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PE Threshold for Business Profits in E-Commerce Context

To what extent does the present Permanent Establishment threshold influence the taxation of Electronic Commerce cross-border transactions?

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I dedicate this thesis to my parents. I want to thank Edoardo Spacca for making it possible for me to continue my studies.

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Summary

Issues related to attribution of profits already exist in the traditional economic framework and are of a different nature, however these issues seem to become more bothersome in transactions conducted in e-commerce context, with an electronic economy. The matter is similar to the traditional economic problems in regard to transfer pricing adjustments; however these issues are much more complex due to the e-commerce nature, especially when considering the fact that multinational enterprises may gather data from different jurisdictions, and for different purposes, which makes the tracing of the source of the data highly complex. These possibilities for MNEs to collect, "analyze and monetize data", make the transfer pricing adjustments difficult in cross-border transactions, as the process of "analyzing functions, assets and risks", becomes much more complex to assign an objective value to the raw data itself, in relation to the processes used to collect analyze and use the data, and the costs attributable to the includible income are much more difficult to be assessed proportionally to the jurisdictions at hand, as determining the income produced and the deductible expenses incurred for such income in e-commerce is difficult, especially in regard to the tax planning strategies in terms of intra group cost allocation. These and similar issues will be addressed from this paper, mainly in *Chapter four*. Beforehand the thesis will present collected data from the digital industry and its growth, supplemented by a theoretical approach in *Chapter two*, where doctrinal debates in regard to international taxation principles are presented. Relevant information in regard to different interpretations from different jurisdictions are presented, in the preceding Chapter. These divergences amount to double or non taxation possibilities. This paper does not intend to provide solutions out of the scope of present law, but it rather analyses the present international taxation framework in regard to the permanent establishment threshold in e-commerce context, and it presents the differences in interpretation, and the results derived from such differences.

Abbreviation list

Art.	Article
ATO	Australian Tax Office
BEPS	Base Erosion and Profit Shifting
CEN	Capital Export Neutrality
CIN	Capital Import Neutrality
DTC	Double Tax Convention
Edt.	Editor
E-Commerce	Electronic Commerce
IFA	International Fiscal Association
IFPI	International Federation of the Phonographic Industry
IRS	Internal Revenue Service
Inc.	Incorporation
MC	Model Convention
MNE	Multinational Enterprise
OECD	Organization for Economic Co-operation and Development
OMC	Organization for Economic Co-operation and Development Model Convention
PE	Permanent Establishment
Pg.	Page
Para.	Paragraph
Prop.	Proposition
Ref.	Reference
TAG	Technical Advisory Group
Vol.	Volume

1 INTRODUCTION

1.1 Background

1.1.1 PE Threshold and Attribution of Business Profits

Inspired from the global trade intensification, and its new means of traffic such as internet, this paper intends to shed light on international tax law and its response to such developments. Attribution of profits features international taxation and bilateral treaties for elimination of double taxation. It is Article 7, OECD MC, that defines attribution of business profits for multinational enterprises (MNEs), who reside in more than one jurisdiction, through permanent establishments. It does so based on two principles that highlight international taxation, source principle and domicile or residency principle. Article 5 on the other hand defines PE as a fixed place of business in its first paragraph, and continues to enlist what shall be deemed as a fixed place of business. In this context Article 5 is crucial in determining the allocation of income taxation in between states. The PE criterion is used in most of the double tax conventions (DTC) in order to determine if certain income shall be taxed in the country where such income originates from, and it serves as a "threshold" for taxpayers who are not residents but have "substantial" connections to that state.¹

Issues related to attribution of profits already exist in the traditional economic framework (out of e-commerce context), and are different in nature, however these issues seem to become more bothersome in transactions conducted in e-commerce context, with an automated economy. In general, for the simplification sake, there is the approach which suggests that in the e-commerce context source taxation shall not continue to exist, while residency would be the only reliable identity to allocate tax to a certain jurisdiction. Whereby the first one relies on the impossibilities that the implementation of the source taxation implies as there is no physical or human presence of a certain enterprise in a country², the other one envisages the legitimacy to tax certain income which is derived from costumers located in one country (economic bonds).³ The legitimacy derives from the benefit theory, whereby a jurisdiction's right to tax certain income relies on benefits a taxpayer incurs from a country, in terms of infrastructure etc. and arguably from the principle of neutrality, in its both dimensions capital export neutrality (CEN) and capital import neutrality (CIN).

If we look back in history, the introduction of the permanent establishment threshold for allocation of taxation to source countries emerged first in the end of XIX century, at the same time with the first bilateral treaty, in between Austro-Hungary and Prussia in 1899.⁴ Beside the international transportation industry at the time,⁵ a fixed place of business concept, could regulate most of the industries in regard to attribution of profits, this mainly because of the

¹ Ekkehart Reimer, Stefan Schmid and Marianne Orell "Permanent Establishments A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective", Third Edition, Wolters Kluwer 2014, pg.11.

² Charles E. McLure, Jr., "Source-Based Taxation and Alternatives to the Concept of PE", Canadian tax Foundation, 2000 World Tax Conference Report (2000): Enforcement concerns, administrative difficulties

³ Klaus Vogel, "Worldwide vs. Source Taxation of Income - A review and Re-evaluation of Arguments (1998), or Dale Pinto "E-Commerce and Source-Based Income Taxation" pg.17-44.

⁴ Dale Pinto, "E-Commerce and Source-Based Income Taxation", IBFD Volume 6, Doctoral Series, March 2002, pg.82 and/or Klaus Vogel "Which Method Should the European Community Adopt for the Avoidance of Double Taxation?", IBFD January 2002, pg.4.

⁵ Today encompassed in Article 8, OECD MC.

immobile nature those industries had at the time in terms of labor, capital and production.⁶ As the mobility grew in terms of the means of production, the PE definition also responded to these changes, thereof arguably eroding this concept itself as Professor Skaar argued since 1991.⁷

The traditional response to such changes was by developing permanent establishment fictions, and the first response is registered to have happened in 1930s when the first *League of Nations Draft Convention on Double Taxation of Income (1927)* was amended with the "construction clause". This clause in Article 5(3) responded to the temporary nature of construction industries, and required at least 12 months for these projects to last, in order to be considered as permanent establishments. Similar approach was taken in 1970s with the so called "offshore clause" for petroleum industry,⁸ or the actual PE fiction in Article 17 (2) OECD, related to "Artists and Sportsmen".⁹

Academic doctrine mainly focuses on three possible solutions: the virtual PE approach (mainly referring to business profits, active income), the base erosion approach (for active and passive income), and the refundable withholding approach (mainly for passive income: royalties, dividends and interests). The classification on active and passive income is for the sake of simplification though there are interferences between those approaches. However this paper will not further elaborate on solutions, it rather identifies the issues at present, and as a result emphasizes the need to move on from the *status quo*.

A similar approach to the doctrine is adopted from certain governments, whereby France on its latest report¹⁰ estimates, in other words, that it is important to distinguish digital economy from the traditional economy. It is expected that by September 2014, there will be concrete proposals from OECD member states in this regard, as clearly the *OECD BEPS Action plan*¹¹ of 2013 requires this. The actual BEPS Action plan entails 15 chapters, and the first chapter is dedicated to e-commerce issues, however it does not contain substantive solutions to the mismatches identified in the areas of intangible products and the development of digital companies.

However not all of the domestic laws follow the OECD Commentaries, as the Spanish Central Economic-Administrative Court, on 15th March 2012,¹² decided that a web page can be deemed as a PE, even when the server is physically located in another country. This decision was a consequence of the observations that Spain made on the aforementioned amendments to the Commentaries on Art.5. Portugal has obtained similar observations to the amendments of late 2000.¹³

⁶ D.Pinto (n4).

⁷ Skaar, Arvid A. "Permanent Establishment: Erosion of a Tax Treaty Principle, (1991), pg.559.

⁸ See The British/Norwegian offshore clause, which deemed a PE by recognizing the mobile nature of the business activities in this industry, and most importantly that these activities did not need any place of business presence in the source countries; Art.23 "Miscellaneous Rules Applicable to Certain Offshore Activities", UK/Norway Double Tax Convention, (12 October 2000).

⁹ OECD MC, Article 17 (2) states: "Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles 7 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised".

¹⁰ Colin and Collin report available at: <http://www.hldataprotection.com/2013/06/articles/international-eu-privacy/proposed-french-privacy-tax-english-version-of-colin-collin-report-available>

¹¹ OECD, Addressing Base Erosion and Profit Shifting (OECD 2013), International Organizations' Documentation IBFD (BEPS Report).

¹² ES: Central Economic-Administrative Court (Tribunal Económico Administrativo Central, 15 Mar. 2012), Case 00/2107/2007.

¹³ Noah Gaoua, "Taxation of the Digital Economy" , (August 2013, IBFD).

1.1.2 E-commerce and Digital Industry

Advertising, payment possibilities, and purchasing is all achievable within the virtual world of internet, and it is referred as e-commerce functions. E-commerce enables its users to use one of these functions for both tangible and intangible products. Purchasing, advertising or paying for an intangible product is referred to as *on-line purchasing or direct electronic commerce*, while the purchase of tangible products with internet means is referred as *off-line or indirect electronic commerce*.¹⁴ The first one entails *digital products* and is referred as digital industry, and digital products amongst others are music, e-books, movies etc. While the so called *off-line* purchasing though is enabled from internet means, the delivery of such products is made through traditional postal services, which is not the case with digital products. This distinction is particularly important in determining the implementation possibilities for source taxation based on customer's location which will be analyzed in detail in the last chapter of this paper.

Professor Arthur Cockfield in his recent co-authored book of 2013, highlights the fact that in an e-commerce context the issues related to transfer pricing rules do not pose different problems in character,¹⁵ from the traditional transfer pricing issues, yet they do pose a greater intensity as the *information and communication* possibilities through technology has improved the speed and has eliminated the obstacles in the mobility, in terms of cross-border transactions, which makes the process of identifying and calculating the contributions and functions a difficult process for tax authorities to identify the relevant parts and distinguish functions in a well centralized business performance or a *contract performance*, made possible from technological means. He further asserts that it is even more difficult to find the suitable comparables in determining the *economic value of the single contribution to the highly integrated Internet transaction in view of its unique features*.¹⁶

Multination Enterprises (MNEs) who's sales are digital products are in a more advantageous situation in comparison to the MNEs with traditional tangible sales, in a traditional international tax law framework, as they are able to better reduce global tax liabilities considering their technological possibilities to better centralize their functions, particularly with software means.¹⁷

The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits (TAG) was set up by the OECD Committee on Fiscal Affairs in January 1999 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”, and a discussion draft of 2003, enlists “various categories of business models and functions enabled or impacted by the advent of Internet-related technologies”.¹⁸ These are: outsourcing, commodity suppliers, manufacturing, retail distribution, delivery, marketing and

¹⁴ D Pinto (n 4) pg.87.

¹⁵ Arthur Cockfield, Walter Hellerstein, Rebecca Millar and Christophe Waerzeggers; “Taxing Global Digital Commerce”; (Kluwer 2013); pg.172.

