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**"Rethinking the Nexus of Permanent Establishment in the Digital Era (for income tax purposes)"**


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*Ai miei nonni e alla mia famiglia*

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## Executive Summary

It has been said that the only two sure things in life are death and taxes. But the latter seems in question, at least for the moment, especially for U.S. tech corporations.

The rule governing taxation of cross-border business income are a threadbare patchwork of national laws and bilateral tax treaties developed almost a century ago and designed for an age of manufacturing, not multimedia.[1] Under current international law, a company can be taxed on its profits where it is resident or where it has a permanent establishment (PE), the parlance for taxable presence in foreign countries. PE concept was developed as an exception to the exclusive taxation by the residence jurisdiction, as being able to encompass all cases in which the exploitation of the market country by an enterprise was habitual and implying a part of the business to be relocated in such country.[2]

Nowadays, technology giants have become masters at minimizing their tax bills by fixing a permanent establishment in a low-tax jurisdiction (like Ireland and Luxembourg), while generating most of their sales from countries where tax rates are higher, like Italy.[3]

This practice allows companies to conduct business without triggering a taxable presence, by establishing a contract-authorizing operation in a low-tax country, as its PE, and through it channelling revenues from its major markets to be taxed at a lower rate.[4]

Reuters investigated on the account of the top 50 U.S. software, internet and computer hardware companies by market capitalization and found that in 2012 the average tax charge on non-U.S. earnings was 6.8%, far below the 12.5% of Ireland, which has the lowest tax rate on business income in Western Europe.[5]

Particularly interesting are the cases of Apple[6] with a tax rate of non-U.S. profits of 1.9% and Google with 2.6%. Such low tax liabilities are not only the result of the avoidance of PE in

[1] Going after Google, Britain's tax men struck a poor deal. But the real problem lies with flawed international corporate-tax rules, 2016, The Economist

[2] Hongler, P. & Pistone, P. 2015, "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy", *IBFD,*

[3] A digital dust-up, The fight against tax avoidance advances, in fits and starts, 2016, The Economist

[4] Bergin, Tom; 2013, Special Report: How big tech stay offline on tax, Reuters

[5] Ibid

[6] Apple Ireland is registered in Ireland but tax-resident nowhere. This mechanism was revealed by a US senator Carl Levin in May 2013, which called it the "Holy Grail of tax avoidance".

countries where their sales arise, but it is due to the employment of aggressive tax planning and tax-avoidance schemes like "Double Irish with Dutch sandwich".

This thesis analyses the challenges that the digital economy poses to the "permanent establishment" concept. The first chapter examines the features of the digital economy that affect the present international tax framework. The second maps out the basic features of the existing international tax regime, in particular stressing on the definition of permanent establishment reported on the OECD Model Convection and its commentary. The third one focuses on how the PE concept can be revised in a way to adapt its boundaries to the new context of the digital economy in order to tie tax more closely where economic activity takes place.
Since the focus hereby is exclusively on the PE threshold as nexus in the digital economy, all other BEPS aspects, such as Action 2 and Action 8-10 are therefore disregarded.

# Chapter 1 Overview of the digital economy

## 1.1 Introduction

Information and telecommunication technologies ("ITC") have profoundly transformed working methods, enterprises' management, learning and interpersonal relations.

The international widespread use of ITC, together with the decline in price and increase in performance of these technologies, have promoted the development of the "digital side" of the existing global economy.
These two key aspects putted together have rapidly expanded market reach at global level, lowered costs and enabled the supply of new goods and services. (OECD 2015)
These technologies have also enabled to change the way in which products and service are delivered to the end-user and dramatically change the nature itself of these products, examples are e-books, streaming music/movies and other downloadable items that previously had physical nature.

Moreover, cross-border transactions are getting a common practice not only for MNEs, but also for the end-consumers that nowadays have access to large offer of whatever he need from all around the world at the best price available.

While it is beyond the scope of this thesis to extensively discuss the functioning of e-commerce and broadly of the digital economy, to fully understand the international tax issues surrounding transactions taking place on the web, it is necessary to have basic understanding of the phenomenon, its size on the world economy and the business models adopted by digital companies.

## 1.2 Key global statistics

The total value of worldwide e-commerce increased from near zero in the early 1990s to at least, $9,950 billion in 2014.

It is important to underline that the business-to-consumer represents alone just a small share of global e-commerce, which is composed mainly by business-to-business transactions.

In 2014, business-to-consumer online sales alone accounted for $1,943 billion with a growth rate over the previous year of 24% and an expected growth for 2015 of 16%. At global level, the top e-commerce countries in turnover are China ($538 billion), United States ($483 billion), United Kingdom ($169 billion), Japan ($136 billion), Germany ($95 billion) and France ($75 billion). United States, China and United Kingdom account for 61% of total business-to-consumer e-commerce sales in the world.[7]

In 2014, 2,737 million of people had access to the web, 1,139 million of them were e-shopper with an average spending of $1,707 and 309 million consumers bought cross-border for a total of $328 billion. The countries with the highest number of consumers buying cross-border are USA (47%), UK (38%) and China/HK (31%). The worldwide web access continues to grow, but a slowdown on e-commerce transactions is forecasted, leading to an annual growth rate around 10% within the end of 2018. Nevertheless, in this year business-to-consumer e-commerce transactions are expected to be close to $2,400 billion.[8]

The area of North America (including USA and Canada) is grown of 12.2% over 2013 reaching $522.9 billion for an average spending per e-shopper of $2,674; the incidence over GDP of B2C e-commerce is around 2.55%

The Asian-Pacific region (including China, Japan, Australia, South Korea, India, Indonesia) has the leading position for B2C e-commerce, accounting for 39% over the global e-sales and a growth rate over 2013 of 44.3%.

