Permanent Establishment – New Concept

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Abstract
The permanent establishment is an essential concept in International Tax Law. The traditional definition was based on the existence of a fixed place of business. At present, the new economy requires a change in the concept of permanent establishment. The topic of permanent establishment is based today on the so-called sufficient economic presence. The European Union is working on the definition of a permanent digital establishment.

Keywords
permanent establishment; fixed place of business; sufficient economic presence; permanent digital establishment; OECD

1 Introduction

The concept of *permanent establishment* is a typical notion of International Tax Law. It is a concept that arises from the definition of Double Taxation Conventions. And the idea of a PE cannot be understood without understanding the content of Art. 5 of the OECD Model Convention (Carmona Fernandez, 2012), in addition to the exclusion of preparatory and auxiliary activities. A first symptom of the crisis of this concept of permanent establishment comes from the important novelties of the digital economy. The emergence of electronic commerce, in the nineties of the last century, raised doubts about the application of the traditional category of permanent establishment.

As García Prats says, the basis of the permanent establishment was traditionally the verification of the existence of a *geographical link* between the activity developed

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and the permanent establishment, in order to demonstrate a qualified connection between the establishment and the territory of the State (Garcia Prats, 1996). Therefore, the idea of a permanent establishment requires a physical presence. From this point of view, the permanent establishment of Art. 5 of the OECD Double Taxation Model is any permanent installation that is integrated into the economy of the country.

This concept is overcome in the context of the digital economy. The adaptation of international taxation to the digital economy is one of the great challenges of today (Pires, 2017).

Different international entities are making proposals on taxation of the digital economy. Thus, Action 1 of BEPS is dedicated to addressing the tax challenges of the digital economy, and identifies the main difficulties that the digital economy poses for the application of existing international tax rules. The Final Report of October 5, 2015 outlines options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. The report of Action 1 addressing the tax challenges of the digital economy was finalised at the last meeting of the Task Force on the Digital Economy and then was ratified by the Committee of Fiscal Affairs. It was issued with other BEPS reports on 5 October, with approval by the G20 Finance Ministers on 8 October in Lima. The report includes the digital tax options (i.e. the digital nexus, withholding tax, or equalisation levies), but it does not stop there. It notes the opportunity to build practical experience of how such options would operate if countries unilaterally adopt them in the short term, potentially encouraging countries to do so. Any country taking this route needs to respect its existing treaty obligations, and to recognise that the outlines provided are not a blueprint and would need more work to be done. So, work will continue with regard to monitoring developments in the digital economy, although it has been left open whether this will be undertaken by the Task Force on the Digital Economy or otherwise (Avery Jones, 2006).

2 Challenges Posed by the Digital Economy in the European Union

Challenges posed by the digital economy to fair taxation in the European Union took centre stage at the informal ECOFIN meeting in Estonia on 15–16 September, during Estonian Presidency.

The Estonian Presidency highlighted that the current tax rules are out of date and in need of reform to aptly deal with the digital economy. The Estonian Presidency says that, while a global resolution is the best solution in the long term, a common solution encompassing all the Member States in Europe is very important in the short to medium term. Estonia suggests that the European Union could mould the global solution in the future if an agreement on the approach inside the European Union is possible. In terms of a solution, the Estonian Presidency proposes changes to the definition of permanent establishment so as to abandon the requirement that companies have to be physically present in a country or own assets there, and replace this with the concept of a virtual permanent establishment. A precondition for this is a more precise agreement on the virtual taxpayers who must to start paying taxes.

On March 21, 2018, the European Commission has proposed new rules to ensure that digital business activities are taxed in a fair and growth-friendly way. The measures would make the European Union a global leader in designing tax laws fit for the modern economy and the digital age.

The proposals come as Member States seek permanent and lasting solutions to ensure a fair share of tax revenues from online activities, as urgently called for by European Union leaders in October 2017 (European Council, 2017). Profits made through lucrative activities, such as selling user-generated data and content, are not captured by today's tax rules. Member States are now starting to seek fast, unilateral solutions to tax digital activities, which creates a legal minefield and tax uncertainty for business. A coordinated approach is the only way to ensure that the digital economy is taxed in a fair, growth-friendly and sustainable way.

Two distinct legislative proposals proposed by the Commission today will lead to a fairer taxation of digital activities in the European Union.

