax bases[43].

II. Permanent Establishment in the New Economy

1. Servers and Web Sites as Business Vehicles

The development of telecommunications and the Internet opened new channels to manage our economical relations. Thus, our physical present world is changing into a digital future world and the Old Economy is in whole transition into a New Economy, for which OECD countries resolved to request a clarification to the Working Party of the OECD. This evolution has posed numerous problems for the application of the concept of permanent establishment utilized in the field of international taxation, specifically in Double Taxation Treaties.

The technological means treated in the OECD Commentary to Article 5 of the Model are servers and web sites. As for the technical elements that constitute a server these machines require the presence of hardware (computer equipment) and software (codified program). Hardware and software need to work as intermediaries between users in the transfer of information or data. For this purpose, a network service provider is interposed to enable communication and exchange of information and data once multiple users get connected[44].

2. New Commentary to Article 5 of OECD Model

In October 1999 the OECD Committee on Fiscal Affairs published a first draft proposal to change Commentary on Article 5 of the OECD Model Tax Convention. On 22 December 2000 the proposed changes on the OECD Commentary to Article 5 were published adding sections 42.1 to 42.10. [45] These changes may be summarized as follows:

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[42] UK Director of Inland Revenue International Division, Inland Revenue Press, Release April 2000, IBFD Reference TNS –138 (2000). See also http://www.inlandrevenue.gov.uk/e-commerce/ecom15.htm. "As for this matter, United Kingdom takes the view that a web site of itself is not a permanent establishment and that a server is insufficient of itself to constitute a permanent establishment of a business that is conducting e-commerce through a web site on the server. This view is regardless of whether the server is owned, rented or otherwise at the disposal of the business."

[43] Bjon Westberg, *Cross-Border Taxation of E-Commerce,* IBFD (2002) p. 135.

[44] " Dr. D.A. Albregtse, *The Server as Permanent Establishment and the Revised Commentary on Article 5 of the OECD Model Tax Treaty. Are the E-Commerce Corporate income Tax Problems Solved?* Intertax, Volume 30; See also in *Er zal Geheven Worden, De server als vaste inrichting en het herziene commentaar op artikel 5 van het OECD-Modelverdrag*, Kluver (2001), p 9.

[45] See http://www.sourceoecd.org

2.1 A Server can qualify as Permanent Establishment

According to the new commentary 42.2 a server "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". As consequence, a computer server may constitute a permanent establishment if all requisites are met, namely: it must be a fixed place of business (*situs test*); located at a certain geographical point (*locus test*); used for a certain period of time (*tempus test*); the server must be owned or leased by an enterprise (*ius test*); business must be wholly or partly carried through the server (*business test*); activities must not be of an auxiliary or preparatory character.

2.2 A web site alone cannot qualify as Permanent Establishment

According to the new commentary 42.2 an internet web site, "which is a combination of software and electronic data, does not in itself constitute tangible property". Also, "it 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, as far as the software and data constituting that web site is concerned".

2.3 A web site hosting arrangement does not generate a Permanent Establishment

According to the new commentary 42.3 the web site and the server distinction permit to separate the enterprise that operates the computer server and the enterprise that carries on business through the web site leaving them on safe tax harbour. The web site through which a foreign enterprise carries on its business may be installed in the server of the ISP that operates the server by means of a hosting arrangement. However, the foreign business enterprise cannot be considered to have acquired a place of business by virtue of a hosting web site arrangement, since the server is not at its full disposal. But, if the enterprise carrying on business through a web site owns its server or has one at its own disposal, "the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met".

Spain and Portugal have expressed a number of reservations and do not consider that physical presence is a requirement for a permanent establishment as stated in Observation 45.6. On the other side, according to Observation 45.5 the United Kingdom takes the view that a server used by an e-tailer, either alone or together with web sites, could not as such constitute a permanent establishment.

Moreover, according to new commentary 42.4 in the case of a server, a fixed place of business is not accomplished if the equipment is in fact moved. Thus, "in order to constitute a

fixed place of business a server will need to be located a certain place for a sufficient period of time to become fixed within the meaning of paragraph 1."

2.4 Human Intervention is not required for the existence of a Permanent Establishment

According to new commentary 42.6, "if an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment."

2.5 Core Business Functions performed by a web-site qualify as Permanent Establishment

No permanent establishment is considered if the business functions carried on through server or web site at a given location are restricted to the preparatory or auxiliary activities covered by paragraph 4 of OECD Model. According to new commentary 42.7 this question must be "examined on a case by case basis, having regard to the various functions performed by the enterprise through the computer equipment." The commentary gives the following examples of activities considered as preparatory or auxiliary: a) Providing a communication between suppliers and customers; b) Advertising of goods or services; c) Relaying information though a mirror server for security and efficiency purposes; d) Gathering market data for the enterprise; and e) Supply of information.

The new commentary 42.8 adds that if the functions form in themselves an essential and significant part of the business activity of the enterprise or other core functions of the enterprise are carried through the computer equipment, which constituted a fixed place of business, there could be a permanent establishment.

Moreover, the new commentary 42.9 establishes that what constitutes core functions depends on the nature of the business carried on by the enterprise. Therefore, it is needed to "examine the nature of the activities performed at the location in light of the business carried on by the enterprise...in order to distinguish preparatory or core activities".

2.6 An Internet Service Provider (ISP) cannot act as dependent agent of another enterprise

Finally, the new commentary 42.10 states that an ISP cannot be considered as dependent agent, "because normally it does not have authority to conclude contracts in the name of the foreign web sited enterprises". Likewise, since a web site is not a "person" an agency cannot be established.