¹⁶ Ibid.

¹⁷ A. Cockfield (n 15) pg.186.

¹⁸ OECD Public Discussion Draft “Are the current treaty rules for taxing business profits appropriate for e-commerce?”, para.5 (26 November 2003).

customer support, information, financial services, other services and digital products (software, music, e-books, video, games, news etc.).

Furthermore in the light of this paper's aim, it should be estimated that the digital industry generates great amount of sales profits, with a constant increasing profit margin whereby eg. **Apple Inc.** Annual Report for 2011, shows that this company has generated a total of 108 \$ billion from net sales of digital products, such as digital music and movies, in a global scale and a net income of 26 \$ billion¹⁹.

Furthermore the numbers indicate a constant growth in both sales and income from digital products as **iPhone** sales (eg. iPad applications and iTunes) have increased for 26 % in the last quarter (fourth quarter) of 2013 Report in comparison to the previous equivalent quarter of the year 2012.²⁰ The same applies to the 2014, unaudited data report first and second quarter, as "*these results compare to revenue of \$43.6 billion and net profit of \$9.5 billion, or \$10.09 per diluted share, in the year-ago quarter.*"²¹ These estimations show the urgency of the OECD late TAGs reports to deal with Article 5, and the *fixed establishment concept*, as the growth of this industry generates great amounts of profit for MNEs who manufacture their goods in different countries and are in advantageous situation to plan their taxes by establishing with a hardware equipment (server) in low tax jurisdictions, and therefore account to these jurisdictions in accordance with Article 7 (2), regardless of their customer base, which in the Apple case is considerably global. For instance Apple Inc. has a subsidiary in Luxemburg, iTunes S.a.r.l., through which Apple Inc. has generated 126 \$ billion in sales, 20 % of iTunes worldwide sales.²² Luxemburg is the lowest income tax jurisdiction in European Union. In professor Cockfield words a tax planning scheme is assisted from the possibilities to sell digital goods or services are simply open to anyone from anywhere who simply has access to the internet, and such goods or services may be sold or provided for anyone anywhere.²³

1.1.3 Emerging Markets

International Federation of the Phonographic Industry (IFPI) a nonprofit organization representing and advocating copyright enforcement for 1300 digital music record companies worldwide, accessing over 60 markets, in its latest report in 2014, has estimated that from 2008 to 2013, only the digital music industry's revenues have grown from 4.0 \$ Billion being in 2008, to 5.9 \$ Billion in 2013, making it one of the fastest growing industries. Spotify is one of the emerging companies that has access in 55 markets worldwide, with 24 Million users, who have accounted to have paid to the right holders over 1 \$ Billion²⁴. IFPI in its annual report further pictures the fast growth of the licensed digital services in the emerging

¹⁹ Apple Inc. 10-K (Annual Report), (26 November 2011).

²⁰ Apple Inc. Q3, (October 28) and Q4 Unaudited Summary Data

²¹ Apple Inc. Q2 2014, (April 23) Unaudited Summary Data Report, available at www.apple.com/pr/library/2014/04/23Apple-Reports-Second-Quarter-Results.html

²² See Charles Duhigg and David Kocieniewski, "How Apple Sidesteps Billions in Taxes", New York Times, 29 April 2012, see also Richard Waters, "Tax Drives US Tech Groups to Tap Debt", Financial Times (6 February 2011); Arthur Cockfield, Walter Hellerstein, Rebecca Millar and Christophe Waerzeggers; "Taxing Global Digital Commerce"; Kluwer (2013); pg.188.

²³ A.Cockfield, W. Hellerstein, R. Millar and C. Waerzeggers; n (15) pg.188.

²⁴ <http://press.spotify.com/us/information/>

market, with figures that show in last three years an increase in digital revenue in Argentina (+69%), Peru (+149%), South Africa (+107%) and Venezuela (+85%)²⁵.

Such figures prove the proposition of this thesis, by underlining the necessity to adopt the PE threshold to the new means of economy, in this case digital economy. This report also points out the importance of licensing the unlicensed internet companies, especially in China, and the start up companies in Africa.²⁶

These figures though emphasize such necessity, yet make it difficult to reach a consensus in international scale, as a specific approach, alternative to the traditional approach also indicates specific revenue consequences for developed and developing countries, as the developed countries are at this stage the largest net exporters of digital products through internet, and reframing the PE threshold impacts tax revenues of each country. The consensus as described in *Part 2.2*, was to maintain the traditional principles of international taxation (*source-residency*), implying the fixed establishment requirement, making it a *status quo* stage.

In line with the aforementioned arguments this paper will continue to practically present and examine the issues through a hypothesized case in *Chapter four*, by so approving this thesis proposition that the traditional-present PE threshold, according to Article 5 *OECD MC* and its Commentaries, may not be suitable in the e-commerce context for the allocation of the taxable income.

1.2 Purpose

Considering the above, raises the question, whether international tax law is sufficiently responding to the electronic economy. In this regard with respect to doctrinal debates and in the light of the proposals for amendments, that will be delivered from the OECD member states, by September 2014, as required from OECD BEPS Action plan 1 of 2013, regarding electronic commerce and taxation, this paper intends to put forward one thesis proposition. The thesis intends to answer the question, *to what extent does the present Permanent Establishment threshold influence the taxation of Electronic Commerce cross-border transactions?* This mainly in regard to the taxable income allocated between jurisdictions in e-commerce cross-border transactions. Possible double taxation or non-taxation scenarios will be analyzed mainly in chapter four, where the production of the income is analyzed and sources where the revenues arise are asserted.

Such question is crucial as it influences certain income characterizations, and as a result allocation of tax. This will be scrutinized in the light of the implementation and enforcement difficulties. In other words, if the physical presence, geographical location and certain period of time²⁷ are suitable factors to deem a PE in the e-commerce environment, particularly for

²⁵ IFPI DIGITAL MUSIC REPORT 2014; This report includes new findings from a consumer study carried out by Ipsos MediaCT, commissioned by IFPI.

²⁶ Ibid.

²⁷ According to the OECD MC Commentary, “a combination of software and electronic data does not itself constitute a place of business”. Paragraph 42.2, states that a server “is a piece of equipment having a physical

active business profits (Article 7 OECD MC). Law as it stands determines two connecting criteria for allocation of tax between states, source (territoriality) and residency (domicile). Determining the presence of a PE in a country is directly important for source taxation on business profits. In this line the paper will analyze, in its *chapter four*, where the income is produced and whether there are alternative possibilities to deem a PE within the actual international taxation framework.

The purpose of this paper is to highlight the issues that derive from the traditional PE definition, in e-commerce context, by also acknowledging the present legal framework. In doing so, the Commentaries of Article 5 OECD MC, will be scrutinized, and a mirror of countries who implement these provisions in their domestic laws will be presented. What happens if different approaches are taken is worthy of analyzing too.

1.3 Method and Materials

This paper will use the legal traditional dogmatic approach, with a *de lege ferenda* purpose on its proposition. It is a holistic approach, emphasizing the importance of the international law as wholeness, and the interdependence of its parts, domestic laws, which arguably is increased with e-commerce.

This will be done in consultation with domestic laws, bilateral tax conventions, international conventions, and principles of international law. Different approaches will be presented in asserting the thesis proposition, whether the implementation factor is the ultimate obstacle to source taxation. The proposition of the thesis will mainly focus on the characterization issues from differences in *domestic laws*, which also cause mismatches in interpretation of *bilateral treaties*, in the light of possible modules for harmonization that were and are proposed. The OECD MC as the most influential treaty, in which most bilateral treaties are based, will be referenced in order to view the international perspective of the law as it stands. This will be done in conjunction with different approaches certain domestic laws have, translated in to specific cases of differences in interpretation.

The selection of the domestic laws is based on the OECD member states domestic jurisdictions, mainly due to the availability in information. The same applies to the case law, which is limited due to the topic which is a recent theme. *BEPS Action Plan 1*, is referenced as it is directly linked to the question of this thesis. Literature is not very extensive in the field, and the academic doctrine will be mainly used to describe the rationale behind the PE threshold. The literature is selected based on the different and opposing views authors have, which in this case is distinguished in two main views, as on how the solutions should be in regard to the PE threshold in e-commerce context, in respect to domicile (residency) principle and territoriality (source) principle.

location and such location may thus constitute a fixed place of business of the enterprise that operates that server". The conditions of article 5 of the OECD Model (2003) have to be met, i.e. 1. the server must be a fixed place of business, 2. located at a certain point (geographically) and 3. used for a certain period of time. 4. The server must be owned or leased by the enterprise. 5. The business must be wholly or partly carried on through the server and the activity must not be considered as auxiliary or preparatory for the business.

1.4 Delimitation

I am aware that the thesis topic might lead to tax competition discussions as many times different interests involved lead to disagreements and non-harmonization. There is a substantial literature on the advantages and disadvantage of tax competition. Mainly these are finance related topics. It is not my intention to add to that literature. Simply speculate shortly in the conclusion on whether tax-based competition and tax competition occur, and why.²⁸ However it should be recognized that tax competition incentives are one of the main factors behind the impotence to reach a common formula that would solve jurisdiction nexus issues, arguably from physical presence factor to formula apportionment corporate income in order to determine the source of income (CCTB type).

“A formula-based system that combined the worldwide income of groups of commonly owned corporations could substantially eliminate the use of transfer pricing and financial structure to shift income and the use of tax havens to shelter it.”²⁹ Moreover, “Under a formula-based system, competition would be based on the effective taxation of the economic activities (e.g. payroll, profits and sales) that are used to apportion income among jurisdictions, not on the taxation of income arising in a given location, as it is measured under the current system”.³⁰

Anyhow the analyses in this thesis will strictly concern the proposal put forward. In this light only the allocation of active business profits in an e-commerce environment will be assessed, in the traditional PE threshold requirement.

It should be acknowledged that there is residence-residence conflicts due to the e-commerce context. This topic concerns the actual Article 4 and its scope to solve residency (domicile) nexus issues, through the actual tie breaker clause in a e-commerce context. However these issues, though relevant to the allocation of taxation, Article 7, do not fall under the scope of this paper, and only the residence-source conflicts in e-commerce context will be scrutinized. It is the relation between Art.5 and Art.7 which is analyzed.

Furthermore this paper is delimited in regard to characterization issues mainly raised in the interpretation conflicts where certain income in certain jurisdiction is considered to be business profits and on the other jurisdiction royalties (*Article 12, OECD MC*). These divergences become even more important to the countries for tax nexus purposes. In practical terms as for instance, in case of different characterization of income for digital products who have intangible nature, and online services may in some cases constitute a transfer of the software right, where the remuneration paid by the costumers could be considered as royalty³¹. However these products according to the law as it stands will be characterized as business profits, rather than royalties.³² This becomes significant as for passive income,

²⁸ Charles E. Mc Lure, “Tax Competition in a Digital World”, (April 2003), pg.155.

²⁹ Ibid.

³⁰ Ibid.

³¹ See: Tatiana Falcao and Bob Michel, "Assessing the Tax Challenges of the Digital Economy: An Eye-Opening case study", (Intertax 2014) pg.317-320.