The first initiative aims to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels. This forms the Commission's preferred long-term solution. The new rules will also change how profits are allocated to Member States in a way which better reflects how companies can create value online: for example, depending on where the user is based at the time of consumption.

The second proposal responds to calls from several Member States for an interim tax (3% Digital Services Tax on revenues) which covers the main digital activities that currently escape tax altogether in the European Union.

The proposal for a Directive laying down rules relating to the corporate taxation of a significant digital presence has a broader scope than the Digital Services Tax and is designed to introduce a taxable nexus for digital businesses operating within the European Union, with no or only a limited physical presence. It also sets out principles to attribute profits to businesses having such "significant digital presence".

The Directive aims at taxing under the normal corporate income tax system of a Member State, profits generated by businesses providing certain digital services and having a "significant digital presence" within this Member State. The notion of "significant digital presence" builds on the existing permanent establishment concept and covers any digital platform such as a website or a mobile application that meets one of the following criteria: the annual revenue from providing digital services in a given Member State exceeds 7 million Euro, the annual number of users of such services is above 100,000, or the annual number of online contracts concluded with users in a given Member State exceeds 3,000.

This package sets out a coherent European Union approach to a digital taxation system which supports the Digital Single Market and which will feed into international discussions aiming to fix the issue at the global level. This interim tax ensures that those activities which are currently not effectively taxed would begin to generate immediate revenues for Member States. It would also help to avoid unilateral measures to tax digital activities in certain Member States which could lead to a patchwork of national responses which would be damaging for our Single Market.

3 The New Dimension of the Permanent Establishment

When the electronic commerce, first the off line, and later, the online one, becomes an important part in the activity of an entity, the question arises whether the traditional characteristics of the permanent establishment concept can be applied to the new reality of the digital economy. Especially the question arises whether it is possible to adapt the concept of *permanent establishment* to the situation of a company that offers goods and services online in a State other than their residence, through a server or a website. It is necessary to remember that the permanent establishment ensures a tax collection to the State of the territory where the benefit is obtained by a non-resident. Remember that a server (Internet Service Provider) allows users to access the network, and can be located anywhere, even without a fixed location. The web page is the instrument through which the company offers its products to the customer. Simply, the website is a combination of software and electronic data easily modifiable and transportable from one server to another (Wagh, 2013). Initially, the response was negative. Operating in the market of a State through a website does not imply the stability of the installation. Nor does it imply connection of the same with the normal exercise of the company. A website is not a fixed installation. Information is distributed through the website, but its content can be modified without difficulty.

And a server does not constitute a stable organisation under the terms of Art. 5 of the OECD Model. The only questionable case would be that of a server owned by an Internet provider. This provider performs the web hosting activity for a plurality of companies, contracting and developing *mediation* functions through computer programs.

4 The Need to Modify the Structure of the Permanent Establishment within the Framework of the Anti-elusive Requirements of the Digital Economy

The adaptation of the category of the permanent establishment to the phenomenon of the digital economy is today a necessary reaction, guided by the demand to implement measures to fight against international tax avoidance. Business models and value chains are changing fundamentally and value creation is becoming increasingly independent of physical presence in a market. A first requirement is the challenge of adapting certain concepts defined for a physical economy model to the new dimension of the digital economy. It is required reflection on whether the current Treaty Rules for taxing commercial profits are appropriate for electronic commerce. For example, and as we said, one of the first dilemmas is if the goods or merchandise concept as an object of what can be stored in facilities includes digital products or data. It is also not clear to what extent the words – storage and delivery – can apply to digital products downloaded from servers through computer networks.

Action 1 of the final BEPS report of October 2015 concluded that the perceived challenge to be addressed is the digitisation of businesses of all types and sectors rather than some idea of a digital economy that one can clearly identify and tax separately.

The problem of the taxation of the digital economy is perfectly summarised by the report of the European Commission, dated 21 September 2017, when it says: *"The current tax rules no longer fit the modern context where businesses rely heavily on hard-to-value intangible assets, data and automation, which facilitate online trading across borders with no physical presence. These issues are not confined to the digital economy and potentially impact all businesses. As a result, some businesses are present in some countries where they offer services to consumers and conclude contracts with them, taking full advantage of the infrastructure and rule of law institutions available while they are not considered present for tax purposes. This free rider position tilts the playing field in their favour compared to established businesses."*

And this, because in the context of increasing globalisation of the economy, the development of new technologies allows the different agents of economic activity to communicate in real time, and even the acquisition of goods or services through the network, which connects customers and suppliers. Likewise, the technological possibilities are giving rise to the development of innovative business models that pose new challenges from the point of view of tax control. It is difficult for the tax administrations to detect these businesses and obtain information from them.