3. Elements of the Electronic Permanent Establishment

The practical application of the permanent establishment concept after the introduction of the revised OECD Commentary could be summarized as follows:

Table 1

	Manual Economy	**Automated Economy**	**Electronic Commerce**
Situs	Physical	Tangible	Intangible
Locus	Fixed Place	Movable Place	Hosted Place
	Geographically Sited	Spatially Sited	Virtual Web Site
Tempus	Permanent	Simultaneous	Instantaneous
Accesorius	Maximum Core Activites, minimum Auxiliary.	Core Activities balanced with Auxiliary	Minimum Core Activities Split with maximum Auxiliary

The original definition of permanent establishment provided in Article 5 of the OECD Model, contains the main legal conditions of *situs, locus* and *tempus*. At a first stage, the elements are referred to a traditional way of developing business activities denominated Manual Economy. At a second stage, further developments of economic business relationships lead to an extension of the original conditions to an Automated Economy. This stage was determined by legal adjustments of the terms originally provided, by way of dynamic interpretation, granting hermeneutic relaxation and providing adequation to automatic economic businesses environment. At a third stage, it was necessary to further adapt the original definitions to Electronic Commerce by way of adding a complete new section to the OECD Commentary. This international "ruling" introduced new distinctions and categories to the original legal concepts applying them to the virtual businesses environment.

Paragraph 42.2 distinguishes between computer equipment (e.g. server) which is tangible and software and data (e.g. web-site) which is intangible. The paragraph concludes that intangibles cannot constitute a place of business, since they do not qualify as premises, facilities or installations in the sense of Article 5 and its commentary. A web - site cannot qualify as permanent establishment, since it conforms a combination of software and electronic data. On the other hand, a server is tangible computer equipment; therefore, can have a physical location which may constitute a fixed place of business. In this case all other conditions for the existence of a permanent establishment must be accomplished.

The particularity of these reasoning is that the commentary makes a distinction between computer equipment, physically located in a jurisdiction, and the software and electronic data stored on the equipment. Thus, by way of intellectual separation of the physical part on which the software of a web site is installed and assuming that the code or

program in itself is intangible, it is concluded that if the web site works alone, since it is merely a combination of electronic data it does not constitute a permanent establishment.

The distinction between a web-site and a server relates to the different characteristics of the enterprise that operate the server (host business) and the company that carries the business through the web site (e-business) hosted in a server. In case of a hosting arrangement with an ISP, the latter provides the service of hosting a web site of another enterprise on its own server. According to paragraph 42.3, the web site does not constitute a permanent establishment for the e-business, since the web site is intangible and cannot be characterized as a place of business. But, if the e-business owns the server where the web site is located, there could be a permanent establishment. This is also applicable if the e-business disposes the server by way of a rental or leasing agreement with the independent hosting service provider.[46] Therefore, under the new commentary there seems to be no problems in relation to web sites installed on an independent ISP, since in no case they are considered permanent establishments.

Under the original concepts the place of business must be fixed in the sense of being linked to a specific geographical point and have a degree of permanency. Nevertheless, paragraph 42.4 does not define a specific time parameter for the development of the activities. For some, a period of twelve months would be necessary in this connection[47] whereas an analogous interpretation of this requisite related to building sites or construction activities, establishes that the activity should last at least six 6 months.[48] The construction clause criterion has been argued to be the underlying concept, since it the commentary establishes that a server needs to be located at a certain place for a "sufficient period of time" to be considered a fixed place of business[49].

On the other hand, paragraph 42.4 seem unsatisfactory to solve the present problem of the great mobility of business factors that allow companies to shift economic activities to low taxing jurisdictions. The original permanent establishment notion developed to categorize something that was fixed in a geographical and temporal sense. On the contrary, servers are highly mobile and flexible, they do not need to have a geographic connection and according to development of new technologies server functions may be split even to allow no

[46] Guy van der Heyden, *De vaste inrichtingproblematiek in de e-business omgeving*, Algemeen Fiscall Tijdschrift, January 2001, p. 6.
[47] Dr. Matthias Geurts, International Tax Review, Volume 28, Issue 4.
[48] Hans Pijl, *The Concept of Permanent Establishment and the Proposed Changes to the OECD Commentary with Special Reference to Dutch Case Law*, IBFD, November 2002, p. 554. For recent application see Australian Taxation Ruling 2002/5.
[49] Giampaolo Corabi, *Legal Qualification of E-Commerce Income*, Tax Planning International E-Commerce N° 7 July, 2001 p. 9.

centralized server location, while maintaining the ability to generate income[50]. Thus, the effect of adding computer servers to the permanent establishment category, in relation to an international e-commerce transaction seems complex. In essence, it appears that in portraying a solution the OECD Commentary confuses the concept of tangible or material place of business, related to the notion of *situs,* plus the other conditions of a fixed place of business, related to the notions of *locus and tempus*, which are the basic elements of the tax principle of territoriality, on one side; with the carrying on a business test, which is a notion linked to the performance of activities of an economical value, which may generate taxable income in a sovereign jurisdiction[51]. As consequence, the application of this concepts to permanent establishment and servers is likely to produce non income allocation to the country where the goods are produced (e.g. in case of information goods), nor to the source country where the consumers of e-commerce goods and services are located and also may allow companies to exploit strategies to allocate tax revenues away from their residence country where the e-business is based[52]. In consequence, there are still unsolved problems regarding the great mobility of a server.