³² However a case where India and USA characterized differently income from digital products, whereby India considered the computer software as falling within the interpretation of Article 12 (2), royalties, while US on the other hand characterized the same income as business profits Article 7: See P No.30 1999 (238 ITR 296); This decision was mentioned in several sources, Indian Electronic Service Report, pg.228, Richard L. Doenberg,

specifically royalties, which are in most double tax conventions, contrary to *OECD MC* zero taxation for passive income, taxed on withholding bases, for the costumer based jurisdictions which would than withhold tax on royalties. This topic concerns mainly Article 12 and its interpretation, particularly paragraph 2³³³⁴(except the limits drawn in paragraph 3³⁵), in regard to the potential definitions for intangible goods (digital products, mainly computer software), however most of the e-commerce sales are considered as business profits and therefore fall under the scope of Article 7, and not royalties³⁶. The key words in Article 12 (2)³⁷ interpretation are related to the interpretation of the "*for the use of, or the right to use*", where a rather restrictive interpretation was adopted from the OECD Report of 1992³⁸, where the word *use* was interpreted not as a total exploitation by the acquirer of the intellectual property of another. As typically computer software is run by the multinational enterprises themselves, who mostly acquire the whole license, and not partially, characterization of computer software will not fall within the meaning of Article 12 (2), according to the OECD MC. In contrast if the transaction grants only limited rights of use for the software from the seller to the acquirer than these transactions would qualify for a royalty consideration.

1.5 Outline

Chapter two will summarize the present law, under the OECD MC and its member states' perspectives. In the first part of *Chapter two* of this paper it will be argued that the traditional rationale for the PE threshold was historically modified for certain industries, like petroleum pipeline industry, construction industry etc.. In harmony with the objectives of the *OECD MC* international taxation principles, it will be argued that the approach towards the PE threshold in e-commerce context, is dependent on the interpretation of such principles, if the principle of neutrality or equity are seen with the domestic or inter-nations neutrality or equity perspectives.

In *Chapter three* different domestic approaches to the allocation of taxing rights will be assessed, mainly in respect to server-web site requirement for constituting a PE in E-commerce. The OECD members have agreed on concluding essential paragraphs 42.1 to 42.10.7 on Article 5 Commentaries, in response to e-commerce developments. Though not all of its member states follow these amendments, and this paper will provide a mirror of the present legislations and different approaches domestic laws take.

"International Tax Issues: The taxation of Business Profits" IFA November 2000, Dale Pinto "E-Commerce and Source-Based Income Taxation", pg.42-43, (IBFD 2003).

³³ OECD MC Article 12 (2): "The term "royalties" as used in this Article means payments of any kind received as a consideration **for the use of, or the right to use**, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."(emphasis added).

³⁴ See OECD Report "The tax treatment of software" (1992).

³⁵ OECD MC Article 12 (3) "The **provisions of paragraph 1 shall not apply** if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the **royalties are paid is effectively connected with such permanent establishment**. In such case the provisions of Article 7 shall apply."

³⁶ D Pinto(n 4) pg.148;

³⁷ OECD Public Discussion Draft (26 November 2003) (n18).

³⁸ Ibid.

Finally in *chapter four* will practically overview the abovementioned through a hypothetical case, where under the light of the *OECD MC* and its Commentaries, it will be argued whether the traditional PE threshold is satisfactory in the E-Commerce context in line with the international taxation principles. Where the income is generated, what income is attributable to the collected data, and how different approaches in domestic laws may amount to double taxation or non taxation possibilities in the actual legal framework, are questions that are analyzed under this Chapter.

2. RATIONALE FOR ARTICLE 5 OECD MC

2.1 Rationale for the Traditional PE threshold

The permanent establishment concept suits for locating and determining the taxability of certain transaction or any other economic activity carried on in another state, or better alleged another jurisdiction. Therefore such concept is basically existential to allocation of taxing rights in between different jurisdictions, and the scope of the rights of one jurisdiction to tax certain enterprise who is a foreign resident and it is affirmed in cross border taxation³⁹.

Originally the permanent establishment concept comes hand in hand with the very first convention for the avoidance of double taxation concluded in 21 June 1899, in between Austro-Hungarian Empire and Prussia, where each good or event became exempt from taxation in the other contracting state⁴⁰, thereby establishing a mutual recognition of source based taxation. It is a natural consequence of a DTC to entail such concept. The debate in the academic doctrine does not concern the existence of the permanent establishment concept itself, but it is rather focused on the PE threshold and the possibilities to reframe such threshold in compliance with the developments in global trade. As the traditional concepts of PEs were initially drafted in a context where the economic activities or the transactions carried in between states had material or physical character,⁴¹ these concepts may not be suitable in internet context. Even before the evolution of E-Commerce the threshold itself was a matter of dispute in academic doctrine, starting from 1991, when Skaar argued that such a threshold was already eroded, and he argues that the taxpayer benefits from the infrastructure provided by the host country, even without any permanent establishment in that country.⁴²

As the debate concerns modalities towards the re-conceptualization of the PE threshold different views, will be presented in *Part 2.2 "Theoretical background"*.

Professor Reimer enlists three main objectives that a PE threshold entails. First he points out that the source based taxation may be regarded as *an international justice requirement*⁴³ as opposed to the practical prudence or a prerogative for residence based taxation. Because the source state grants efforts to *create, maintain and safeguard*⁴⁴ economic conditions for foreign investors, the rationale behind the PE threshold lies in the right of the source state to therefore tax such income. This is mostly manifested with the abstention of the residency state to tax such income arising from the source state. Thus then takes the form of an

³⁹ Manoj Kumar Singh "Taxing E-commerce on the Basis of Permanent Establishment: Critical Evaluation", (Intertax) pg.325.

⁴⁰ D Pinto (n 4) pg.13; Hemetsberger-Koller, "Der wirtschaftspolitische Hintergrund des Doppelbesteuerungsabkommens zwischen Österreich und Preußen 1899", in Gassner et al., Die Zukunft des Internationalen Steuerrechts, Schriftenreihe zum Internationalen Steuerrecht, (Vol. 10, 1999).

⁴¹ Eric. C.C.M. Kemmeren, Principle of Origin in Tax Conventions a Rethinking of Models, Pijneburg (2001), pg. 34; or Cristián Gárate "The "Fixed Place of Business" in the Context of Electronic Commerce", (Linde Verlag 2003).

⁴² S Arvid A. (n 7) pg.559.

⁴³ E. Reimer (n 1) pg.11.

⁴⁴ Ibid.

exemption or a credit⁴⁵ in the residence state. The residence state refrains and allows for the source state to effectively materialize such economic incentives offered to its investitures, and thereon tax such income arising from business profits. It is natural to this process that it takes mutual recognition from two states, typically in DTCs, to acknowledge each other's right to taxation. In this sense it is important to point out that asymmetric economic relations especially in between developing and developed countries make the PE threshold crucial.

The second objective of the PE threshold is to put a non-resident PE in the same footing with the residents, which theoretically takes the form of the neutrality principle. This will further be elaborated under Part 2.2. Lastly the "practical justifications",⁴⁶ for such threshold are related to the efficiency arguments. In professor's Reimer words *A pure and unconditional source-based taxation may impede international exchange and raise unnecessary costs of compliance and administration.*⁴⁷ It is exactly the loose and non substantial economic connections that may arise with a foreign country which should not be affecting the residence state's right to tax, and the threshold suits this objective with the *tempus, situs and locus test.*⁴⁸ These objectives characterize the justifications behind such tests enlisted in the PE threshold and as such shall sue for the constitution of the PE.

2.2 Theoretical background

2.2.1 Allocation of taxable income

In a discussion paper from the OECD Technical Advisory Group (TAG), dating 2001, who's duty was to monitor the existing *Treaty Norms for the Taxation of Business Profits*, the issues related to e-commerce and allocation of tax were raised. In the introduction this report acknowledges possible residence-residence conflicts due to the e-commerce context. It emphasizes the impotence of the actual Article 4 to adequately solve residency (domicile) nexus, through the actual tie breaker in a e-commerce context. However these issues, though relevant to the allocation of taxation, Article 7, do not fall under the scope of this paper, and the most common conflicts in the e-commerce context arise in residence-source jurisdiction conflicts.⁴⁹

⁴⁵ For further details regarding the methods, Prof. Dr h.c. Klaus Vogel and Harvard's Richard Musgrave and Peggy Musgrave have considerably contributed to the debate, concerning the rationale behind both methods in the light of the principle of neutrality in both its dimensions, CIN and CEN. See. Eg. Prof. Klaus Vogel "Which Method Should the European Community Adopt for the Avoidance of Double Taxation?", IBFD January 2002, or/and Musgrave Peggy, "Taxation of Foreign Investment Income. An Economic Analysis", 1963.

⁴⁶ E Reimer, S Schmid and M Orell (n1) pg.12.

⁴⁷ Apple inc. (n 20)

⁴⁸ See Part 3.1

⁴⁹ The Impact of the Communications Revolution on the Application of "Place of Effective Management" as a Tie Breaker Rule; A Discussion Paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits, February 2001; Draft for Public Comment, para. 7: 7.OECD (n18) " Most instances of double taxation will arise as a result of residence-source jurisdictional conflicts. However, double taxation can also arise from residence-residence conflicts where both Contracting States treat a person as a "resident" for tax purposes under their domestic law (with the result that the person is fully liable to tax in both States)."

In this OECD document tax nexus purposes are as usually divided in residence and source taxation. For this purpose it's important to highlight the definitions from the OECD documents referring to such principles.

*4. Income derived by a person may be taxed by a country because of a connection between the country and the **generation of the income** (source jurisdiction). For example, a business is carried on in the country, **real property is located** in the country, or an employee works in that country. Countries assert source jurisdiction to tax income on the basis that the income is generated from economic activity within the country.*⁵⁰ **(Emphasis added; Source taxation)**

*5. Countries may also tax income (wherever derived) because the person earning the income is a resident of that country (residence jurisdiction). A country's justification for residence tax may be seen to rest on the need to finance its public goods and social infrastructure, and the **nexus between the consumption of such public goods and social infrastructure by persons who are residents having an over-all capacity to pay.***⁵¹ **(Emphasis added; Residence taxation)**

As pointed out in *Part 2.1 "Rational for the PE Threshold"*, the PE traditional threshold criterion has lost its importance especially regarding the physical requirement, as the nature of internet is outside the physical aspect, as transactions are conducted in another context, which is within the network, or technically within the bits and bytes.⁵² Therefore based on the "reality" some authors argue that such threshold shall be enshrined and that the residency shall be the only reliable factor to tax nexus purposes, this due to the impossibility to really track the link between economic activity and the taxing jurisdiction⁵³. On the other hand by first accepting the source taxation legitimacy, some authors argue that there shall be appropriate adjustments to the PE threshold which would guarantee the maintenance of the source taxation. Therefore due to the changing circumstances in the e-commerce context it is relevant to see if the traditional source taxation is theoretically justifiable in the new transaction environment.