The Executive Summary of the Final Report of Action 1 BEPS notes that the digital economy is the result of a transformative process brought by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy. It adds: *"Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. The digital economy and its business models present however some key features which are potentially relevant from a tax perspective. These features include mobility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and* *online payment services. The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations."*

The Final Report of Action 1 of BEPS mentions the so-called strategies and recommendations to address the problems of BEPS in the context of the digital economy. These strategies include, among others, modifying the list of exceptions to the definition of a permanent establishment.

For the OECD the most important modifications are the following. In the first place, those related to preparatory or auxiliary activities. The activities previously considered to be mere preparatory or auxiliary in nature for the purpose of the exceptions usually found in the definition of permanent establishment may nowadays correspond to core business activities of an enterprise, particularly in the digital economy. For example, the maintenance of a very large local warehouse in which a significant number of employees work for the purpose of a storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customer and the need for quick delivery to clients) would constitute a permanent establishment for that seller.

Thus, in relation to the concept of permanent establishment in the digital economy, it should be assessed whether certain activities previously considered preparatory or auxiliary for the purposes of these exceptions may constitute increasingly relevant elements of companies in the digital economy. It is necessary to examine in what circumstances these principal activities could be classified, as well as the possibility of formulating a reasonable administrative rule for these purposes. Also, it is necessary to clarify under what circumstances the fact of owning a warehouse can constitute a main activity so that it is excluded from the exceptions provided for in Art. 5 of the OECD Model Convention. In addition, it is proposed to introduce anti-fragmentation criteria for the activity in the State where the permanent establishment operates.

Therefore, the digital economy and its transformations on business models and value creation are interconnected with Action 7 of BEPS – preventing the artificial avoidance of permanent establishment status – and that means that a modification or reconfiguration of some of the permanent establishment sub-rules must be made so that the rule can fully achieve its objectives.

Precisely for that reason it was agreed to modify the definition of permanent establishment contained in Arts. 5(5) and 5(6) of the OECD Model Tax Convention to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that sales should be treated as if they had been made by that country (Pires, 2017).

It is about dealing with situations such as those in which "a seller in line of tangible products (the proximity of customers and the need to make appropriate deliveries quickly being the essential component of the business model) have a large local warehouse in which a considerable number of employees work and use these facilities for the storage and delivery of goods or merchandise sold online to said customers". This would be an assumption that for the BEPS report it should be a permanent establishment modality. In addition, it is necessary to provide rules that prevent eligibility for exceptions to the permanent establishment status through the fragmentation of operations between the different entities of the same group.

But, Action 1 of BEPS is imprecise and does not provide decisive solutions. Suggests several options, but does not opt for any. It is possible to find in the Report of the Action 1 of BEPS the evaluation of three alternatives to the existing threshold of permanent establishment.

The first alternative is to find a new nexus based on the concept of significant economic presence. As the report says: *"This option would create a taxable presence in a country when a non-resident enterprise has a significant economic presence in a country on the basis of factors that evidence a purposeful and sustained interaction with the economy of that country via technology and other automated tools. These factors would be combined with a factor based on the revenue derived from remote transactions into the country, in order to ensure that only cases of significant economic presence are covered, limit compliance costs of the taxpayers, and provide certainty for cross-border activities."*

The second alternative is a withholding tax on certain types of digital transactions, imposed "on payments by residents and local permanent establishments of a country for goods and services purchased online from non-resident providers. This withholding tax could in theory be imposed as a standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online or, alternatively, as a primary collection mechanism and enforcement tool to support the application of the nexus option described above, i.e. net-basis taxation" (Pires, 2017). But when dealing with this option the BEPS report withdraws the possibility based on technical issues and on specific challenges regarding the law of European Union (Pires, 2017). And, the third alternative is the introduction of an *equalization levy,* "intended to serve as a way to tax a non-resident enterprise's significant economic presence in a country. As Pires says, in order to provide clarity, certainty and equity to all stakeholders, and to avoid undue burden on small and medium-sized businesses, therefore, the equalization levy would be applied only in cases where it is determined that a non-resident enterprise has a significant economic presence" (Pires, 2017).