With relation to the question of what degree of human intervention is needed paragraph 42.6 expresses that the presence of human personnel is not sufficient to regard the activities performed as a permanent establishment. The use of personnel in the country of residence of the permanent establishment is important in order to asses the character of the activities as auxiliary or core and also for the attribution of profits to the server[53]. Nevertheless, it seems correct to interpret Article 5 as meaning that there need be no human intervention at a permanent establishment, because Article 5 states it is a fixed place of business through which the business of an enterprise is wholly or partly carried on. According to this definition, businesses can be carried on through a place without human beings acting at that place. Thus, OECD Commentary does not say that human intervention is not needed at all, since in any case some human activity is needed to set up a website[54].

Also, there is no requirement that persons dependent on the enterprise are present at the place where the permanent establishment is located in order to create the conditions for

[50] Arthur J. Cockfield, *Should We Really tax Profits From Computer Servers? A Case Study in E-Commerce Taxation*, Special Report, Tax Notes International, November 2002, p. 2412.
[51] Eric C.C.M. Kemmeren, E-Commerce, Kluwer, 2000 p 366.
[52] Arthur J. Cockfield, *The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles*, IBFD, 2002, p. 606. See Infra 2.8.2.
[53] Dr. D.A. Albregtse, *The Server as Permanent Establishment and the Revised Commentary on Article 5 of the OECD Model Tax Treaty. Are the E-Commerce Corporate income Tax Problems Solved?*, Intertax, Volume 30, issue 10. See also, *Er zal Geheven Worden, De server als vaste inrichting en het herziene commentaar op artikel 5 van het OECD-Modelverdrag,* Kluver 2001, p 9.

the business activity. But, if these persons are present at a particular location and the idea is not to qualify as permanent establishment, their activity should not go beyond putting the equipment into operation[55]. Therefore, companies that need personnel in order to establish a server or a web site should restrict the activity of these persons to mere putting the equipment into operation.

According to paragraph 42.7 the performance of preparatory or auxiliary functions by a web site are not regarded as constituting a permanent establishment. However, if the functions developed are essential and significant part of the core business activities, they may be regarded as a permanent establishment. In conclusion, if the web site on a server is operated for collecting information, advertising and ordering purposes and the distribution of goods is made in a conventional way (off-line), these activities will not qualify as a permanent establishment. Conversely, if products and services are distributed virtually (on-line) the web site may constitute a permanent establishment if the other conditions of Article 5 are met. Nevertheless, still problems exist with the distinction between principal and auxiliary activities.

Paragraph 42.10 solves the status of the ISP in order to exclude the agency problem or constitution of a permanent establishment representative. In case the enterprises web site carries business in the server owned by the ISP, the new commentary takes the view that this does not constitute a permanent establishment, since the ISP does not have authority to conclude contracts in the name of this enterprise nor constitutes and independent agent[56].

4. Integration and Cohesion within the OECD Commentary

In respect to the addition of paragraphs 42.1 to 42.10 to the OECD Commentary on Article 5 some remarks on integration and cohesion with the former text are herein envisaged.

Paragraph 2 of the OECD Commentary (Paragraph 2) refers to the conditions contained in the definition of paragraph 1 of Article 5 of the OECD Model. In doing so, Paragraph 2 lists some examples to further illustrate the meaning of the concept "place of business", including in its wording: "facilities such as premises or, in certain instances, machinery or equipment". Furthermore, Paragraph 4 of the OECD Commentary (Paragraph 4) contains a general explanation for the interpretation of the term "place of business".

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[54] Richard Baron. Institute of Directors, London, *Tax planning in International E-Commerce*, Volume 3 N 3 March 2001.
[55] Eric Tomsett, Deloitte & Touche, *Commentary on OECD Definition of PE in E-Commerce, Tax planning in International E-Commerce*, Volume 3 N 2 February 2001.
[56] Gyöongyi Vegh, *Facing the Challenges of Electronic Commerce (Direct Taxation)*, European Taxation, IBFD April 2001 p 439.

Paragraph 4 states in its first sentence that: "The term place of business covers any premises, facilities or installations used for carrying on the business of the enterprise, whether or not they are used exclusively for that purpose". As clearly reads, the wording of Paragraph 4 accepts a broad concept of place of business. The grammatical understanding of the word "any" enunciates a general purpose clause, followed by mere illustrative examples. All of these cases include material or physical objects that comprise an idea of tangibility.

Paragraph 4, further clarifies in its second sentence that: "A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal". As reads, Paragraph 4 includes the possibility of a simple amount of space being at disposition; which means that the term was intended to have a very flexible interpretation, not circumscribed necessarily to the physical objects of the nature described in the illustrative cases presented in its first sentence. Therefore, one may ask the question, in the light of the natural meaning of the words employed in Paragraph 4, if a certain amount of space in a hard disk at disposition of the e-business by means of a web site hosting agreement is not sufficient to match with the original criteria of the place of business contemplated in Article 5? In this respect, Paragraph 42.2 of the OECD Commentary clearly seems to disrupt the original sense of the concepts contained in Paragraph 4, since it affirms that the data and software conforming an Internet web site which is stored in a hard disk do not is not really amount to "space". Moreover, OECD Commentary on Paragraph 42.3 affirms that in case the use is done in the server of an ISP, by means of a hosting agreement, this contract does not really entail disposition for the e-business. How is these conclusions are obtained?