It is interesting to see that even though Asia-Pacific achieved the highest B2C e-commerce sales last year, it also had the lowest Internet penetration. When this rate increases, its ecommerce turnover will grow even more. Forecasts provided by Emarketer.com on 2013 estimated China's e-sale incidence over e-commerce sale of Asian region to reach 70% in the 2018, but the threshold has been reached already on 2014. The country counts the higher number of e-shopper (242 million) and it is expected to rapidly grow in the next years. In

[7] E-commerce Europe 2015, "Global B2C E-commerce Report 2015",
[8] E-commerce Europe 2015, "Global B2C E-commerce Report 2015",

China, e-commerce has led to a change in the retail industry and to the purchasing decisions by customers: all major brands are starting to strengthen this distributing channel.
North America, Asian-Pacific region and Western Europe will continue to represent the 90% of the global e-sales.

Global e-commerce market is still young and future growth performances are expected to last for a reasonable period of time. It is important to note that the growth of this kind of market is strictly related with the familiarity and the confidence of internet users, but also to the ease of use of electronic device, like smartphones[9] and tablets which enable to close transactions and develop that particular e-commerce's sector known as mobile-commerce (m-commerce).[10]

Another key component of the digital economy is represented by online advertising. Online advertising is rapidly growing both in term of total revenues and in market share (on total advertising expenses). Online advertising alone counts for $100,2 billion in 2012 with a growth over the previous year of 17% and a market share of 20% over the overall advertising market. This particular branch of advertising market is expected to grow at an annual rate of 13% till 2017 reaching $186 billion.[11]

### 1.2.1 E-commerce in Europe

E-commerce market shows a continuous growth all over the Europe. In 2014, 490 million people use the internet and 274 million purchased goods and services through the web channel. On the same year, more than twice as many enterprises engaged in e-purchases than in e-sales. 40 % of enterprises in the EU-28 made purchases electronically. In the same period, only 19 % of enterprises made electronic sales.[12]
The percentage of turnover on e-sales amounted to 17 % of the total turnover of enterprises with 10 or more persons employed in the European Union.

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[9] In 2014, smartphone sales increased by 48% in the developed world, but by 164% in the emerging countries. (E-commerce Europe 2015)
[10] Valente, Piergiorgio., Ianni, Giampiero., Roccatagliata,Franco., IPSOA., 2015, *Economia digitale e commercio elettronico : fiscalità in Internet nella gestione d'impresa,* Wolters Kluwer, Milanofiori-Assago (Mi)
[11] Ibid
[12] Eurostat 2015, "E-commerce statistics",

*Table 1.1: E-sales and e-purchases, turnover from e-sales, 2008 to 2014, EU-28 (% enterprises, % total turnover)*
Source: *Eurostat*

Nevertheless, there was a significant variation in the share of enterprises conducting e-sales and the turnover from the e-sales according to the size of the enterprise.
During 2014, 43 % of large enterprises made e-sales corresponding to 24 % of total turnover in this size class. Similarly, 28 % of medium sized enterprises made e-sales corresponding to 13 % of total turnover in this size class. By contrast, 17 % of small enterprises engaged in e-sales, corresponding to only 6 % of the turnover of such enterprises.[13]

In 2014, among the European Union, the percentage of enterprises making e-purchases varied widely across the union, ranging from 11 % in Greece to 68 % in Austria. Similarly, the percentage of enterprises with e-sales ranged from 7 % in Greece to 32 % in Ireland, followed by Sweden (28 %) and Denmark (27 %).