Professor Dale Pinto lays down traditional tax principles, which are in line with the OECD principles and aims⁵⁴, and argues that source based taxation is justifiable under principles of neutrality, benefit theory, principle of equity, and the entitlement concept and therefore should continue to be applicable in e-commerce.⁵⁵ As each principle is co-related to the arguments related to the physical aspect of Article 5, OECD, other authors, like eminently

⁵⁰ OECD Draft for Public Comment, "The Impact of the Communications Revolution on the Application of "Place of Effective Management" as a Tie Breaker Rule; A Discussion Paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits", para. 4-5 (February 2001).

⁵¹ Ibid.

⁵² Richard L. Donenberg, "Electronic Commerce: Changing Tax Treaty Principles Bit by Bit?", *Tax Planning In International E-Commerce*, Volume 3, N° 3 (2001).

⁵³ C Gárate, (n 41) pg.29, see the Commentary of the OECD Model Tax convention on Income and on Capital, 2010, Art.5.

⁵⁴ See OECD Committee on Fiscal Affairs, *Electronic Commerce: "Taxation Framework Conditions"* (OECD 1998) Ottawa Taxation Framework.

⁵⁵ D Pinto (n 4) pg.17-44.

Charles E. McLure argue that each of the aforementioned principles need pragmatic considerations. Regarding the **benefit theory** he estimates that, if the value is entirely produced in the residence country, as in the e-commerce environment, than only the residence country is able to tax such income, regardless of the customer base, as the source country provides no real benefits to the production.⁵⁶ Again Skaar and Dale Pinto argue that, it is exactly the customer base concept and the market itself, which allows for certain Multinational Enterprise (MNE) to incur certain income. Moreover such income may arise due to certain infrastructure the source country provides, which in this case may be the *local access numbers, telecommunications infrastructure, delivery of goods, place of the contract which is judicial infrastructure etc.*⁵⁷ In this line Skaar argues that a permanent establishment serves only as an evidence of the economic bonds between a non-resident and a particular jurisdiction, and that as such it may not be seen out of its purpose, and be simply considered as the ultimate reason for source taxation. He further ascertains that a Multinational Enterprise (MNE) may be engaged and may derive *considerable advantages from the community* in which its income arises or its sourced.⁵⁸

2.2.1.1 Neutrality principle

Neutrality principle relates to efficiency argument, whereby tax policies would not interfere with the economic activities, in a scale where such interference would harm productivity. In the light of Article 7 and the paper's concern capital export neutrality (CEN) and capital import neutrality (CIN) are principles that need to be maintained according to the actual international legal framework, as both are valid, the first one through worldwide taxation with a foreign tax credit and the second one with the exemption from the source taxation by the residence jurisdiction.⁵⁹ These are typically framed under bilateral double tax conventions in between countries. Whether CEN or CIN is the right approach, it is important to assess whether the estimation is made based on the international context or domestic context, as Vogel suggests.⁶⁰ If the approach is international, then it is suggested that *inter-nations neutrality* would favor CIN. In Vogel's words:

"Inter-nations neutrality then means that this relation must not be altered to the disadvantage of persons investing in foreign countries. In other words, inter nations neutrality requires that a taxpayer who conducts an enterprise in another country- or market - and thus utilizes the other country's facilities (public goods) can be sure of being taxed no more than anyone else who, under the same circumstances, uses these facilities to the same extent. This can be achieved only by

⁵⁶ Charles McLure, Jr. "Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm": (1992), pg.145-153, National Tax Journal.

⁵⁷ All of these factors are easily disputable due to their technical complexity and will be presented under the *hypothetical case, fourth chapter* of this paper (local access numbers, telecommunications infrastructure, delivery of goods, place of the contract which is judicial infrastructure etc.)

⁵⁸ A Skaar, (n 7) pg.559-600; See D Pinto (n 4) pg.21-22.

⁵⁹ Prof. Klaus Vogel "Which Method Should the European Community Adopt for the Avoidance of Double Taxation?", January 2002, pg.4.

⁶⁰ D Pinto (n4); Klaus Vogel, "Taxation of Cross-Border Income, Harmonization, and Tax Neutrality under European Community Law: An Institutional Approach" (1994), pg.20-21;

restricting each country to taxing income from domestic sources. Worldwide taxation is inconsistent with this neutrality principle".⁶¹

In this light it should be stressed that if the inter-nations neutrality approach would be taken in consideration, it is suggested that there should be a re-conceptualization of the PE threshold, whereby the notion of fixed place of business shall be framed in accordance with the nature of e-commerce, regarding the allocation of profits (Article 7), where source taxation would arise based on the customer base approach. Inter-nations neutrality is also mentioned in the Public Discussion Draft from the Technical Advisory Group (TAG) in line with the other principles enlists also the requirement for "The need to have universally agreed rules" in order to pursue the objective of avoiding double or non-taxation of business profits.⁶² It was concluded as mentioned in the previous part that the existing rules (residency-source taxation) are widely accepted and that questions like: *how likely it is that such new rules could reach the same level of acceptance?* and *what transition issues would arise from the replacement of the current rules? How likely is it that new rules could be agreed to⁶³?*, would make it impossible to reach a different outcome due to the consensus issues.

2.2.1.2 Equity Principle

Similar distinction applies to the **Equity principle**, whereby individual equity and international equity are two objectives. In practice Vogel argues again that the taxpayers with a foreign income should be compared to the competitors in the source country, and not only to their residence competitors.⁶⁴ Similar to the previous argument inter-nation equity is connected to the benefit theory or entitlement theory, thereby favoring source based taxation. One may argue, as professor Peggy Musgrave does since 1963, that domestic tax payers shall be treated equally to those with a foreign income residing in the same jurisdiction, by highlighting so the equality principle, and the ability to pay principle.⁶⁵

In any circumstance the above mentioned arguments and principles underline the necessity for a re-conceptualization of the PE threshold, firstly in order to cope with such principles, therefore theoretically answering the proposition of this thesis, which points out that the law as it stands under Article 5, OECD and its Commentaries from 42.1 to 42.10.7, are not suitable in e-commerce context. Whether source taxation shall continue to feature international taxation law, or it shall be reframed in e-commerce context, or even abolished in this context due to implementation difficulties is another discussion. The Commentaries on Article 5 are not sufficient especially in terms of the possible divergences in interpretation of double tax conventions, and future developments as prescribed in the next *Chapter three, Different Interpretations in Domestic Laws*.

⁶¹ D Pinto (n 4) pg.30-31; see K Vogel, (n 3) and K. Vogel "Worldwide vs Source Taxation of [Income - A review and Re-evaluation of Arguments (Part II)" (1988), 10 Intertax 210, pg.314

⁶² OECD Public Discussion Draft (n 18).

⁶³ Ibid.

⁶⁴ K Vogel (n 3), pg. 34.

⁶⁵ Peggy Musgrave, "Taxation of Foreign Investment Income: An Economic Analysis" (1963), pg.11; see D. Pinto (n 4) pg.33.

3 OVERVIEW OF THE PRESENT LAW

3.1 OECD Commentaries to Article 5 "*situs, locus, tempus*" test

The OECD Committee on Fiscal Affairs on its attempts to reform the international tax policies, in 1997 in Turku, Finland, has held its first meeting which concerned e-commerce tax related topics⁶⁶. A year later the member countries in a ministerial level meeting, in Ottawa, Canada, reached a landmark agreement, by so finalizing the Turku meeting. In abstract Ottawa meeting concluded that the traditional international tax law principles shall continue to be applied even in the e-commerce context⁶⁷, by maintaining a *status quo*. However alternative approaches were acknowledged as long as the measures intended to respond to e-commerce were in line with the existent tax principles:

*(the) approach does not preclude new administrative or legislative measures, or changes to existing measures, relating to e-commerce, provided that those measures are intended to assist in the application of the existing taxation principles (...) (A)ny adaption of existing international taxation principles should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base (...) and to avoid double taxation and unintentional non taxation.*⁶⁸

The OECD highlights the traditional principles such as the necessity to maintain neutral tax treatment in between e-commerce and traditional commerce, low administrative and compliance costs for the taxpayer and the authorities, reducing tax evasion and avoidance. A specific principle added to the traditional framework, is the necessity for a flexible approach towards the technological developments.⁶⁹ The Ottawa meeting created five Technical Advisory Groups (TAGs) that were assigned to promote analyses and propose solutions, and the first TAG was assigned the duty to review the PE threshold and to come up with possible amendments that would address the e-commerce dimension. This was concluded with the additional amendments in paragraphs 42.1 to 42.10.7 in the OECD Commentaries⁷⁰.

The jurisprudence of the states suggests different solutions, however most of the OECD states follow the amendments, of early 2000, to the Commentaries on Article 5, essential paragraphs 42.1 to 42.10.7,⁷¹ which deem physical presence as the key factor to determining the existence of a PE in the e-commerce, which further according to Article 7 (1) assumes

⁶⁶ See OECD, E-Commerce: The challenges to Tax Authorities and Taxpayers (OECD 1997), OECD Turku Report.

⁶⁷ A Cockfield, W Hellerstein,, R Millar and C Waerzeggers (n 15); pg.115.

⁶⁸ Ottawa Taxation Framework (n 53); see OECD Committee on Fiscal Affairs, Electronic Commerce: Taxation Framework Conditions (OECD 1998) Ottawa Taxation Framework.

⁶⁹ IFPI (n 25).

⁷⁰ OECD Commentaries, 22.July.2010, Article 5, para.42.1-42.10.7.

⁷¹ On 22 December 2000, the Committee on Fiscal Affairs published a proposal to modify the Commentary on Article 5 of the OECD Model (2000), by adding paragraphs 42.1 to 42.10.7. OECD Committee on Fiscal Affairs, Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention Article 5 (OECD 2000). OECD Model Tax Convention on Income and on Capital: Commentary on Article 5 (29 April 2000), Models IBFD.

source taxation on business profits in proportion to the profits attributable (Article 7 (4))⁷² to such permanent establishment. So if there is no server (physical presence) in a fixed place of business - *situs test*, located at a certain point (geographically) - *locus test*, used for a certain period of time - *tempus test*, a PE is deemed to not exist. Moreover the server should be owned or leased by the enterprise - *ius test*, the business itself must be wholly or partly carried on through the server and the activity must not be considered as auxiliary or preparatory for the business - *business activity test*, in order to be able to deem it as a PE, and consequently to infer Article 7 (1) (4).

It should be estimated that an approach that recognizes a server as a PE, under certain conditions, might not solve the difficulties to allocate taxable income in between different jurisdictions, especially if we consider the fact that a server may host more than one web site, or that a web site may be hosted in many servers⁷³.⁷⁴ In the second possibility a web site may be hosted in different servers, located in different parts of the world. Therefore one might argue that a server is not the best *proxy* to spot certain economic activity or a transaction, and that it would be an arbitrary *tax standard*⁷⁵.

This paper will focus on the three first criteria, at *situs*, *locus*, *tempus tests*, as they pose a higher level of complexity in international tax law, and are unique in nature and in relevance to e-commerce, while the "*right of use test*" and the "*business activity test*" are relevant, their character has been dealt with in the "manual traditional economy" and as such they pose a lower complexity towards international tax law. The most important and contested amendment in paragraph 42.2, is the precise interpretation that a website in itself shall not constitute a PE:

*"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."*⁷⁶

⁷² OECD MC Article 7 (4): "(...)Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts..."