In principle, software and electronic data are supposed not to constitute in nature "physical matter"; legally speaking: "tangible property". Paragraph 42.2 refers to Commentary of Paragraph 2 to ground the consistency of this argument. However, as aforementioned, OECD Commentary specifically addresses the interpretation under its Paragraph 4. Thus, under Paragraph 4 the principal question is not really if the web site is tangible or not, but if the web site does occupy a simple amount of space or not, which is originally the broadest application of this interpretation guidelines. Likewise, in case of servers, described in the last sentence of Paragraph 42.2, there is not doubt that Paragraph 2 of the Commentary is the correct support, since servers could be regarded as a piece of equipment, which perfectly fits in the examples of the words "machinery or equipment" contained in Paragraph 2; but this same examples do not seem proper for web sites which should be referred to Paragraph 4.

Consequently, by pointing the examples applicable to solve the situation of a server contained in Paragraph 2, Paragraph 42.2 does not recall the word "space" contained in Paragraph 4, to solve the question of web sites. Moreover, it seems to be that the underlying argument is to introduce a distinction between "physical space", applicable to the cases initially envisaged and "virtual space", applicable to the bits and bytes of information which constitute the software and data stored in the hard disk of a server, which are excluded. The introduction of this second meaning to the natural words of the Commentary seem complex and clearly may introduce problems of integration and cohesion between the original and secondary meaning of the term used[57]. Thus, it could be argued that Paragraph 2 does not clarify the situation of a web site. Conversely, the general rule is explained in Paragraph 4 using the wording „ a certain amount of space", which should be used as the last rule for reasoning in the web site case. This contradiction is amplified in Paragraph 43.3 were it is illustrated that the payment of fees made to the ISP under a Hosting Agreement may be based on the amount of „disk space" used to „store" the software and data required by the web site.

A second problem of consistency arouses in case the web site is not installed in a proper server but is hosted in a server operated by an ISP by means of a hosting agreement. In this example, Paragraph 42.3 concludes that the existence of this agreement does not make the enterprise carrying business to have disposal over the server. This could be incongruent with Paragraph 4, which establishes that it is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. According to Paragraph 42.3 it is not sufficient to have a hosting agreement, since disposal means exclusivity and control of operations of the server; thus, by virtue of a hosting agreement, the ISP would only grant concurrent rights of use with other web sites. Nevertheless, under the original sense of Paragraph 4 there is not a requirement of exclusivity nor of a degree of control for the use of a place of business; only of disposal in the sense of availability of the space for the functions of the company to be performed.

Finally, OECD Commentary on Paragraph 42.4 seems not to be in line with OECD Commentary on Paragraph 6. Paragraph 42.4 states that 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. It adds that a server will need to be located at a certain place for a sufficient period of time. The question that arouses is if Paragraph 6, which entails a very short term to match with the criteria of Article 5, in cases where the nature of the business is such that it will only be carried on for that short period of time, could be used as a rule for reasoning. Furthermore,

[57] This could amount to a fallacy in the line of argumentation.

Paragraph 6.3 states that if at the outset the place was designed to be used for a short period of time, such a period can no longer be considered as a temporary one, it becomes a fixed place of business and thus, retrospectively, a permanent establishment. Under this general interpretation rule, it seems that if a relocation of server takes place or if a web site utilizes simultaneously or consequently multiple servers to avoid the configuration of the temporal requisite, Paragraph 6 should have been used as renvoi criteria. Therefore, if the server is set up merely for a temporary purpose or if at the outset the server is utilized for minimum time, it could constitute a permanent establishment. However, this is contrary to the line of reasoning designed in Paragraph 42.4.

5. Present State of the Art: Doctrinal Confrontation

After the release of the new OECD Commentary there has been a large debate on its practical interpretation. Many doctrinal positions have been released with respect to paragraphs 42.1 to 42.10.

For some scholars, looking for practical – based approach the commentaries to electronic commerce allow a better determination of the matter which was obscure and ambiguous. The bottom line is the belief that the current principles contained in the permanent establishment concept are capable of being applied or extended to virtual businesses without substantial revision[58]. As from their release, the guidelines provide hints to determine when a server can be regarded as permanent establishment. Also, in the utilization of web-sites installed on an independent server, there seems to be more clarity in the sense that generally they do not constitute a permanent establishment. For this position, the additions to the OECD Commentary are welcome, since they provide substantive guidance as to when a server, a web-site and an ISP constitute a permanent establishment.

For other scholars, with a more theoretically - based approach the interpretation of the terms contained in the OECD Model seem to move far a way from the original sense and may lead to results which seem to be absurd or unreasonable from the point of view of the consistency of the international tax law. The starting point, is to recognize that regulations of internet activities must necessarily differ from the regulatory framework of real activities, since virtual businesses do not have a territorially based structure and may occur in multiple eligible jurisdictions [59]. Therefore, the attempt to adjust the original concepts contained in the

[58] Randolph J. Buchanan, *The New Millennium E-Commerce Tax Dilemma*, Tax Notes International, Spacial Report, August 26, 2002, p. 1120. Also, Arthur Cockfield, *Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation*, Minnesota Law Review 2001, Vol 85, p. 1187.
[59] David R. Johnson & David Post, *Law and Borders – The Rise of Law in Cybersace*, 48 Stan.L. Rev. 1996, p. 1367. See also www.temple.edu/lawschool/dpost/Anarchy.html.