[13] Ibid

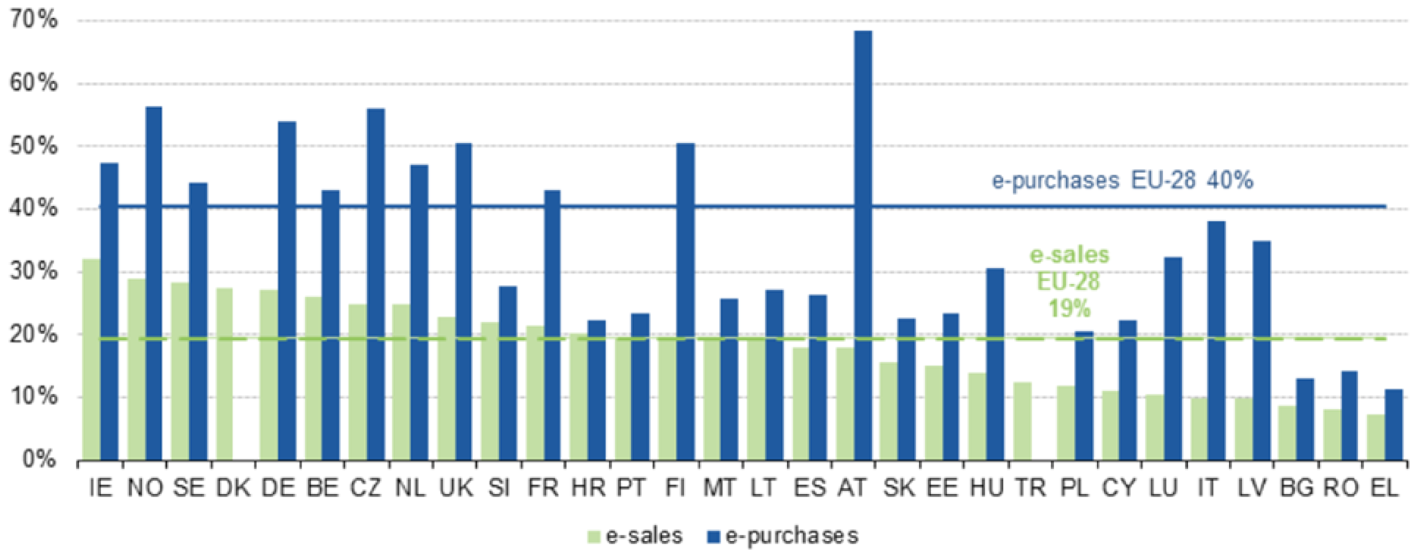


*Table 1.2: E-sales and e-purchases, 2014 (% enterprises)* Source: *Eurostat*

During 2014, among all Member States, the percentage of turnover realised from e-sales ranged to 37 % in Ireland, followed by the Czech Republic (30 %), Finland and Slovakia (both 21 %). The worst performing in turnover realised from e-sales are Greece (1%), Bulgaria (5%) and Cyprus (6%). In Italy the percentage of enterprises making e-purchases is 38% and the percentage of turnover from e-sales is lower than the EU average and equal to 9%.[14]

In 2014, Ecommerce Europe estimates that the incidence over the GDP of business-to-consumer e-commerce is about 2.5%, a percentage that will double on 2016 and triple on 2020.

The number of jobs created directly and indirectly by the B2C e-commerce sector is estimated at nearly 2.5 million in Europe, a figure that will grow with the on-going increase and penetration of the Internet in the European society.
According to data from Ecommerce Europe, the number of B2C websites to have grown to around 715,000 at the end of 2014.[15]

[14] Ibid
[15] E-commerce Europe 2015, "European B2C E-commerce Report 2015",

The European leader in term of B2C e-sales is UK. Its market has a share of almost one third of the entire European e-commerce market. In addition, the share of the UK is more than twice as much as all the other countries outside the top 12 combined.
The share of the top 12 countries in the total European B2C ecommerce (€372.7bn) markets is almost 90%. However, within the top 12 the difference between the top 3 and the rest is also significant. Together, UK, Germany and France account for 60.2%, while the other nine countries combine for 27.6%.[16]

An interesting trend is that the growth rate of the mature markets is levelling off. However, the overall European growth rate is maintained due to the rapid increase of Eastern European e-commerce markets.
As consequence, the share of the three leaders in Europe – the UK, Germany and France – of 60% will gradually decrease to around 55% in 2016. Countries such as Russia, Spain and Italy are still well behind these three leaders, but they will very probably gain some ground and improve their share in the European B2C e-commerce market of goods and services.
Decisive factors for such a growth will be growing confidence in surfing the web and payment methods, higher disposable incomes and a further growth in fast, affordable mobile Internet through smartphones and tablets.[17]

As far as the cross-border e-commerce transactions, it has been estimated that 15% of all individuals in the European Union purchased goods and/or services through the Internet from sellers outside their country of residence, but within the EU28. This represents an increase of 25% compared to 2013. Reasons for purchasing cross-border were a more competitive price or a wider offer of goods and services available.
Cross-border EU purchases by individuals were highest in either smaller member states with a limited domestic market available, such as Luxembourg (65%) and Malta (39%), or in member states with strong geographical and linguistic ties to neighbouring countries such as Austria (40%), Finland (36%), Denmark (36%) and Belgium (34%).
Given the fact that in almost all countries cross border e-commerce grew considerably last year, it is safe to say that cross-border will be one of the major drivers of e-commerce in Europe and around the world.[18]

[16] Ibid
[17] Ibid
[18] Ibid

In spite of the wild growth of e-commerce, many internet users are still sceptical on this kind of commerce, not having bought any item on the web. The reasons are mainly the distrust on payment methods, the inability to physically evaluate the item and the bias over the internet as a shopping tool.[19]

## 1.3 Key features of the digital economy

This paragraph is going to briefly report the key features of the digital economy that are potentially relevant from a tax perspective[20]. They include:

- mobility;
- reliance on data;
- network effect and use of multi-sided business model;
- tendency toward monopoly and oligopoly;
- volatility.

Mobility refers both to intangibles, mobility of users and of business functions. Intangibles are a core component for value creation and business' success for enterprises in the digital economy. In particular, intangibles are often transferred to associated enterprises (called patent or cash boxes) located in tax haven or low-tax jurisdictions in order to minimize the tax burden by shifting profits therein. Mobility of users relates to the increasing ability of users to carry on commercial activities remotely with no consideration to national borders and this could have an impact for VAT purposes.[21] Additionally, digital economy and the widespread information and communication technologies has enabled enterprises to access remote markets and to manage global operations on an integrated basis. Thus, enterprises in the digital economy are able to choose the optimal location, even if that location is not close to the location of their customers.

[19] Valente, Piergiorgio., Ianni, Giampiero., Roccatagliata,Franco., IPSOA., 2015, *Economia digitale e commercio elettronico : fiscalità in Internet nella gestione d'impresa*, Wolters Kluwer, Milanofiori-Assago (Mi)
[20] OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* Organisation for Economic Co-operation and Development
[21] *"A user can reside in one country, purchase an application while staying in a second country, and use the application from a third country".*

Data constitute the lifeblood of the digital economy. Businesses collect data to improve existing products and services, to customize their services and to recommend products to their customers. Data can be licensed to third parties as well.[22] The World Economic Forum estimated that sources such as online or mobile financial transactions, social media traffic and GPS coordinates generate in excess of 2.5 exabytes (billions of Gigabytes) of data daily.