In summary, on the digital tax options (i.e. the digital nexus, withholding tax on certain types of digital transactions, unilateral tax changes, digital equalisation levy, etc.), the report's conclusions remain that none of the options outlined are recommended by the Task Force but it does not stop there. It is worth mentioning the proposal of a digital concept of permanent establishment and a withholding that would work similarly to the British Diverted Profit Tax for the digital economy. In the first case, the Report of February 5, 2015 points to the creation of a new concept of virtual permanent establishment. In the second case, the model would be the British tax on diverted profits, to which we have already referred.

Finally, the Interim Report of 2018, *OECD/G20 Base Erosion and Profit Shifting Project Tax Challenges Arising from Digitalization* remembers that: "The possibility to reach and interact with customers remotely through the Internet, together with the automation of some business functions have significantly reduced the need for local infrastructure and personnel to perform sales activities in a specific jurisdiction (i.e. scale without mass)"; adding: *"This is the case when the functions allocated to the staff of the local subsidiary under contractual arrangements (e.g., technical support, marketing and promotion) do not correspond to the substantive functions performed. For example, the staff of the local subsidiary may carry out substantial negotiation with customers effectively leading to the conclusion of sales. Provided the local subsidiary is not formally involved in the sales of the particular products or services of the group, these trade structures generally avoid the constitution of a dependent agent-permanent establishment in the market jurisdiction".*

On the other hand, Europe has already pushed ahead in this regard with the 2015 changes to the taxation of digital services focusing the determination of the tax based on the final market. But the taxation in the place of consumption through a Diverted Profit Tax or an equalisation levy generates many problems.[2] For business, the danger of double taxation would increase. The application of VAT on a broader range of deliveries of digital goods and services would be a better option of taxation than the proposals outlined.

The fundamental issue is whether it is possible to create a concept of digital permanent establishment. The Report of February 5, 2015 points to the creation of a new concept of virtual permanent establishment that, in principle, would only be applicable *to fully dematerialised companies* (which only sell digital goods and services, with virtual contracts, card payments, in which the only possibility of contact with the company is via the web, without physical offices or that are only secondary support, in which the residence of the seller is irrelevant).

The basis of this digital establishment would not be the physical presence, but the sufficient economic presence (tax nexus concept of *significant economic presence*).

But it is necessary to establish criteria to determine the economic presence of a digital company in another country. For example, number of days or number of transactions. This is what certain international rules provide. Par. 3 of Art. 5 of the OECD Model Convention provides that a building site, or construction or installation project constitutes permanent establishment only if it exists more than *twelve months*. However, defining criteria of degree of permanence in terms of days or months may not be feasible as well as desirable for e-commerce transaction. This is because, a website might have only a handful of transactions in certain number of days. In case of a website, a degree of permanence can be inferred by the number of

2 Equalization Levy has been defined as: "Tax levied on consideration received or receivable for any specified service under the provisions of this chapter". The levy would be under a separate self-contained code and is not part of the income tax law. The Equalization Levy would be applicable at 6% on gross consideration payable for a 'Specified Service'. 'Specified Service' is defined as follows: a) Online advertisement; b) Any provision for digital advertising space or facilities/service for the purpose of online advertisement; c) Any other Service which may be notified later.

transactions taking place on the website in that country. The number of transactions on the website is the indicator of the business activity carried on by the website with the subjects of that country.

The Report of Action 1 itself recognises that, in relation to the concept of permanent establishment in the digital economy, it should be assessed whether certain activities previously considered preparatory or auxiliary for the purposes of these exceptions may constitute increasingly relevant elements of companies in the digital economy. It points out the need to examine in what circumstances these principal activities could be classified, as well as the possibility of formulating a reasonable administrative rule for these purposes. It would try to clarify under what circumstances the fact of owning a local warehouse or warehouse can constitute a main activity so that it is excluded from the exceptions provided for in Art. 5 of the OECD Model Convention.

5 Conclusions

Therefore, the digital economy and its transformations on business models and value creation are interconnected with Action 7 – preventing the artificial avoidance of permanent establishment status – and that means that a modification or reconfiguration of some of the permanent establishment sub-rules must be made so that the rule can fully achieve its objectives.