⁷³ This may be done for security reasons, and the second server suits as a backup server in case the information is without authorization changed.

⁷⁴ Manoj Kumar Singh, "Taxing E-Commerce on the Basis of Permanent Establishment: Critical Evaluation", (Intertax) pg.331-332.

⁷⁵ Ibid

⁷⁶ OECD Commentaries, 2010, para.42.2.

Therefore a server in comparison to a website fulfills the three first tests, by being a tangible (*situs*), geographically located (*locus*) and consequently may be temporarily maintained (*tempus*). All of the three criteria are interrelated cumulatively. The tangible character of the server is undisputed, however concerns related to the *de minimis* size are valid, especially for tax avoidance purposes, as a small server is easily movable, thereof making it difficult to locate it for a certain amount of time (*tempus*). This issue of the *de minimis* test which is related to the time test, was addressed from the Australian Tax Office (ATO) in a case, where it was decided that an automated computer trading system with 2.6m x 3.98m x 4.7m, weight 168 kg, and value of 200,000 AUD was not sufficient to constitute PE. As the system conducted 50 % of the trading automatically for the company ATO decided, that this was not enough to constitute substantial means to the enterprise.⁷⁷ Such an interpretation is in line with paragraph 42.5 of the OECD MC Commentaries on Article 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.**"*⁷⁸ (emphasis added).

Similar complexities mainly raise and amount to Implementation difficulties, many times beyond reach for a traditional framework of international taxation principles. Practical examples of other complexities are presented under *Chapter four Hypothetical case*.

3.2 Different interpretations in domestic laws

3.2.1 Overview of the domestic laws

The entirety of International tax law is the reconciliation of double tax treaties and national laws of different states. They both considerably interact in between, and influence each other in law-making (legislation and treaty making).⁷⁹ The negotiation of DTCs is normally influenced from the domestic laws of one country in bilateral negotiations for concluding such agreements. However professor Reimer's asserts that the main feature of international taxation law is the asymmetry between the international tax law and domestic law, whereby the domestic laws in their wholeness constitute international tax law even though they have different approaches. It is further asserted that the decisions *to impose tax, to increase it, or to reduce or abolish any tax privilege is exclusively contained in domestic law. DTCs are like*

⁷⁷ ATO Interpretative Decision ID 2006/337; see E Reimer, S Schmid and M Orell (n 1), Australia - pg.31.

⁷⁸ OECD Commentaries, 2010, Article 5 para.42.5. For further details on what "Core functions" covers refer to para.42.6, 42.7, 42.8 and 42.9.

⁷⁹ E Reimer, S Schmid and M Orell (n 1), pg.6.

stencil paper - they let the laser beam of national tax claim pass through or block it, **but it is never the DTC which imposes tax.**"⁸⁰.

As mentioned earlier in this paper, OECD MC reflects one of the most influential multilateral tax treaty models. However not all of its members follow the amendments enacted in early 2000 in the Commentaries on Article 5, essential paragraphs for e-commerce 42.1 to 42.10.7. Not all of them have deliberate reference to such issues⁸¹, and as such most of them silently follow the OECD MC actual interpretation⁸².

OECD member countries that follow 2000 amendments entirely: <i>situs-locus-tempus test</i> (server may constitute a PE, but a web site not)	OECD member countries that do not follow 2000 amendments entirely, only: " <i>tempus test</i> " and reframed <i>situs-locus test</i> (web site may constitute a PE)	OECD member countries that silently follow 2000 amendments: <i>situs-locus-tempus test</i>
Australia ⁸³	France	Austria
USA	Spain (observation)	Belgium
UK	Portugal (observation)	Denmark
Italy	Greece ⁸⁴	Germany
Estonia		Japan
		Switzerland
		Hungary
		Denmark
		Netherlands
		Sweden

3.2.1.1 Observations and alternatives to the amendments

France is one of the few countries where the government and the parliament have addressed the PE server issues, by answering questions that are not in line with the actual OECD

⁸⁰ Ibid.

⁸¹ See In Austria, Switzerland, Belgium, Denmark or Japan there are no rules or case law regarding the Server PE notion, however they follow the commentaries, as neither of them made any reservation to the OECD MC Commentaries, and all of them differentiate the server from a web site, by deeming only the server as a PE; Further see E Reimer, S Schmid and M Orell (n1), Austria - pg.11; Switzerland - pg.14; Japan - pg.21; Belgium pg.17, Denmark - pg.16.

⁸² UK, US and Australia follow the Commentaries of OECD MC and further insist on maintaining similar interpretation to the actual definitions. All countries were active participants in OECD reflections, in early 2000, which led to the revision of the Commentaries; see E Reimer, S Schmid and M Orell (n 1) United Kingdom - pg.16; United States - pg.15; Australia - pg.31.

⁸³ See Australian Taxation Office (ATO), Tax Determination TD 2005/02: "Web site alone does not constitute PE".

⁸⁴ E. Reimer (n 1).

interpretations. France has also issued a report⁸⁵, taking the initiative with a proposal to the OECD for the next amendments, that are to be proposed in the next *BEPS OECD* meeting in September 2014. In addition there are alternative approaches being observed from OECD member states for income derived in e-commerce context, like France with the Collin and Colin Report,⁸⁶ which suggest that the implementation issues are possible to be solved with different approaches. Rather than being considered as a contradiction with the OECD interpretations, this approach shall be regarded as a response to the OECD requirements for proposals in this matter⁸⁷. According to this proposition, which was enacted in France as an answer from the Ministry to the parliament, though not covered yet from the French tax authorities guidelines, there is no need for physical human presence (employees) as long as there is a server running preparatory and auxiliary activities, a PE will be alleged.⁸⁸ This is in line with the OECD Commentaries to Article 5. This solution applies to the cases where the contract, the treatment of the payment and the online performance of the services is automated a server is deemed to be a PE. However the aforementioned report suggests a broader scope, and the foundation of an independent definition of PE for e-commerce purposes, whereby a PE would be deemed to exist in the state where the *customers' data* is collected and where the services would be delivered, unconditional of the real physical establishment of the digital companies,⁸⁹ justifying customer base approach for source taxation.

This approach is held from the French jurisprudence, where the court ruled in compliance with the "customer base doctrine" long time ago, in favor of source based taxation based on "economic bonds". This goes back to 1968 in a case where, Conseil d'Etat ruled that a non-resident broadcaster physically situated in Monaco with *no physical presence* whatsoever in France was held to be taxable on business profits in France⁹⁰. If such approach will be followed from the OECD remains to be seen, though as pointed out earlier it is highly expected that there will be no unanimous approach.

Similar approach was taken from the *Spanish Central Economic-Administrative Court*, on 15th March 2012⁹¹, ruling that a web page can be deemed as a PE, even when the server is physically in another country. This decision was a consequence of the observations that Spain made on the aforementioned amendments to the Commentaries on Article 5. *Portugal* has obtained similar observations to the amendments of late 2000.⁹²

⁸⁵ Colin and Collin Report available at: <http://www.hldataprotection.com/2013/06/articles/international-eu-privacy/proposed-french-privacy-tax-english-version-of-colin-collin-report-available>.

⁸⁶ <http://www.hldataprotection.com/2013/06/articles/international-eu-privacy/proposed-french-privacy-tax-english-version-of-colin-collin-report-available>.

⁸⁷ N Gaoua (n 13), "Taxation of the Digital Economy - French Reflections" , (August 2013, IBFD).

⁸⁸ Ibid.

⁸⁹ Ibid, "Mission d'Expertise sur la Fiscalite et l'Economie Numerique", (18 Jan. 2013).

⁹⁰ Conseil d'Etat, 13 Juillet 1968, N° 66 503, Dupont 1968, p. 447; See Cristián Gárate, "The "Fixed Place of Business" in the Context of Electronic Commerce", (Linde Verlag 2003), pg.10; See also Marcellin Mbwa-Mboma, Tax Notes International, (2002), Volume 26 N°.

⁹¹ Central Economic-Administrative Court (Tribunal Económico Administrativo Central, 15 Mar. 2012), Case 00/2107/2007.

⁹² Spain observations were submitted in 2003 and 2005 versions of the Commentary. In both versions paragraph 45.6 states: "Spain and Portugal have expressed a number of reservations on the Report" "Clarification of the permanent establishment definition in e-commerce." Observations were submitted from Greece, Spain and Portugal concerning the paragraphs 42.1 to 42.10 of the Commentary. As the OECD continues analysing the e-commerce taxation, these States will refrain from aforementioned paragraphs until the OECD reaches a conclusion; see Dr Noah Gaoua, "Taxation of the Digital Economy" , August 2013, IBFD.

3.2.1.2 OECD member states implementing the amendments

On the other hand most of the OECD member countries follow the 2000 amendments. In the *German domestic law*, a server can constitute a PE without the need to have any personnel. However the German law specifies that the nature of such an enterprise needs to be such that doesn't require any personnel.⁹³ German domestic law emphasizes the difference between the main and auxiliary activities that a server might run. In this sense if a server serves only for auxiliary functions⁹⁴ of an enterprise, it shall not constitute a PE⁹⁵. German domestic law does not in any way go beyond the actual OECD MC interpretations; therefore the physical aspect constitutes a PE even in the e-commerce context. A similar approach is adopted from Estonia as well.

In contrast to the French approach, *Italian domestic law* expressly forbids the characterization that the existence of a server which collects data as means of auxiliary nature to the core business activities, shall in itself constitute a PE⁹⁶. This is an alternative approach to the French one, where a non-resident company that holds a server only for data collection for the purpose of selling goods or services, shall not constitute a PE. It can be interpreted as an extensive interpretation of the OECD Model, in line with the Commentaries⁹⁷.

Swedish Supreme Administrative Court in a preliminary ruling⁹⁸, a ruling that is binding for the Swedish Tax Agency and courts if the taxpayer requests it to be binding, has decided that a website may not constitute a PE. Such a ruling is possible to be appealed at the Supreme Administrative Court. The circumstances were concerning two legal persons, a parent company, Y, and its subsidiary, X, who planned to establish a data center in Sweden. They asked whether a server and certain software would constitute a PE. Both companies were part of a corporation developing technical solutions in various areas. Y carried on business activity in country A which included technical services, marketing and sales. X only performed services to other companies within the corporation, among them the parent company. X planned to establish a server in Sweden whereby Y would own and provide the software and neither X nor Y would have any employees Sweden. No decisions or agreements (contracts) would be made in Sweden. The Swedish tax rules defining the concept of PE are built on the OECD model tax treaty (MTC). Similar to German domestic law, the board pointed out that there is an exemption in cases where the activity is of preparatory and auxiliary character. In Swedish case law this exemption has been interpreted narrowly. It is doubtful whether such activities can constitute a PE. According to the MTC this exemption is applicable in case the activities regards only the own company and not if the services are performed to other companies as services. The Board further referred to the commentaries in the MTC and concluded that software

⁹³ E Reimer (n 1); BHF, 30 Oct. 1996, II R 12/92, BStBl. II 1997, 14.