Direct network effects refer to the fact that decisions of users may have a direct impact on the value of a product by other users. Network effects exist whenever compatibility with other users is important, examples are operating system and telecommunications networks like skype, since their attractiveness is boosted based on the number of users using the service.[23] In contrast, indirect network effects exist when one population of users obtains benefits from the size of another population of users.[24] Indirect network effects lead to multi-sided business model that are based on a market where multiple distinct group of users interact through a platform and the decision of each group of users affects the outcome for the other group of users through a positive or negative externality.[25] Examples of a multi-sided business models are online auction platform like Ebay, where more potential buyers attract more sellers to sell goods on the platform as the likelihood to sell their goods increases with the number of potential buyers and competition among buyers for the good will be more intense and, as consequence, auction revenues are likely to be higher.[26] Moreover, a higher number of sellers makes the platform more attractive for potential buyers. This realization is called "Chicken-and-Egg-Problem", where the two sided of the market are interdependent each other and both affect the value of the underlying platform.[27]

Due to the previously discussed network effect and multi-sided business models, together with low incremental costs and the role of intellectual property, enterprises in the digital economy easily achieve a dominant position in very short period of time (*"winner-takes all effect"*). The most successful internet-based companies like Google, Amazon, and Facebook

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[22] Collin, P. & Colin, N. 2013, "Tax Force on Taxation of the Digital Economy",

[23] Katz, M.L. & Shapiro, C. 1985, "Network Externalities, Competition, and Compatibility", *The American Economic Review,* vol. 75, no. 3, pp. 424-440

[24] Expert group on taxation of the digital economy 2014, "Working paper: Digital Economy - Facts and Figures",

[25] OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, Organisation for Economic Co-operation and Development

[26] Haucap, J. & Heimeshoff, U. 2014, "Google, Facebook, Amazon, Ebay: Is the internet driving competition or market monopolization?", *International Economics and Economic Policy,* vol. 11, no. pp 49-61

[27] Caillaud, B. & Jullien, B. 2003, "Chicken & Egg: Competition among Intermediation Service Providers", *The Rand journal of economics,* vol. 34, no. 2, pp. 309-328

are monopolists or highly concentrated. The common feature of those enterprises is that they do not generate content by themselves, but only provide access to different content on the web.[28]

As far as volatility, the lack of barrier to entry for new Internet-based enterprises and the destructive innovative potential in this context, make enterprises in the digital economy with a dominant position, at risk to lose ground in term of market share in short periods of time, after a new player enters into the business arena.

[28] Haucap, J. & Heimeshoff, U. 2014, *Google, Facebook, Amazon, Ebay: Is the internet driving competition or market monopolization?*

# Chapter 2 The Permanent Establishment threshold in the OECD MC

## 2.1 History and rationale of source-based taxation

Before arguing about the concept of permanent establishment, it is worth to begin with a well-defined concept of "source". The country where the business is established is referred to as the "residence state", while the country in which the business conducts its activities and earns its income is usually regarded as the "source state". (Skaar 1991)
Vogel observes that "source" refers to *"a state that in some way or other is linked to the production of the income in question, to the state where value is added to a good"*.[1]
Tough issues could arise in ascertaining the kind of link that is required to establish source. Historical development of the way in which source is defined shows a preference for relying on the concept of "economic allegiance" to establish this connection and determine the source of income. Economic allegiance is based on the factors aimed at measuring the existence and extent of the economic link between a particular state and the income to be taxed. The committee of economists appointed by the League of Nation defined four key factors to establish the economic allegiance:

- Origin of wealth or income
- Situs of wealth of income
- Enforcement of the rights to wealth or income
- Place of residence or domicile of the person entitled to dispose of the wealth or income

Among those factors, the committee concluded that the greatest weight should be given to "the origin of the wealth and the residence or domicile of the owner who consumes the wealth".
This historical background is a key factor because on the basis of this early work, the League of Nations developed a series of model conventions that reflect the economists definition of source.[2]

[1] Vogel, K. 1991, *Klaus Vogel on double taxation conventions,* Kluwer law and taxation, Deventer Boston

After WWI governments were in dire need of revenue to rebuild their economies, they began to try to tax the incomes of the visiting businessman and the profits of the foreign enterprise on good sold through him, leading to international juridical double taxation[3].
In the 1920's, the League of Nations dealt with double taxation of non-resident enterprises' business profits. Reports submitted to the League of Nations in 1923 and 1925 underlined the need for mechanisms against double taxation. In 1927 and 1928, the League of Nations introduced the concept of Permanent Establishment as a means of distributing taxing rights among residence and source states.
The work of the League of Nations has been continued under the patronage of the OECD, which has included the present formulation of PE in the OECD Model Tax Convention (OECD MC).
The 1963 OECD MC represents an important breakthrough for uniform bilateral treaties. The model was updated in 1977 and in 1992, though the definition of PE has kept the same.

The OECD model is constituted by 28 articles, pooled in seven chapters, which arrange in detailed manner the provisions for allocating taxing jurisdiction. A brief presentation is shown below:

- ✓ I and II: these chapters contains the scope of the convention;
- ✓ III: it provides the limiting rules regarding income taxation;
- ✓ IV: it introduces the limiting rules regarding capital taxation;
- ✓ V: this chapter describes the two reliefs mechanisms for preventing double taxation (credit and exemption methods)
- ✓ VI: it contains special provisions like non-discrimination, mutual agreement procedure, exchange of information and assistance in the collection of taxes;
- ✓ VII: this last chapter deals with entry into force and termination.

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[2] Pinto, Dale.,International Bureau of Fiscal Documentation., 2003, *E-commerce and source-based income taxation,* IBFD, Amsterdam

[3] Juridical double taxation is the imposition of comparable taxes in two (or more) countries on the same taxpayer in respect of the same income. Double taxation is considered a distortion of efficient (In Pareto efficiency terms) allocation of resources and thus, it has harmful effects on the international exchange of goods and services and cross-border movements of capital, technology and persons. (Organisation for Economic Co-operation and Development,, 2014)

OECD MC represents a kind of "orientation" to the decisions of contracting states. Such orientation is not binding, meaning that it does not force the states to comply with the provisions of the model, for this reason it is not a source of international law. (Ripa 2004)

## 2.2 Legislative framework defining source jurisdiction

Definition of source may be found in a country's domestic legislation and in the treaty laws, their combination provides the rules commonly referred to as the body of "international tax law".[4]
For the purpose of the thesis, the domestic law implications of any particular country will not be examined in any detail, though Italian Tax Code provisions on source-based taxation will be briefly introduced later on.