OECD Model based in physical presence transactions to virtual transactions seems problematic and unease to fit coherently under international tax principles governing permanent establishments. It is argued that the inclusion of the server under the category of permanent establishment breaches the historical rationale of the concept, originally designed to share tax revenues between resident and source countries, when significant tax revenues took place within their territorial borders, something unlikely to effectively occur in electronic commerce transactions[60]. Furthermore, since traditional commerce and electronic commerce are not comparable it is not possible to sustain the idea that entrepreneurs should be treated in the same way, independent of whether they operate traditionally or electronically, without subverting the principle of tax neutrality[61]. Thus, the business after tax position of the e-business in the state where the customers are located should be different to the same position of this enterprise in the state of residence, since their economic allegiance under the territoriality principle differ. In conclusion, application of the original tax concepts developed by the OECD on the basis of territoriality seems inconsistent with the principle of equality[62].

A very interesting position analyses the functions of e-commerce infrastructures as compared to traditional infrastructures using the substance over form doctrine. The importance of the approach is to focus on whether ISP, web sites or servers constitute infrastructures that can be categorized as permanent establishments for income tax purposes, taking into account what they are capable of accomplishing in substance, without consideration to their specific characteristics. Looking to the development of the concept of permanent establishment, the comparable category under discussion in the context of electronic commerce infrastructures would simply be an office. Thus the web site would be the determinant infrastructure for triggering the income source taxation if compared to on office in the traditional economy. In this case, the reason for taxing web companies in the same way as physical infrastructures would simply rely in the fact that they have substantially the same function and play the same role as physical business infrastructures categorized as permanent establishments. The question is therefore whether its function or role in international business is substantially the same as those of a traditional permanent establishment[63].

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[60] Arthur J. Cockfield, *Transforming the internet into a Taxable Forum: A Case Study in E-Commerce Taxation*, Minnesota Law Review, 2001, Volume 85, p. 1205 .
[61] Lisa Cox, *Permanent Establishments, the Borderless World of Electronic Commerce*, New Zealand Journal of Taxation Law and Policy, March 2001, p 8.
[62] Eric C.C.M. Kemmeren, E-Commerce, Kluwer 2000, p. 366.
[63] Jeff Mukadi Ngoy, *E -commerce Permanent Establishment,* Tax planning in International E-Commerce, Volume 3 N° 8, 2001.

In any case, scholars underline that in tax practice the interpretation of the conditions for the application of the concept of permanent establishment to electronic commerce has the effect of limiting the number of cases where a server constitutes a permanent establishment and make it easy for the enterprise to manipulate the application for tax planing purposes[64]. Thus, the clarifications become a "tool for manipulation in international tax planning" and effectively erode the permanent establishment concept as a tax attribution criterion[65].

6. Recent Jurisprudence

Recent jurisprudence unfortunately has not given much light in order to determine the application of the Commentaries to practical cases. Nevertheless, some recent example may be recorded in the context of electronic commerce.

The Federal Tax Court (Bundesfinanzhof) in Munich ruled on 5 June 2002 that a company maintaining a VIDEOTEXT server in Switzerland on leased premises was liable to German corporate income tax on its related income rather than being tax exempt according to the activity clause contained in the Germany Switzerland Treaty. The decision did not provide an interpretation regarding whether or not a server constitutes a permanent establishment. Nevertheless, the lower finance court had interpreted that the VIDEOTEXT server constituted a permanent establishment and the income derived from it in Switzerland was tax exempt in Germany under the same Treaty.[66]

7. Interpretation of OECD MTC Conventions on Inheritances and Gifts.

The recent changes introduced to the OECD Commentary on Article 5 could be relevant for other fields of international taxation where these same concepts are utilized. In this regard, the studies of international inheritances and gifts taxes results in the application of similar concepts, since countries charge their taxes on two grounds: worldwide taxation based on the connection of the taxpayer with the country and assets situated in one of the countries[67]. Furthermore, the OECD Model Double Taxation convention on Estates, Inheritances and Gifts (hereinafter OECD Model on Inheritances) tries to shorten the situs taxes (taxes on the basis of location of the property transferred upon death or by gift) by

[64] Prof. Luc Hinnekens, *How OECD Proposes to Apply Existing Criteria of Jurisdiction to Tax Profits Arising from Cross-border Electronic Commerce*, International Tax Review, Volume 29, Issue 10, 2001.
[65] Prof. Luc Hinnekens, *Income Taxation of Electronic Commerce and other Cross Border Business Coordinated buy the OECD*, European Taxation, IBFD 2001, Vol 41 p 299.
[66] Finazgericht Schleswig-Holstein, Decision of 6 September 2001, case no II 1224/97.
[67] Dr. F. Sonneveldt, *General Report:Avoidance of multiple inheritance taxation within Europe*, EC-Tax Review 2001-2002, p. 81.

applying the concept of permanent establishment of a business[68]. Basically, the definition set forth in article 5, paragraph 1 of the OECD Model is also contained in Article 6 (2) of the OECD Model on Inheritances. In this case, the wording of Article 5 of the OECD Model is applied to movable property of an enterprise which forms parts of the estate of, or of a gift made by a person domiciled in one Contracting State, which is business property of a permanent establishment situated in other Contracting State.