For the OECD, the most important modifications are the following. In the first place, those related to preparatory or auxiliary activities. The activities previously considered to be mere preparatory or auxiliary in nature for the purpose of the exceptions usually found in the definition of permanent establishment may nowadays correspond to core business activities of an enterprise, particularly in the digital economy. For example, the maintenance of a very large local warehouse in which a significant number of employees work for the purpose of a storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customer and the need for quick delivery to clients) would constitute a permanent establishment for that seller.

Finally, it is necessary to remember that Action 15 of the BEPS Plan provides for the development of a *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (MLI), to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties.

The multilateral instrument of BEPS Action 15 is a key part of the OECD's effort toward implementation of the recommended measures. The instrument will implement the tax treaty related BEPS measures into existing bilateral or regional tax treaties. Currently more than 3,000 of such treaties are in force. Bilateral renegotiations of these treaties in the conventional ways would potentially take decades and would therefore hamper the swift implementation of the treaty related BEPS measures. The multilateral instrument could potentially lead to the amendment of at least 2,000 of these treaties in the coming years and was designed to be flexible enough to accommodate the positions of different countries and jurisdictions.

The report *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* concluded that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly. It is about interested parties developing a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to quickly adapt to this evolution and to streamline the implementation of the BEPS Action Plan.

On October 5, 2015, the OECD released its final report on developing a multilateral instrument to modify bilateral tax treaties (Action 15) under its BEPS Plan. And, on November 24, 2016, the OECD released the text of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS) under BEPS Action 15. The text and the related explanatory statement were formally adopted by approximately 100 countries at a ceremony hosted by the OECD following the conclusion of the negotiations during the week of 21 November 2016.

On June 7, 2017, over 70 Ministers and other high-level representatives participated in the signing ceremony of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. A number of jurisdictions have also expressed their intention to sign the MLI as soon as possible and other jurisdictions are also actively working towards signature. The MLI will only enter into force after countries have ratified it and will apply for a specific tax treaty, after all parties to that treaty have ratified the instrument; and a certain period has passed to ensure clarity and legal certainty.

The tax treaty related BEPS measures covered by the multilateral instrument include elements of Action 7 on the artificial avoidance of the permanent establishment. Therefore, the permanent establishment rules can be adopted by countries through the MLI. The various measures outlined in the final 2015 BEPS Action 7 Report are currently being implemented in a number of existing tax treaties through the MLI, as well as in the course of bilateral tax treaty negotiations. Based on the provisional positions of the jurisdictions that have signed the MLI. However, it is estimated that the changes recommended under Action 7 will only be implemented in a fairly limited number of bilateral treaty relationships.

Some countries have indicated that they will not adopt these rules in their treaties due to either the factor not being a risk for their jurisdiction due to domestic legislation, or due to the lack of clarity on the profit that must be attributed to permanent establishment rules. Further guidance and clarity on profit attribution would lead to more jurisdictions gaining comfort on adopting these new standards.

The OECD Secretariat is developing a toolkit for Application of the Multilateral Instrument for BEPS Tax Treaty Related Measures that will include innovative tools to facilitate the application of the Multilateral Instrument to existing tax treaties. The MLI currently includes the MLI Matching Database and this will assist in determining whether an in-force tax treaty between countries has been modified by the countries' later decision to sign and ratify the MLI. The database matches information provided by tax treaty signatories on their MLI positions.

For the revised dependent agent/permanent establishment definition [Art. 5(5) of the OECD Model], it is estimated that, based on the positions taken so far, this revised definition would apply to around 17% of the 1,246 tax agreements currently covered by the MLI (approximately 206 bilateral tax agreements).

For the revised provision defining specific-activity exemptions [Art. 5(4) of the OECD Model]: It is estimated that, based on the positions taken so far, this revised provision would apply to around 22% (approximately 277 bilateral tax agreements).

Furthermore, the adoption rate of the new permanent establishment definition may also increase over time as governments will base treaty negotiations on the 2017 OECD Model incorporating those changes. The OECD Model has long served as the basis for the negotiation of bilateral tax treaties, and the expectation is that countries will continue to draw on the OECD Model for future tax treaty negotiations.

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