In considering how source is defined in treaty law, reference needs to be made to bilateral, multilateral treaties and trade agreements. Most countries of the world have signed bilateral treaties with their trade partners and nowadays there are more than 1,500 agreements in force.[5] The majority of these treaties (commonly known as double tax agreements (DTA)) are based on the OECD MC and its commentary, this model will be used to illustrate treaty considerations as it represents one of the most important framework in international tax law.
The first goal of DTAs is to avoid double taxation in cross-border transactions and to prevent fiscal evasion. DTAs delineate agreed upon rules of taxation by distributing taxing rights over income between the signing parties and by requiring the "residence" country to provide relief from double taxation for any "source" taxation that is levied in accordance with the treaty's provisions. Relief mechanisms are granted through foreign tax credit or through exemption of foreign income from tax.[6] In practice, many jurisdiction use a mixture of these approaches, i.e. exemption methods for income attributable to a PE, credit method for categories of income subject to withholding.

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[4] *"There is no such thing as international tax law, although this term is used generally to encompass all sources and aspects of taxation that have international implications"*. (Doernberg 2001)
[5] Pinto, Dale.,International Bureau of Fiscal Documentation., 2003, *E-commerce and source-based income taxation*, IBFD, Amsterdam
[6] Foreign tax credits are usually limited to the amount of domestic tax that would have been due on the foreign-source income earned in the taxpayer's country of residence (no-refunding allowed)

Distributing rules contained in DTAs not only serve to allocate different categories of income to residence and source jurisdictions, but they often provide the tax treatment relating to the category of income concerned. Under these rules, there are two main categories of income where the source is defined differently. The first concerns active business income derived by non-residents. Active business income includes independent service income and income from business activities carried out in the source state through a physical presence (permanent establishment) or via a representative presence (agency PE). In both cases, active business income is subject to full taxation by the source country with deduction allowed for expenses associated with the activity carried out through the PE.

The PE concept acts as a threshold which, by measuring the level of economic presence of a non-resident enterprise in a given country through objective criteria, defines the circumstances in which the foreign entity can be considered sufficiently connected into the economy of a state to justify taxation in that state.[7]

Given this integration in the source country's economy and participation in the life of source country's economy, the rationale for source country taxation could be justified with the benefit theory.[8]

Under the benefit theory, taxes are considered as the price paid for all public services and countries obtain their jurisdiction to tax based on services and benefits provided (Pinto 2006). In other words, the benefit criterion provides that a state has the right to tax resident and non-resident corporations which get a benefit from the services it provides. These benefit can have a specific or general nature. In terms of general benefits, education, police, fire and defence protection are obvious examples. However, there are more specific benefits like conducive and operational legal infrastructure for the proper functioning of business, stable legal and regulatory environment, protection of intellectual property rights and knowledge-based capital, enforcement of consumer protection laws, well-developed transportation, telecommunication, utilities and other infrastructure.[9]

The second categories involves passive non-business income (dividends, interests and royalties) that may be earned from source countries without any personal contact in the sense of physical or representative presence in the source jurisdiction. In this case, the residence of

[7] Holmes, K.J. 2007, *International tax policy and double tax treaties : an introduction to principles and application,* IBFD, Amsterdam

[8] Pinto, Dale.,International Bureau of Fiscal Documentation., 2003, *E-commerce and source-based income taxation*, IBFD, Amsterdam

[9] Ibid

the payer determines the source of dividends, royalties and interests under tax treaty provisions.[10] In the case of outbound payments of dividends, interests and royalties, generally countries impose tax on a gross basis (not reduced by the deduction of expenses) by means of a withholding tax. Bilateral tax treaties usually specify a maximum withholding rate applicable by the source country, with the residual right to tax belonging to the country of residence (OECD 2014).

The lower tax rate applied to these incomes (compared with tax rate on business profits) reflects the fact that territorial connection for an active business within jurisdiction is more significant than the territorial link required for passive income.[11] Moreover, a low withholding rate on gross income is justifiable considering that gross-based withholding taxes lead to high rates of tax on net income.

As far as Italian Tax Code definition of permanent establishment can be found in article 162 of TUIR (testo unico delle imposte sui redditi). The domestic definition parallels the concept of permanent establishment (PE) as defined under tax treaties (OECD MC). The domestic definition is applied only for those cases in which the foreign enterprise is resident in a state that has not signed any DTA with Italy. In case of conflict between domestic definition and treaty definition of permanent establishment, the treaty definition prevails over the domestic one as granted by Italian Constitution.[12] Only in the situation in which the domestic provisions lead to a more favorable treatment of the nonresident taxpayer compared with treaty provisions, the domestic regulations will prevail over treaty.[13] Treaties can only limiting the efficacy over domestic legislation and they cannot create new tax obligations not in force in domestic law of the contracting states.[14]

The practicality of article 169 TUIR is concrete since the differences in the domestic definition of positive and negative lists, minimum time limit for the construction sites and the marine agent (in agency PE contest).[15]

[10] See article 10 (Dividends), 11 (interests) and 12 (Royalties) of the OECD MC

[11] Pinto, Dale.,International Bureau of Fiscal Documentation., 2003, *E-commerce and source-based income taxation,* IBFD, Amsterdam