The question that arises with the new changes to Article 5 of the OECD Model is if further analysis should be carried on to determine that these same solutions could be applied *mutatis mutandis*, according to the purpose and context of each convention, to treat analogous cases. There could be some strong legal reasons for this conclusion. First, from an *ad simili cogent* (razone materiae) there would be no reason to apply a different solution in interpreting the concept of permanent establishment in both tax arena to similar tax matters. In support of this position there could be also an argument on the basis of the systematic element of interpretation within the scope of the international tax legal legislation contained in OECD Model Conventions, in order to maintain legal coherence. Second, according to the Vienna Convention the ordinary meaning of the term "permanent establishment" should be interpreted in their context. This is defined in any agreement between the parties relating to the treaty or other unilateral instruments accepted by the other parties, made in connection with the conclusion of the treaty.[69] In this sense, the context could include the Treaty on Estates, Inheritances and Gifts and also other agreements accepted by the other parties, such as the OECD Commentary to the Model on Estates, Inheritances and Gifts, which have their source and foundation in the OECD Commentary on the Model of Income and Capital. *A contrario sensu*, the argument looks weak, since it is evident that this latter OECD Commentary with the recent changes are not agreed, nor have any connection with the conclusion of the other type of treaties outside the scope of income and capital taxes[70]. However, according to the opinion of some authors, under the principle of specialty of Article 31 (4) of the Vienna Convention, the OECD Commentary and their recent changes in the field of businesses carried in the Internet could also render applicable.[71] In this case, it is argued that if the OECD Commentary provides a special meaning of treaty terms the parties intended that this specific understanding should be applied.[72] Finally, other possibility could be to

[68] Dr. J.F. Avery Jones, *A Comparative Study of Inheritance and Gift Taxes*, Introduction, IBFD, 1994 p. 639.
[69] Vienna Convention, Article 31 (2), letter (a).
[70] Dr. Kees van Raad, *Interpretatie van belastingverdr, Maandblad Belasting – Beschouwingen,* 1978, p. 48.
[71] Dr. Klaus Vogel, *The Influence of the OECD Commentaries on Treaty Interpretation,* IBFD 2000, p. 583.
[72] John F. Avery Jones, *The Effect of changes in the OECD Commentaries After a Treaty is Concluded,* IBFD March 2002, p. 102.

assert that the commentaries of the OECD Model on Inheritances should be regarded as preparatory work based on the OECD Commentary on Income Taxes and Capital. In this case, the recent amendments to Article 5 of the OECD Commentary should be seen as supplementary sources of law, according to Article 32 of the Vienna Convention, to which recourse in absence of other solutions[73].Thus, in this case the interpretation could be supplied on grounds that the matter is ambiguous, obscure, absurd or unreasonable[74].

It is interesting that according to Article 3 (2) of OECD Model on Inheritances any term not defined in the convention, unless the context otherwise requires, has the meaning which it has under the law of that state concerning the taxes to which the convention applies. Thus, this convention also follows the renvoi clause to determine which of the states laws are to be applied.

Apart from the discussion whether the law to be applied is the law of the state of residence or the law of the state of source and assuming that the law contained in the Tax Conventions are part of the legislation of a contracting State, the question could be if the treaty law of the Convention on Income and on Capital and in particular the OECD Commentary, which is part of its internal law, could be applied to solve problems *pari materia* within the scope of the OECD Model on Inheritances[75]. In legal practice, the best way to find a legal interpretation to parallel cases could be to conform to the current interpretation of the Commentaries to Article 5 (2), making them applicable *mutatis mutandi* to 6 (2) of the Estates and Inheritances and Gifts by reason of their drafting similitude[76].

III. Practical Cases

The following paragraphs focus on the practical application of the OECD Commentary to Electronic Commerce.

1. OECD Server Test Cases

The following paragraphs try to show the current results under the OECD Commentary in cases were an enterprise resident in one state develops business activities through a web site installed on a server in another source state. In order make an accurate analysis of the cases the situation comprises two jurisdictions, the state were the server is

[73] Dr. John F. Avery Jones, *The One True Meaning of a Tax Treaty*, IBFD, 2000, p. 573.
[74] Commentaries to Article 31 of the Vienna Convention on the Law of Treaties, paragraph 19.
[75] Dr. John F. Avery Jones and other authors, *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, British Tax Review 1984, p, 25.
[76] Johannes Heinrich, *Die Verteilung der Besteuerungsrechte im ErbSt-MA,* Erbschaftssteuern und Doppelbesteuerungsabkommen, Band 21, Linde Verlag, p. 85.

located (State S) and the state were the e-business has its Residence (State R), comparing results as to the positions of each state with regards to Double Taxation.

Table 2

Cases	PE Article 5 OECD	State of Source	State of Residence
1	PE in S / Taxable Profits in S	Taxed	Not Taxed: Exemption Method 23 A OECD Not Taxed: Credit Method 23 B OECD
2	PE in S / Taxable Profits in S	Taxed	Taxed :Double Taxation
3	No PE in S / No Taxable Profits in S	Not Taxed	Non Taxed : Double Non Taxation
4	No PE in S / No Taxable Profits in S	Not Taxed	Taxed : Single Taxation

In Case 1 if the State of Source accords its interpretation to the OECD Commentary a permanent establishment of the e-business could exist if core businesses activities are carried on through the web site that is hosted in a proper server or one that is at its full disposition, provided the server also complies with the requisites of article 5 of the OECD Model. In this scenario, the State of Source, where the web site server is physically located, should have taxing rights upon the income generated by the permanent establishment. In case the e-business operates in agreement with an ISP server then the e-business web site will be hosted; thus, there would be no permanent establishment of the e-business web site. Nevertheless, there could be a permanent establishment of the ISP server, if its core business consists in rendering hosting services, provided the ISP server complies with the requisites of article 5 of the OECD Model. The State of Residence, where the owner of the server is incorporated, could not tax the profits attributable to the permanent establishment. Thus, according to articles 23 A or 23 B of the OECD Model a relief by way of exemption or credit should be granted upon profit remittance to the State of Residence.