⁹⁴ See. Eg. Advertising purpose/functions.

⁹⁵ These criteria are enlisted in Article 1.03(A)), E. Reimer (n1).

⁹⁶ Testo Unico delle Imposte sui Redditi (TUIR); Italian Consolidated Tax Act, Article 162, para.5.

⁹⁷ Cristián Gárate, "The "Fixed Place of Business" in the Context of Electronic Commerce", (Linde Verlag 2003), pg.29, see the Commentary of the OECD Model Tax Convention on Income and on Capital, 2010, Art.5.

⁹⁸ Högsta förvaltningsdomstolens dom/beslut: dom 2013-12-06 (mål nr. 4890-13); The Supreme Administrative Court's judgment / decision : Court 2013-12-06 (case no. 4890-13).

cannot constitute a PE since it is an immaterial asset. On the other hand, a server can constitute a PE. The Board in line with the MTC concluded that software cannot constitute a place for business activity, therefore Y was found not to have a PE in Sweden, and however, a server can constitute a PE. The Board was of the opinion that the exemption for services of preparatory and auxiliary character was not applicable in this case, since the services that X would provide would be provided to other companies as well. Thus, X would have a PE through server.

The US Model and the Internal Revenue Service (IRS) on the other hand insist on maintaining the traditional principles of international tax law, and the geographical location, with a degree of permanence. Even more the IRS has published decisions that a PE does not need to be fixed (*locus*) within the meaning of the word itself, in this way implying the server issue, and disregarding in the strict sense the server's movable character.⁹⁹

US Texas Court in a case *Piedras Negras Broadcasting Co v. Commissioner*, ruled in favor of the Mexican radio broadcaster who transmitted advertising with a US market target, for the Texas listeners. According to reasoning of the ruling the place of production-performance (*situs*) of the services, in this case Mexico, shall be deemed to be the place where the income has arisen thereof the source taxation is in Mexico, independent of the customer base.¹⁰⁰ The broadcasting industry and this case is comparable to the e-commerce context, as the information programmed in a server with internet access involves cross-border possibilities, in particular with digital products, which are easily downloadable through a website, independent of the server location. Similar to this case the product itself may target exclusively a specific market customer base.

Non OECD members who have passively participated in working TAG groups like **Russia or India** follow the server rule, for the interpretation of the fixed establishment rule. However India additionally has made observations in the late amendments to the Commentary, by stating that if a web site is hosted in a server in a particular location it may give rise to a PE. - There are no indications so far related to Russian jurisdiction, as there is no particular case or legislation related to these issues. Law as it stands in the international tax mosaic with the different standings from domestic laws---- shows an increasing tension in regard to the two different approaches. While the debate in European doctrine is mainly focused on "how" to tax internet, in USA the debate focuses on "whether" internet shall be taxed at all. This tension is arguably due to the fact that "*United States is the largest net exporter of internet goods and services*", leaving the rest, or most of the World as a net importer.¹⁰¹

These divergences will be scrutinized under the next *Chapter four*, through a hypothetical case, where such divergences will amount to double taxation or non taxation possibilities. This will be done in consultation with the *BEPS ACTION Plan 1*, and the conclusions reached in *Chapter three*.

⁹⁹ 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); and see E Reimer (n1), Cockfiled (n 16), pg.9-10.

¹⁰⁰ Commissioner of Internal Revenue v. Piedras Negras Broadcasting Co. No. 10035 United States Court of Appeals for the fifth Circuit, (Texas, April 3 1942).

¹⁰¹ C Gárate (n 87), pg.30.

4 Case Study: Analyses of possibilities to constitute a PE

4.1 Hypothetical case

After pointing out the aforementioned figures in *Chapter one*, which suggest that the digital industry is a fast growing industry, this paper will continue to provide for specific issues in regard to legal, implementation and interpretation possibilities in the actual international taxation legal framework. In the first part of *Chapter two* of this paper it was argued that the traditional rationale for the PE threshold was historically modified for certain industries, like petroleum pipeline industry, construction industry etc., than it was found out that there is no homogeneous approach to the allocation of taxing rights, mainly in respect to server-web site requirement for constituting a PE in E-commerce. The OECD members have agreed on concluding essential paragraphs 42.1 to 42.10.7 on Article 5 Commentaries, in response to e-commerce developments. In harmony with the objectives of the *OECD MC* international taxation principles, it was argued that the approach towards the PE threshold in e-commerce context, is dependent on the interpretation of such principles, if the principle of neutrality or equity are seen with the domestic (CIN-CEN) or *inter-nations neutrality or equity* lenses.

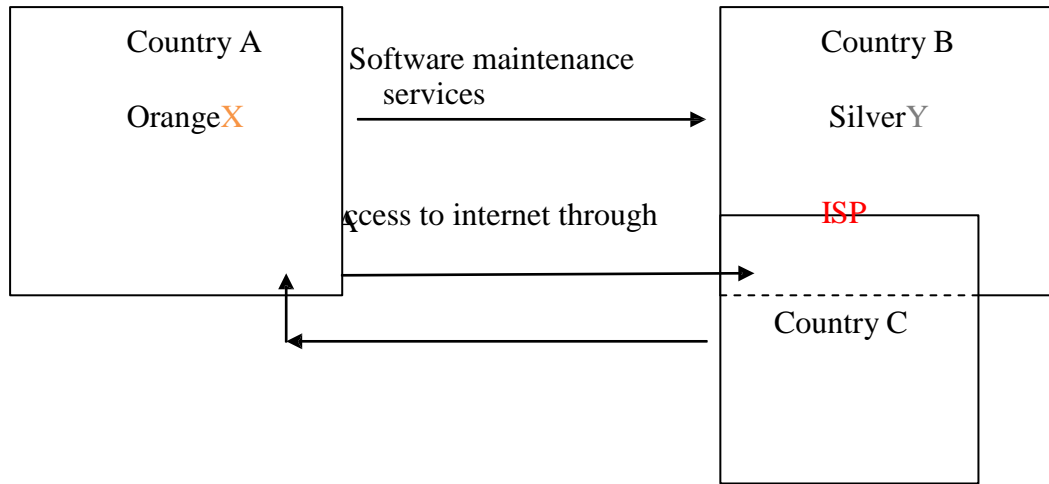
It was also concluded that at this stage there is no sufficient case law from domestic jurisdictions that suggests any solutions, making the future unpredictable, though *OECD MC* member states in great majority silently follow the fixed establishment by not making any observations to such amendments, leaving the rest with open observations specifically in regard to the *situs, locus* and *tempus* test, which translates in to the question whether a web site constitutes a PE in case when the goods are considerably connected to the costumers in a specific jurisdiction.

In this light, the following hypothetical example emphasizes the practical issues raised from the e-commerce transactions in a globalised market, within the actual legal framework.

E.g. Company OrangeX is a resident of country A, which provides services related to software, mainly maintaining-administrating web sites. The scenario implies company OrangeX who would provide services to Company SilverY, a resident in B. However Company OrangeX does not have any physical or human presence in state B. These services would simply be provided with internet means, where Company SilverY would be provided through a web site arranged from Company OrangeX. The only connection company OrangeX has with country B is the agreement they have with an internet service provider (ISP) in country B, who enables them internet presence in country B. Of course the other connection is the costumers themselves (referred as “*costumer base*”), which is SilverY, who is a resident of B. If the *customer base* and the *independent contract* with an *ISP (local access numbers)* is sufficient to determine the presence of OrangeX in B, with a PE, therefore accountable in accordance with Article 7 OECD MC for business profits, remains to be scrutinized under different views and research done.¹⁰² The possibility for the ISP to

¹⁰² See: the Technical Advisory Groups (TAGs) within OECD who are in charge of interpreting “Treaty Characterization of Electronic Commerce”. One TAG has attempted to clarify the distinction between the types

be located in a third jurisdictions is anticipated, both in the chart and the scenarios developed below.



4.2 Where is the income produced?

It was affirmed that E-commerce context blurs the geographical location of both the customer and the enterprise, therefore it is difficult to determine where certain economic activity is taking place and as a consequence where the source of such activity is.¹⁰³ The PE itself as described in *Chapter two* of this paper, is a definition through which the source and the residency state *trade* their taxation rights.¹⁰⁴

According to the hypothetical above it could be affirmed that OrangeX is generating its income from country B, as the location of its customer SilverY is in that jurisdiction. The opposite may be alleged as well, as OrangeX is incorporated in country B. As pointed out in *Chapter three*, in accordance with the actual interpretation of the essential paragraphs to the e-commerce and Article 5, the law as it stands does not support the existence of the OrangeX PE in jurisdiction B. However in the light of the Public Discussion Draft----- BEPS ACTION 1: which addresses the tax challenges of the Digital Economy¹⁰⁵ and recent academic doctrine

of income originating in electronic commerce, especially that between royalties and business income. 2. Another TAG is examining whether the presence of a PE is still the appropriate test of jurisdiction to tax. 3. Finally the same TAG is looking at a third question whether separate accounting for legal entities and the arm's length standard should be modified or replaced. Other TAGs mostly deal with VAT related questions. There are 5 groups, from which two deal with questions related to direct taxation. For the relevance purposes, only the first two questions, and not two TAGs, are relevant for this paper.

¹⁰³ Manoj Kumar Singh "Taxing E-Commerce on the Basis of Permanent Establishment: Critical Evaluation", (Intertax) pg.327.

¹⁰⁴ Ibid

¹⁰⁵ Public Discussion Draft BEPS ACTION Plan 1: "Address the Tax Challenges of the Digital Economy", 24 March 2014 – 14 April 2014.

such interpretation might be amended in near future. *Chapter VI* of the BEPS ACTION 1 raises tax nexus challenges in the e-commerce, especially in regard to the possibility to have a "significant presence without being liable to tax"¹⁰⁶ similar to the hypothetical above. As it is phrased in paragraph 179 of this Action plan, "... it is increasingly possible for a business's personnel, IT infrastructure (e.g., servers), and customers each to be spread among multiple jurisdictions, away from the market jurisdiction. Advances in computing power have also meant that **certain functions, including decision-making capabilities, can now be carried out by increasingly sophisticated software programs and algorithms.**"¹⁰⁷ Contracts are established through software programs whereby the costumers or different parties may electronically sign a contract for certain transactions, and no human intervention is necessary from the staff.¹⁰⁸

One of the possibilities to account OrangeX in jurisdiction B for tax on business profits is by deeming its contractor SilverY, or the Internet Service Provider (ISP) in jurisdiction B, where OrangeX hosts its web site, as OrangeX's dependent agent in accordance with Article 5, paragraphs 5 and 6. This will be further elaborated under *Part 4.3.1"Physical presence through Infrastructure or other representation"*.

If the double tax treaties (DTC) are consulted, there is no specific clause that permits the taxation of business profits if there is no PE, however most jurisdictions would not tax such income in their domestic laws, based on the sales to their domestic costumers.¹⁰⁹ However due to the fast growth of the digital industry in specific, this approach is changing, from certain jurisdictions, as prescribed above in *Chapter three*.