[12] See article 10 of Italian Constitution

[13] See article 169 Italian tax code (TUIR)

[14] Viviano, M.R. 2007, *La stabile organizzazione del non residente in Italia,* Jovene, Napoli

[15] Ripa, G. 2004, *La stabile organizzazione delle imprese,* CEDAM, Padova

## 2.3 Permanent Establishment definition under the OECD MC

The permanent establishment is defined by article 5 of the OECD MC as "*a fixed place of business through which the business of an enterprise is wholly or partly carried on*".
The existence of a PE is the minimum threshold required for a source-country to tax nonresident enterprises' profits derived from sources in that jurisdiction where the business is carried on. PE is often referred to as the "legal fiction" by way of which a country can widen its capacity to tax over a foreign nonresident entity where no other links to the territory of the jurisdiction is provided.[16]
If a multinational company incorporates a subsidiary in another jurisdiction, the subsidiary is treated as separate legal entity that is liable to tax as a resident of that state. But if the business entity is not a resident of the jurisdiction in which it is located, that state may not levy taxes on its profits unless those profits can be attributed to a PE located therein (art. 7 OECD MC). The relevance of a PE is that, it enables the source-country to tax business profits, notwithstanding the fact that the PE is not a separate legal entity.[17]

The definition of the first paragraph of article 5, known as the "*basic rule*", represents the general criterion for the purpose to identify a physical permanent establishment; paragraphs 2 and 4 better define the case in which a PE is deemed to exist by providing a positive and a negative list.
The doctrine and the commentary defines objective, subjective and functional requirements to get a PE.

### 2.3.1 Objective presence

The two tests of the objective presence of the taxpayer are the *place of business test* and the *location test*.

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[16] Singh, M.K. 2014, "Taxing E-Commerce on the Basis of Permanent Establishment: Critical Evaluation", *Intertax,* vol. 42, no. 5, pp. 325-333
[17] Skaar, A.A. 1991, *Permanent establishment : erosion of a tax treaty principle,* Kluwer Law and Taxation Publishers, Deventer; Boston

The place of business test identifies the criteria to locate the place in which the nonresident taxpayer's activity is carried on. The commentary suggests that the focus of enquiry is on tangible assets used to carry on the business.[18] The place of business covers any premises, facilities or installations used for carrying on the business of the enterprise in whole or in part, that are economically suited to serve as the basis for a business activity.[19] The presence of premises is not a necessary condition, since a certain amount of space at disposal is enough to have a place of business. The commentary adds that a place of business can be constituted even in the business facility of another enterprise.

The location test requires the existence of a link between the place of business and a specific geographical spot, but the place of business does not need to be physically fixed to the soil on which it stands. The fixedness requirement does however not mean that the relevant equipment cannot be removed.[20] The commentary requires only that "in the normal way" there has to be a link to the ground, but those words are not further explained by the OECD, so for certain business activities the location requirement may be interpreted extensively.
However, the commentary also writes in the same paragraph that "it immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place", implying that a distinct place (not necessarily a fixed one) must exist.
In particular, the commentary suggests that the nature of the business activity should be taken into account and the location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to the business.[21]
Following the example of paragraph 5.2 of the commentary, the geographical and commercial coherence requirements are met when the locations are neighboring and the same business activities are carried on in those areas. Any geographical area which economically and commercially constitutes a unit may be considered as a fixed place of business even if the activities move around a certain district and without staying fixed in a place for a specified period of time.[22]
In conclusion, a sufficient spatial delimitation would be enough to obtain a fixed place of business.

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[18] See commentary on article 5 of Model Convention, paragraph 4
[19] Skaar, A.A. 2000, "Erosion of the concept of permanent establishment: electronic commerce", *Intertax,* vol. 28, no. 5, pp. 188-194
[20] Schaffner, J. 2013, "The territorial link as a condition to create a permanent establishment", *Intertax,* vol. 41, no. 12, pp. 638-651
[21] See commentary on article 5 of Model Convention, paragraph 5.1
[22] Skaar, A.A. 1991, *Permanent establishment : erosion of a tax treaty principle*, Kluwer Law and Taxation Publishers, Deventer; Boston

### 2.3.2 Subjective presence

The subjective presence refers to the relation between the fixed place of business and the non-resident entity. The two test of subjective presence are the *right of use test* and the *permanence test.*

The right of use test refers to the provision of the OECD commentary requiring that the place of business has to be “at disposal” of the enterprise.[23] The commentary makes also clear that the mere existence of a fixed place of business is not sufficient to constitute a PE, but the non-resident taxpayer must have the place at its disposal. The term “disposal” means that the taxpayer cannot be excluded or restricted from using the permanent establishment, except under extraordinary circumstances.[24]

It is not necessary that the enterprise has a formal right (legal right acquired by law, contract or other lawful formalised agreement and whether in form of ownership, lease, deposit, pledge or other) to use the place. The commentary explicitly states that there is no need for that and even illegal occupation may lead to a PE, under the condition that the illegal occupation is tolerated by the authorities or has not yet been discovered by them. On the other hand, the simple presence of an enterprise at a particular location is not sufficient to meet the disposal threshold, as provided by the examples in the commentary.[25]

The other subjective condition for PE is the permanence test, which in the OECD language is included in the requirement of *fixed* place of business.

Permanence does not mean that the right of use to the place of business must be perpetual or everlasting, rather it should be interpreted as continuing indefinitely and of a lasting kind. The word “permanence” does not apply to the place of business as such, but it refers to the business exercised through it.

The concept of permanence shall be opposed to something which is only temporary.