In Case 2 if the State of Residence does not follow the interpretation of the OECD Commentary and assumes that there is no permanent establishment as aforementioned, then this jurisdiction could claim that has taxing rights to tax the whole amount of profits generated by the activities carried on in the territory of the State of Source. Conversely, if the State of Source does conform to the interpretation of the OECD Commentary, assuming that there is a permanent establishment, it could claim rights to tax the whole amount of profits which are attributable to the web site server and / or to the profits attributable to the ISP server physically located in its territory. In this case, the different interpretations would collide and result in double taxation for the same amount of profits. The only possibility of solving the disputes would be through a mutual agreement procedure.

In Case 3 if the State of the Source does not conform to the OECD Commentary and assumes that there is no permanent establishment then the whole amount of profits generated could not be taxed in its territory. On the other hand, if the State of Residence does conform

to the OECD Commentary, then it would consider that in this case there is a permanent establishment and could not tax the profits remitted from the State of Source. This would result in a case of double non taxation. Discussion of this case encompasses two contradictory positions actually held in the international tax law. For some scholars, this case is not solved and the State of Residence could not tax income according to article 23 of OECD model. For other scholars, the interpretation of international tax treaties according to the Vienna Convention on the Law of Treaties determines not to provide for unintentional double non-taxation, since this would be against the object and purpose of International Tax Treaties[77].

Lastly, in Case 4 if the State of Source does not conform its interpretation to the OECD Commentary exerting no taxing rights and the State of Residence does not conform to the proposed OECD interpretation and asserts that there is no permanent establishment, then it could claim that has taxing rights to tax the whole amount of profits generated by the activities carried on the territory of the State of Source. In this case, single taxation could be applied by the State of Residence.

2. Web site Activity Cases

The following paragraphs try to apply the OECD Commentary on Electronic Commerce to practical cases were an e-business resident in one State splits its different business activities through a web site installed on a proper server or one at its full disposition located in another source State. In order make an accurate analysis of the cases, the situation comprises two jurisdictions, the State were the web site server is located (State S) and the State were the e-business has its Residence (State R), comparing results as to the positions of each jurisdiction with regards to taxation of web- site business activities.

Table 3

Case	Web Site Business Activities	State of Source	State of Residence
1	Advertisement and information of goods and services.	No	No
2	Ordering of goods and services; off -line payment.	No / Yes	Yes
3	Ordering of goods and services; on-line payment; off-line or on-line delivery of goods and services.	Yes	No
4	Ordering of goods and services, on-line payment, on-line delivery.	No	No

In Case 1 if the operations carried on through a web site are restricted to auxiliary or preparatory activities covered by paragraph 42.7 no permanent establishment could be generated, no taxation could arise in the State of Source. In Case 2 if web site activities allow

[77] *Server als Betriebsstätte/Doppelt ansässige,* Steuer & Wirtshaft International, Oktober Nr. 10. See also http://fgr.wu-wien.ac.at/INSTITUT/FR/kolb.pdf.

the ordering of goods and services located in State of Residence, this latter would have tax jurisdiction on the profits made by the e-business that owns the web site. Conversely, if the State of Source regards such functions as an essential and significant part of the business activity of the enterprise as a whole, according to paragraph 42.8, then could claim taxing jurisdiction on the profits attributable to the web site permanent establishment. In this case, a double taxation scenario is likely to occur, which should be resolved by a mutual agreement procedure between State of Source and State of Residence. In Case 3, web site activities allow a virtual payment and a traditional delivery of goods; thus, under paragraph 42.9, the activities could be regarded core web site functions that could qualify as permanent establishment taxable in the Source State. The State of Resident should grant relief to the tax payer upon profit remittance according to articles 23 A or 23 B of the OECD Model. In Case 4, a permanent establishment is envisaged according to the core business activities of the web site. However, it is likely that all of the integrated functions of the web site would be carefully split into servers located in different jurisdictions, making the source State incapable of taxing the income generated in its territory; moreover, the e-business enterprise would probably have residence in a low or nil tax jurisdiction.

3. Effect of the Changes of OECD Commentary in Ongoing Treaties.

The effect of the evolution of the law on the interpretation of legal terms in international treaties has always been a delicate problem[78]. Tax laws are general legal prescriptions. Therefore, they cannot foresee all conditions of its implementation making ongoing interpretation of tax law essential for its application[79]. In this sense, paragraph 29 of the introduction of the OECD Model states that, although they are not binding instruments as the Treaties itself, the OECD Commentary can be of great assistance in the application and interpretation of the conventions and in the settlement of any disputes[80].