4.2.1 Generated income attributable to the collected data

This is acknowledged also from the BEPS ACTION 1¹¹⁰, whereby the generation of income may be attributable **to the data** collected with digital means, primarily from the users, costumers or other sources of information, which in our case the source of such data would be SilverY or the Internet Service Provider (ISP) if located in B. The attribution of value created from the generation of marketable location, data gathered through the use of digital products and services as in the case, through *social networking* or *cloud computing* and alike, would be immensely difficult, especially if such data is gathered in more than one jurisdiction as it is the case with the MNEs. It is confirmed in paragraph 184 of the BEPS ACTION 1, that the key issue is attributing the value of data, and the approximation to the extent that would be proportional to the systems, *software, and the people that gather, analyze and make use* of such data, which in the end produces the final product be it tangible or intangible.¹¹¹

The whole process of attributing the value created in one jurisdiction through digital means becomes even more complicated if the data gathered from OrangeX is collected from customers or devices in one country using technology developed in country A, or the

¹⁰⁶ Ibid Relevant paragraphs 178-182.

¹⁰⁷ Ibid 179

¹⁰⁸ Ibid.

¹⁰⁹ Ibid.

¹¹⁰ Ibid relevant paragraphs 282-285

¹¹¹ Ibid, para.184.

gathering of such data might be done even in a third country (Country C).¹¹² Determining the profits attributable to each jurisdiction is a difficult process in e-commerce context.

The issues are similar in nature to the traditional economic issues in regard to transfer pricing adjustments; however these issues are much more complex due to the e-commerce nature, especially when considering the fact that OrangeX may gather such data from all three jurisdictions, and for different purposes, which makes the tracing of the source of the data highly complex.¹¹³ These possibilities for MNEs to collect, "analyze and monetize data", make the transfer pricing adjustments difficult in cross-border transactions, as the process of "analyzing functions, assets and risks", becomes much more complex to assign an objective value to the raw data itself, in relation to the processes used to collect analyze and use the data,¹¹⁴ and the costs attributable to the includible income are much more difficult to be assessed proportionally to the jurisdictions at hand, as determining the income produced and the deductible expenses incurred for such income in e-commerce is difficult, especially in regard to the tax planning strategies in terms of intra group cost allocation.

Whether country B may tax OrangeX on business profits based on the data collected from its customer SilverX, is disputable especially under the *OECD MC* Commentaries at stand. The transmission of bits and bytes, electronic signals, from OrangeX to its customer in country B cannot be estimated as constituting physical presence in the later jurisdiction, as they are merely electronic impulses and do not fall under the meaning of physical presence.

Such estimation may be challenged by amending Art.5 para. 2, or specifically for data gathering in e-commerce context, by amending Art.5 para. 4, point d), where "the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of **collecting information**, for the enterprise;"¹¹⁵ may not be deemed as a PE, according to this provision at present. By amending paragraph two the solutions are difficult to be reached, as the terms in this paragraph are of a general nature and are positive and inclusive, and such approach would not suit the objective to deem a web site as a PE. Mentioning the web site in the list of this paragraph might create further issues in regard to the interpretation possibilities, even though this could be further delimited in the Commentaries. The second possibility is by amending para. 4 of Art.5 (d), and such a possibility is mentioned both in the literature and relevant OECD documents.

Such suggestions have been raised from the proposals of different interested parties¹¹⁶ in to the Public Discussion Draft on BEPS *Action Plan 1*¹¹⁷, where it was proposed to modify Art.5 (4) by amending it or removing the exemptions on constituting the PE status. Removing subparagraphs a) to d), would allow for recognition of the PE status to the e-commerce related economic activities.¹¹⁸ However such a step is criticized from the opposing interest

¹¹² Ibid paragraph 184

¹¹³ Ibid

¹¹⁴ Ibid

¹¹⁵ OECD Model Convention Taxes on Income and on Capital, Art. 5 (4) (d).

¹¹⁶ Comments Received on Public Discussion Draft BEPS ACTION Plan 1: "Address the Tax Challenges of the Digital Economy", (16 April 2014); Approximately 70 Comments from interested groups were received from the OECD.

¹¹⁷ OECD BEPS ACTION Plan 1 (n 93); and Additional Comments Received on Public Discussion Draft BEPS ACTION 1: "Address the Tax Challenges of the Digital Economy", 18 April 2014. Mouvement des Entreprises de France (MEDEF).

¹¹⁸ Most of the interested parties have asserted that in line with the Ottawa meeting, the principles and objectives shall not be modified, implying that the PE threshold should not be modified. This seems to be understandable

groups, who argue that such removal, might generate insecurity, administrative costs, and that PEs in those situations represent a low taxable base, as PEs with *auxiliary, storage, display and delivery functions*,¹¹⁹ are considered to not generate essential profits, making such amendment non proportional to the objective.

Moreover certain companies who submitted comments emphasize the idea that such issues may be dealt and are solvable under Controlled Foreign Corporation (CFC) rules or other anti tax haven legislative forms, in line with BEPS *ACTION PLAN 3*, as for example Association Francaise des Femmes Fiscalistes does by stating that "Fixing well-known holes in specific country's local CFC regulations would resolve the perceived issue with international tax and digital economy much better than adding new measures specific to the digital economy, at the risk of increasing uncertainty and risk of double taxation for businesses.",¹²⁰ making the key issue in effectiveness of CFC rules which would prevent accumulation by MNEs of foreign business profits never subject to tax¹²¹. As already mentioned such approach suggests that digital economy does not pose different issues in nature from the traditional ones, and that CFC rules may tackle the same issues whereby anti tax-haven legislations would be sufficient. This is considered to be an alternative path to addressing the same issues, however one must not forget that constituting a PE is essential to the attribution of the source taxation to a certain jurisdiction, and this is important especially if considering the fact that as in the hypothetical where OrangeX has incorporated its server in jurisdiction A or C, which could easily be a tax haven, especially if OrangeX would provide intangible goods to SilverX (software), and this would raise enforcement concerns, as the CFC rules would be under pressure in terms of enforcement options especially for sales contexts where the purchaser and the seller meet in virtual world of internet where the geographical aspect is blurred.

If these enforcement concerns are sufficient to amend or remove subparagraphs a) to d), Art.5 (4), or even develop a new concept of PE for e-commerce purposes, remains to be seen in the following years, when presumably the digital industry will considerably grow, by so pressuring the revenues of the states, for alternative approaches.

4.3 The "Fixed place of business" in the hypothetical

Since Company OrangeX has no direct physical or human presence in country B, the only possibility to account this company for PE profits in B, is by first referring to the Commentaries on Article 5 OECD, paragraph 10, whereby accordingly the activities conducted in B need no human presence, and the automated devices conditioned from other paragraphs may constitute a PE. Vending machines and similar devices are held to be PEs if the enterprise's activities for the business concerned go beyond the installation or

as most of the comments were received from the interested parties who advocate tax payers rights. Most of them oppose the idea of amending or removing para.4, Art.5.

¹¹⁹ OECD MC Art.5 para. 4 (a) to (d).

¹²⁰ OECD BEPS (N 93), pg3-11.

¹²¹ "CFC rules distinguish a foreign corporation whose undistributed income should be taxed to its shareholders from a foreign corporation whose income should be taxed to its domestic shareholders only when such income is distributed to them." ; This distinction is made on three bases: "1) domestic shareholders must control or have significant ownership in the foreign corporation, 2) the geographical location of the CFC, suspecting the tax haven jurisdictions and 3) the nature of the activities and the character of the income derived (distinguishing bona fide economic activity from domestic tax avoidance." A Cockfield, W Hellerstein, R Millar and C Waerzegger (n 15); pg.181.

maintenance of those machines.¹²² However in the hypothetical above OrangeX has no physical presence as well. In such circumstances if paragraphs 42.1-42.10 are consulted OrangeX will not be held with a PE in country B, mainly because it lacks physical presence, attached structure, which could be held as existent if an automated device as the server would be in country B. Therefore the human presence prerequisite is not essential, however the fixed establishment is a requirement to constitute a PE according to the OMC. One must not forget that there were observations in the Commentaries,¹²³ and as a result deeming a PE in the e-commerce context through a web site is possible in certain jurisdictions and this would as a result impede the objective of avoiding double or non-taxation possibilities, if as in the hypothetical in one side country A would follow the OMC commentaries, and the country B on the other side would deem a PE in its own jurisdiction. OrangeX would be accounted in both jurisdictions for business profits. Double tax conventions many times do not refer specifically to the PE threshold and e-commerce. If jurisdiction A and B follow the present *OMC Commentaries* for e-commerce essential paragraphs on Article 5, it would be possible that certain profits would not be taxed in any of the jurisdictions, due to the mobile nature of a server, which would be easily moved. This would potentially be considered as *evasion*, as according to paragraph 42.4 the temporary attachment aspect of the PE needs to be considered on case-by-case scenarios. One might consider this as a difficult process to be proven, due to the implementation difficulties to factually prove such changes.

The issues raised in other industries and the solutions are hardly comparable to the e-commerce context. However parallels may be drawn for deeming a PE, in different context.

4.3.1 Physical presence through Infrastructure or other representation

Technological developments have made it possible for important functions, implying decision-makings to be reached through these means that use software and algorithms.¹²⁴ Contracts may be well concluded and accepted from particular software programs, therefore making the human intervention (local staff) unnecessary.¹²⁵ Such possibilities raise questions of different nature in international taxation law, however *businesses still need to source and acquire inputs; create or add value; and sell to customers to generate income*,¹²⁶ remaining in the same logic of accounting.

As in the example a MNE might have an exclusive market, with specific costumers, eg. by selling specific literature of books, in a specific language through software means. The question that may be raised is, how would the physical presence be held otherwise? As it was confirmed with the Ottawa Taxation Framework that the principles and objectives remain the same such question identifies the possibilities to account for business profits within the actual legal framework.

One of the possibilities is if in conjunction with Art. 5 (5) in accordance with the limitations set in Article 5 (4), an ISP in this specific case would be sufficient to constitute a PE within the meaning of Article 5 (4) in B jurisdiction:

¹²² OECD Commentaries, 2010, Article 5 para.10.

¹²³ See Part 3.2 "Different Interpretations in Domestic Laws".

¹²⁴ Public Discussion Draft BEPS ACTION 1: "Address the Tax Challenges of the Digital Economy", 24 March 2014 – 14 April 2014 "3. "Nexus and the Ability to have a Significant Presence without Being Liable to Tax".

¹²⁵ Ibid.

¹²⁶ OECD BEPS (n 11), para. 178.

*"(...)where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise,(...)"*¹²⁷

The human presence or intervention originally found in the PE threshold, needs to be re-conceptualized in e-commerce, as the software may easily carry certain functions for the enterprise and so substitute or supplement the human intervention.

Would an ISP hosting the web site of OrangeX in country B, be considered as a "person other than an agent" in the light of Article 5 (5)?

Article 5, Commentaries on paragraph 5, 42.10 states 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."¹²⁸

Such a possibility was exhausted in the latest amendments in the Commentaries, essential paragraph 42.10, where such question is directly raised: "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 ISPs."¹²⁹ The paragraph continues to consider such a possibility as "*unusual circumstances*" and based on that it states that "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.**" (emphasize added).