To make a distinction between “temporary” and “permanent”, the intention and of the non-resident entity should be taken into account. If the enterprise plans to exercise its operations through the fixed place of business for an indefinite period, a PE exists even if *de facto* the intentions are not realised. In the event in which the taxpayer was going to use a place of

[23] See commentary on article 5 of Model Convention, paragraphs 4-4.1

[24] Schaffner, J. 2013, *The territorial link as a condition to create a permanent establishment*, Kluwer Law International

[25] See commentary on article 5 of Model Convention, paragraphs 4.2-4.5

business for a short period of time, but for some reasons the usage has lasted over time, a PE is established retroactively (effective criterion)
The commentary on paragraph 6 suggests a 6 months “duration test” as proxy to determine whether the permanence requirement is met, since that time limit is generally applied by many contracting states.
The time limits starts running from the day in which the place of business is at the taxpayer’s disposal. The PE ceases to exist when the taxpayer’s disposal over the place of business for business purposes is terminated.
The exception to the general rule is where a particular place of business is used for only very short period of time, but such usage takes place regularly over long periods of time (seasonal use); in such cases, each period of time during which the place is used has to be considered in combination with the number of time during which the place is used.[26]

### 2.3.3 Functional criteria

The functional criteria defines the connection within the fixed place of business and the business activities carried on.
The mere ownership of a physical object is not enough for the constitution of a PE. Only a physical object that serves a business activity may create a PE.
The business connection test expressly requires that the business activity of the enterprise must be connected to the place of business. However, the attraction approach accepts that a PE could exist even though the place of business only supports a core business activity performed outside the place of business, provided that the core business is carried on within the same jurisdiction. Under this approach, the activity conducted through the place of business may also be an auxiliary one.[27]
There is no requirement that the PE’s business overlaps the entire business of the parent company, since it can realize a single activity, specific function or replicate the same activity of the parent company.

[26] See commentary on article 5 of Model Convention, paragraphs 6-6.1
[27] Skaar, A.A. 2000, *Erosion of the concept of permanent establishment: electronic commerce*, Kluwer Law International

Secondly, the wording of "carry on" suggests continuity and regularity. So, only income derived from business activities can be the basis for the existence of a PE. Other income generating activities (dividends, royalties and interests) fall outside the purpose of article 7 of the OECD MC and cannot be the primary reason for establishing a PE.

The *productive character* of the establishment was required until the UN MC of 1946, since it was useful to identify which activities were able to produce income by themselves, in order to constitute a PE. With the introduction of the 1963 OECD MC, the productive character was omitted from article 5, on the assumption that each part of an enterprise contributes to the productivity as a whole.[28] The UN MC of 1946 was based on the idea that place of business with no productive nature and having no precise link with profits should not constitute a PE.
Accordingly, the new concept of place of business may lead to a PE even if activities have mainly or nothing but expenditures.
The new OECD and UN MC deal with the problem of excluding such activities, by proving a precise negative list in the article defining the PE.

## 2.4 Positive list

Paragraph two of article 5 contains a list of examples each of which can be regarded, prima facie, as constituting a permanent establishment. This list is known as positive list in contrast of the negative list provided by paragraph 4. Article 12 of the commentary states that this list is by no means exhaustive and the examples are to be seen against the basic rule given by paragraph 1. Therefore, the examples reported by the list may constitute a PE only if they meet the requirements of paragraph 1.
Nevertheless, Italy did not accepted such interpretation by making an observation to model treaty, with whom Italy states its opposition to paragraph 12 of the commentary and applying the same framework of the commentary of 1963. Such an observation leads to consider the examples provided by paragraph 2 "absolute hypothesis" for the purpose of Italian tax treaties.
Below, the single elements of the list will be briefly analyzed.

[28] See commentary on article 5 of Model Convention, paragraph 3

*a) Place of management*

The commentary does not provide a definition of place of management, but simply states that the term “place of management” has mentioned separately because it is not necessary an office. The place of management should be interpreted as the place where decisions are undertaken limited to a certain geographic area. Moreover, the place of management is the place in which decisions undertaken affect the business activity and those decisions can relate one or more branches, so the enterprise could potentially have many places of management located in different locations with even different area of expertise (finance, operations, distribution).

The place of management is different from the “place of effective management”.

The place of effective management is one of the tie-breaker rule provided by article 4 of the OECD MC in the case of double residence of legal persons. The place of effective management is the place in which all the most important decisions are undertaken for the company as whole. In the case in which the functions carried out by the place of management would affect the whole business of the organization, such organization would be deemed to be a resident of that state, and as consequence, the entity will be taxed on the worldwide income therein.

*b) Branch*

The branch is, basically, a secondary seat of a company. The branch has the power to represent the nonresident enterprise, it acts with a certain degree of autonomy limited locally and functionally, in order to determine the “dependence link” with the principal organization.

Concluding, the branch has a certain independence both commercially and economically, in carrying on its activities for the principal and those activities are not within the meaning of merely preparatory and auxiliary character.[29]

*c) Office*

The office represents a broad category, since its definition depends on the functions carried on within the organization. In some circumstances can coincide with the notion of “branch” and

[29] Vogel, K. 1991, *Klaus Vogel on double taxation conventions*, Kluwer law and taxation, Deventer Boston

"place of management". The office is the business unit in charge of administrative aspects of the enterprise.
As for the previous categories, it's necessary to evaluate whether the activity carried on through the office are within the negative list of paragraph 4 (purpose of storage, display, delivery, purchasing of goods or merchandise or of collecting information, any other activity of a preparatory or auxiliary character), in those cases the office is not considered a PE of the non-resident enterprise.

*d) Factory and workshop*

The factory is the place in which the production takes place. In particular, for factory you mean any industrial plant in which operations of manufacturing, assembling, reparation and maintenance occur.
The workshop is an equipped place to carry out experimental, technical or productive activities or scientific researches. In these case as well, the activities carried out have to have a productive link, so when the workshop is employed solely for scientific research, no PE exists.