In this area, a distinction has to be made. First, OECD Commentary that is contemporary to a tax treaty based in the OECD Model is applied in practice by States to confirm their ordinary meaning, whether in the sense of context, as special meaning or as preparatory work[81]; specially, when no observations have been made. Second, OECD Commentary which is released after a tax treaty is concluded cannot be regarded according to principal means or supplementary means of interpretation contemplated in the Vienna Convention. Clearly, it cannot form part of the intention of the treaty negotiators; nor be

[78] Commentaries to Vienna Convention on Law of Treaties, paragraph 16.
[79] Victor Thuronyi, *Tax Law Design and Drafting*, Kluwer, 2000, p. 33.
[80] Introduction to the OECD Model Tax Convention and Commentaries, paragraph 29.

regarded as an agreement made in connection with the conclusion of the treaty for its interpretation; nor be treated as a subsequent practice in the application of the treaty which establishes the understanding of the parties regarding its interpretation; nor be considered as technical or special meaning of terms for their interpretation[82]. Moreover, the utilization of revised versions of the OECD Commentary to interpret earlier tax treaties may pose constitutional problems in many jurisdictions.[83]

Nevertheless, from a practical point of view several arguments exist in favor of applying the revised OECD Commentary, specially in the field of e-businesses and technology, in order to clarify obscurities of old tax treaties. First, dynamic interpretation of statues conforms to legal domestic practice. Moreover, no rule exists against dynamic interpretation within the scope of international tax law. To this regard, the inter-temporal problem of interpretation was expressly avoided in article 31 (3) of the Vienna Convention not to restrict the evolution of the law on the interpretation of legal terms in a treaty"[84]. Also, when later Commentaries have the virtue of clarifying obscure passages of tax treaty law, *a fortiori* they can serve as supplementary means of interpretation, if no observation is made at the time of their release between OECD member countries. It has also been argued that the OECD Commentary is mandatory to the governments whose representative approve the changes, according to the binding recommendation of the OECD Council.

However, for the majority of countries, there is no binding obligation under the OECD Model to apply the draft text in bilateral negotiations or the commentaries to the interpretation of a concluded tax treaty. In general, it seems that what has been called a "soft" obligation to apply the OECD Commentary prevails between tax treaty authorities of OECD and Non OECD Countries, although courts do not necessarily conform to this view; since this type of material does not have any clear recognition within the framework of the Vienna Convention[85].

IV. Conclusions

The work of the OECD seems to be a good proposal to tranquilize the cyberspace were e-business navigate and temporarily balance the present interests of the different actors

[81] Articles 31 (1), 31(4) and 32 of the Vienna Convention on the Law of Treaties.
[82] Dr. John F. Avery Jones CBE, The Effect of Changes in the OECD Commentaries after a Treaty is Concluded, IBFD, Vol 56 N° 3, p.102.
[83] Michael Lang, *How significant are the amendments of the OECD Commentary adopted after the Conclusion of a Tax Treaty*, Diritto e Pratica Tributaria, Vol LXXIII, 2002, N.2, p.10. Also, *Die Bedeutung des Musterakommens und des Kommentars des OECD Steuerausschusses für die Auslegung von DBA*, in Gasner/Lang/ Lechner, Aktuelle Entwicklungenim Internationalen Steuerrecht, 1994, 22, 30 et seq.
[84] Commentaries to Vienna Convention on Law of Treaties, paragraph 16.

involved. For this purpose, the released OECD Commentary on Article 5 results in interesting guidelines for enterprises, in order to develop their electronic commerce activities safely. Likewise, the guidelines serve for administrations and jurisdictions to take position with regards to taxation of electronic commerce activities operated through e-businesses. As a result, presently the different approaches at stake show an increasing tension, meanwhile the moratorium declared by USA will expire in 2003[86]. The latter is in line with the debate existent in America on "to tax or not to tax" Internet; but is diametrically opposed to the debate existent in Europe on "how" to tax the Internet. Underlying this tension and the distinct differences is the fact that the United States is a net exporter of internet goods and services, while most of the rest of the world is a net importer of the same.

In the intermediate time, the OECD Commentary effectively serves as a tax planning guideline for e-businesses to survive in the electronic tax haven. Presently, the free tax zone left to servers and web sites seems a good place for a status quo, in as much good profits are envisaged and governments do not gain consensus in enforcing tax jurisdiction over income gained with electronic commerce. Anyway, still there is much discussion, since the OECD Commentary on Profit Attributions has already established that in case a State exerts its taxing sovereignty, minimum profits should be attributed to web sites, according to a functional analysis[87]. As a corollary, the actual message seems to be that e- businesses should translate the new guidelines into a practical tax planning checklist: a) companies should be able to avoid the creation of permanent establishment through the use of separate ISP to host their web site; b) companies should be able to avoid creation of permanent establishment through the functional split of core activities from auxiliary activities in multiple host servers; c) companies should be able to settle servers who perform core business activities in countries with low tax jurisdictions; d) companies should be able to use servers for a short period of time, since there is no temporary parameter for the presence of the server; e) companies should be able to use smart servers, mirror servers and stand alone servers, where physical presence of human personnel is no longer necessary; and f) companies that need personnel in order to establish a server or install a web site, should restrict the activity of these persons to mere start up activities.

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[85] Victor Thuronyi, *Tax Law Design and Drafting*, Kluwer 2000, p. 33.
[86] November 28, 2001, H.R. 1552, extends the Internet Tax Freedom Act moratorium by two years.
[87] OECD, Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce, February 2001.

AUTHOR

Cristian Gárate, I.B. Santiago College, Chile (1989); J.D. summa cum laude (1996), Faculty of Law University of Chile; Ph. Jessup Moot, UN, New York (1996); Member of the Chilean Bar (1997); Postgraduate Financial and Accountancy Analysis (1997) Faculty of Economy, University of Chile; Instructor Professor, Department of Economy and Law, University of Chile (1997); IFA Associate Researcher (2003), IBFD, Holland. Has worked as corporate and tax lawyer for large firms in Chile: Carey & Co. and Delloite & Touche (Chile).