Typically an ISP hosts more than one web site, and its course of ordinary activities has not much to do with OrangeX activities itself. The assertions are contextual, though a claim that this may arise in special or "unusual circumstances" may not be the case in near future, as indicated in the previous *Chapter one*, due to the fast growth of digital industry.

Further one might argue that Internet Service Providers (ISP) are not very reliable factor to be considered as a representative presence since it could be said that costumers in country B might also use another ISP, for hosting their web site, who would be a resident of a third country (state C), and the web site of OrangeX would be hosted in country C where no costumers are located. This is possible and normal in the course of ISP's business activities to independently conclude contracts on hosting its customer's web sites. Again there is even no indirect physical presence of ISP (C) in state B, as services are provided from country C. The only connection OrangeX has with country B is its costumer, SilverY. In such circumstance, no matter what the arguments may be for source taxation on business profits in state B, there

¹²⁷ OECD MC Article 5(5).

¹²⁸ OECD MC Commentaries on Article 5 (5), paragraph 42.10.

¹²⁹ OECD MC Article 5 Commentaries, paragraph 42.10 Electronic Commerce.

are legitimate suspicions raised concerning the enforcement possibilities of source taxation. The only physical presence in this case could be deemed to be the **customer's computers** who logged in to the OrangeX website which can be proven from the HTML page records, and were provided with the services offered from them through sales. Nevertheless the HTML page can be stored only temporarily on the customer's hard drive, and it is erasable. No matter how important this might be for instance for VAT purposes, in correlation to Article 5 and Article 7 OECD MC this is not within the scope of deeming a PE, as an ISP is deliberately considered to not constitute a PE within the meaning of Article 5 (5)¹³⁰. It is increasingly possible for a business's personnel, IT infrastructure (e.g., servers), and customers each to be spread among multiple jurisdictions, away from the market jurisdiction.

Similar implementation concerns may be addressed if a PE would be deemed through other telecommunication devices as for instance, through phone lines or routers, which enable OrangeX to have access to internet transmission¹³¹. There are parallels drawn, as professor Dale Pinto does when he compares the German oil pipeline case with e-commerce, where such pipelines were used for transit in Germany and according to the Supreme Court these pipelines were sufficient to constitute a PE as they filled all criteria of fixed nexus and the duration. A comparison between oil pipeline industries and telecommunications infrastructure may be criticized as they may not be comparable in context and in regard to enforcement concerns in e-commerce, however both are considered within the *benefit theory* and the infrastructure being provided from one state, as a factor which allows taxation in accordance with Article 7 to the source country. However the Danish Ministry of Taxation on the other hand, in a case where a resident of Sweden transported electricity through Denmark with an electrical cable, was considered not to have a PE in Denmark as the only connection was the cable, making such interpretation contextual.¹³² Such differences may easily account to double or non-taxation possibilities for the MNEs.

4.3.2 Physical Presence for certain degree of Time

The *tempus* requirement for constituting a PE in e-commerce is important mainly due to the mobile nature of the servers, especially when considering the fact that such equipments can be of a small physical size and easily moved. In this sense the temporary aspect is inter-related to the physical requirement for establishing a PE.

According to paragraph 42.4 of the OECD MC Commentaries a "Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed."¹³³ The "*tempus aspect*" is settled based on case to case and the requirement for a "*de minimis*", sufficient period as foreseen in paragraph 1 of Article 5 OECD MC Commentaries "certain degree of permanence", however such period is not specified as further the 42.4 paragraph 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. 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...".¹³⁴

¹³⁰ Ibid.

¹³¹ A Cockfield, W Hellerstein, R Millar and C Waerzeggers (n 15), pg.119.

¹³² Ibid.

¹³³ OECD MC Commentaries on Article 5, paragraph 42.4.

¹³⁴ Ibid.

It remains to be seen if there will be specific case law raising such concerns in specific legislation, as for instance when this was addressed from the Australian Tax Office (ATO) in an interpretative decision.¹³⁵ Such *de minimis* rule shall take in consideration the ambulatory nature of the servers and the ambulatory nature of the e-commerce as a short term economic activities are common and transactions may involve several parties, just as in the hypothetical above.

¹³⁵ ATO Interpretative Decision (n69).

5 CONCLUSION

As mentioned in *chapter one*, e-commerce and the digital industry in particular are developing fields, and e-commerce has its own characteristics, and such characteristics need to be taken into account, therefore remains to be seen how the decisions are reached on case by case bases in different jurisdictions. In absence of specific case law from domestic jurisdictions, one has to find comparables, and in this case oil pipeline industries or electrical transmissions, are considered to be similar to the e-commerce context and the necessity to re-conceptualize the PE threshold requirement for accounting the business profits. Differences in those industries did not amount to great urgency as it will arguably be derived from the digital industry in near future, and divergences may not be affordable from the international taxation framework, as in the case with the oil industry. States will arguably be pressured to come up with alternative approaches.

If the digital economy will constitute new principles of international tax law, is highly unexpected at this stage, as most of the *OECD* member states, and the interested parties oppose such approach, as it is asserted as not feasible or appropriate measure, and that the Ottawa framework will continue to feature international taxation principles, a statement that was confirmed also by *BEPS Action Plan 1*.¹³⁶

Under *Chapter two* of this paper these principles were scrutinized under different academic approaches and it was concluded that one has to differentiate in between inter-nations neutrality and domestic neutrality, and in between inter-nation equity and individual equity. In the doctrinal debates these principles are many times interpreted differently making the efficiency argument move from one to the other interpretation, in relation to capital import neutrality and capital export neutrality. It is asserted that such conclusions are essential for the topic, as constituting a PE in a certain jurisdiction for business profits is essential to source taxation, which is another international taxation standard. Whether this will go in dispense of the source taxation principle by excluding it, or the source will be re-conceptualized for e-commerce purposes is another question, however the necessity to have a different approach for e-commerce transactions is widely acknowledged, thereof affirming the proposition of this thesis, that the traditional PE threshold is not sufficiently responding to the e-commerce context.

Chapter three further affirmed the proposition of this thesis, by asserting the differences in domestic laws, whereby the essential paragraphs 42.1-42.10.7 of the *OECD MC Commentaries* on Article 5, are followed from most of the member states, however with the *BEPS ACTION Plan 1*, it is assumed that such amendments are not finalized, due to the evolution in interpretation in certain jurisdictions. In *Chapter four* these divergences were estimated to amount to double taxation possibilities and it was found that there is a demand for consolidation in the international taxation framework in regard to anti tax avoidance principle. Whether Article 5 will be amended, in its *fourth paragraph*, by removing subparagraphs a) to d), remains to be seen, though it should be estimated that the *Public Discussion comments* delivered from the interested parties, in the *BEPS report*, show that most of the comets consider such approach as not proportional and burdensome towards the taxpayer, as *auxiliary, storage, display and delivery functions*, shall sue their motive to

¹³⁶ OECD BEPS (n 93), para. 59, 204 and 205.

differentiate such PE functions from the principal core business substance. It was argued that present domestic CFC rules might be a solution to maintaining the actual PE threshold, however again one might argue that CFC rules do not have efficient scope in regard to e-commerce transactions as the geographical location is vastly blurred in e-commerce context. The possibility to deem a PE through the ISP, by deeming them as a "a person other than an agent" within the meaning of Article 5 (5) in accordance with the limitations set in Article 5 (4), was exhausted in the previous amendments of 2000, OECD MC Commentaries, essential para. 42.10, where such possibility was deliberately excluded. It was concluded that the reasoning in the Commentaries in regard to the ISP and the possibility to be considered a *person other than an agent* within the meaning of Art. 5 (5), might not sue in the future, especially in regard to the allegation that a company would host its web site in another ISP which would be able to automatically conclude contracts through the software, only in "unusual circumstances". This may easily become a normal course of conducting business for MNEs, as it centralizes the functions, and minimizes costs.

Defining where the income is generated is essential to the allocation of tax, and the e-commerce poses a different nature in comparison to the other industries especially in regard to the PE threshold and its requirement for a fixed establishment. E-commerce can generate income without physical presence, and *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)*.¹³⁷ The present approach in relation to the server-web site PE might not be a long term solution, due to the highly mobile nature of such equipments. Even though the server in comparison to a website fulfills the three first tests, by being a tangible (*situs*), geographically located (*locus*) and consequently may be temporarily maintained (*tempus*), and that the tangible character of the server is undisputed, concerns related to the *de minimis* size are valid, especially for tax evasion purposes, as a small server is easily movable, thereof making it difficult to locate it for a certain amount of time (*tempus*). OMC Commentaries suggest a case by case approach, however in line with the assertion that the digital industry will grow, this approach seems to be a short term solution, by so once more affirming the thesis proposition.

It was affirmed that the extend to which the PE threshold influences cross border e-commerce transactions, is considerable. It was found that theoretically there might be a gap between the principles of international tax law in one hand and the PE threshold in the other. Moreover the PE threshold shall sue its purpose which is the recognition of the source taxation. This gap is recognized also within the international taxation framework, whereby in one hand Ottawa Taxation Framework recognizes the continuity in the application of the traditional tax *nexus* principles, source-residency, and on the other hand it interprets Art. 5 OECD MC, rather in a restrictive way, and arguably not proportional to the objective of the permanent establishment concept.

The PE threshold at present enables residence states, who's MNEs are the biggest net exporters of internet goods and services, to centralize their functions in terms of manufacturing, marketing and costs, and without any physical presence in the consuming non developed states sell their goods and services, this especially in regard to on-line intangible goods where no physical delivery occurs.¹³⁸ The tax administrations of such countries have less or nothing to do, due to the enforcement concerns, as prescribed under *chapter four, hypothetical case*. In Mark Lampe's words "developed export economies counteracted taking

¹³⁷ C Gárate (n 41).

¹³⁸ Ibid.

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"¹³⁹. This is recognized also from the recent discussions mentioned earlier, especially the Based Erosion and Profit Shifting (BEPS) reports, which's objectives are essentially related to this topic. One might argue that there is a contradiction between the Ottawa Taxation Framework decision to continue with and preserve the traditional principles of international taxation (source-residency), and the decision to maintain the PE threshold in terms of physical presence requirement, which is a *significant departure from traditional international tax principles*¹⁴⁰. Anyhow a specific principle was added to the traditional framework, and that is "the necessity for a flexible approach towards the technological developments".¹⁴¹

¹³⁹ Ibid, see Marc Lampe, "Broadening the Definition of a Permanent Establishment: The Pipeline Decision." European Taxation. IBFD, 1998, pg. 69.

¹⁴⁰ Benjamin Hoffart "Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through an Access to Markets Proxy Approach", (Northwestern Journal of Technology and Intellectual Property 2007), pg.113. see also: Arthur Cockfield, "Digital Biosphere" "Taxation of Electronic Commerce, Economic Objectives, Technological Constrains, and Tax Laws" (Tax L. Rev. 425) (1997).

¹⁴¹ Ottawa Taxation Framework (n53).

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