*e) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources*

A mine, an oil or gas well, a quarry or any other place of extraction of natural resources can constitute a PE. Paragraph 14 of the commentary states that "any other place of extraction" should be interpreted broadly.[30]
Floating platforms anchor on sea bottom for the extraction of oil or natural gas represent fixed installations with a precise location, so unless such premises are of temporary nature, a PE is deemed to exist.
This subparagraph refers only to the extraction of natural resources, but does not mention the exploration of such resources. This is because of the lack of any common view (in the OECD assembly) on the allocation of taxing rights among countries and on the qualification of income arising from exploration activities.

[30] It includes, for example, all places of extraction of hydrocarbons whether on or off-shore.

The commentary suggests that in the case of exploration activities, the question whether these activities are carried on through a permanent establishment is governed by paragraph 1; nevertheless, the Contracting States may introduce a specific provision in their treaties.[31]

### *f) Construction PE*

According to the third paragraph of article 5 of the Model Convention, *a building site or a construction or installation project constitutes a permanent establishment only if it lasts for more than twelve months*.

The key point of this paragraph is the duration of the construction, which has to exceed twelve months, therefore when the time limit is not reached, no construction PE may exist.

In this contest, the various criteria to create a physical PE are adapted here, in particular, the so called "permanence test" is overcome by the introduction of minimum time limit and it represents a waiver of the basic rule provided by paragraph 1.[32]

Building site and construction or installation project include construction of buildings, roads, bridges, canals, the laying of pipelines and excavating and dredging. Restoration works falls in this category, unless they are ordinary maintenance or redecoration projects.

The "term installation project" is not restricted to an installation related to a construction project, but includes installations of complex machinery and equipment in an existing building outdoors.[33]

The time limit applies to each individual site or project. In determining the time span, no account should be taken of time previously spent by the contractor concerned on other sites or projects, which are not linked to each other. The construction site should be considered as a single unit even if it is based on several contacts, provided that it constitutes a coherent whole "commercially and geographically".[34]

In order to define the time span of the building site, you need to know when it start and when it cease to exist. The commentary states that a site exists from the date on which the

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[31] See commentary on article 5 of Model Convention, paragraph 15. "They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State: a) shall be deemed not to have a permanent establishment in that other State; or b) shall be deemed to carry on such activities through a permanent establishment in that other State; or c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time."

[32] Schaffner, J. 2013, *The territorial link as a condition to create a permanent establishment*, Kluwer Law International

[33] See commentary on article 5 of Model Convention, paragraph 17

[34] See commentary on article 5 of Model Convention, paragraph 18

contractor begin his work (inducing any preparatory work) in the country where the construction is to be established, for example, when the enterprise settles a bar, a crane, a planning office. It cease to exist when the work is completed or permanently abandoned.
Vogel suggests that the end of the existence of a building site has to be evaluated applying the same criteria that rule the creation of building site, so the time needed to test the project has to be included in the count.[35]
A site does not cease to exist when work is temporarily discontinued, therefore any interruption due to bad weather or shortage of materials or employees should be included in determining the life of a site.[36]
In the contest of a building site where the enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts part of the project to third enterprises (subcontractors), the period of time spent by subcontractors working on the project must be considered in the count as being spent by the first enterprise.
The subcontractors themselves have a PE at the site if their activities last more than twelve months.[37]
A site, for its particular nature, may require that the activity has to be relocated continuously or in consideration of the project's progression. The activities performed at each particular location are part of a single unit and, as consequence, the life of the project must be derived considering it as a whole. This is the case of sites for the construction of roads and canals.[38]

## 2.5 Negative list

Paragraph 4 of article 5 includes a list of examples that are exceptions to the general definition laid down in paragraph 1 and which are not deemed to be permanent establishments, even if the activity is carried on through a fixed place of business. Thus, the provisions of this paragraph are designed to prevent an enterprise of one state from being

[35] Vogel, K. 1991, *Klaus Vogel on double taxation conventions*, Kluwer law and taxation, Deventer Boston
[36] See commentary on article 5 of Model Convention, paragraph 19. Thus, for example, if a contractor started work on a road on 1 May, stopped on 1 November because of bad weather conditions or a lack of materials but resumed work on 1 February the following year, completing the road on 1 June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1 May) and the date he finally finished (1 June of the following year).
[37] See commentary on article 5 of Model Convention, paragraph 19.
[38] See commentary on article 5 of Model Convention, paragraph 20.

taxed in the other state, if it carries on activities of a merely preparatory or auxiliary character.[39]

The reasons for the exclusion are both of economic and practice nature, since they are preparatory/auxiliary activities that even if they contribute to the value creation, the services they perform are remote from the actual realization of profits and those profits are hard to allocate to the fixed place of business in question.[40]

The single elements of the lists are shown below.

*a) The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise*

A PE does not exist in the case the place of business is used solely for the purpose of storage, display or delivery of goods and merchandise, thus not for selling activities.

In particular, the display consists in placing the products of the non-resident enterprise in a fixed location, with the only purpose of advertising, as it happens in a showroom. Nevertheless, if in the same location, the non-resident enterprise collects orders from customers, the negative provisions do not hold good.

In the case of after-sale assistance, where the enterprise maintains a fixed place of business for the supply of spare components to customers for machinery previously sold, moreover, it maintains or repairs such machinery, a PE could be constituted. After-sale organizations carry out an essential and significant part of the services of an enterprise and their activities are not merely auxiliary ones.[41]

*b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery*

This subparagraph differs from the previous one since it does not require the "use of facilities". It applies, for example, to the case of a warehouse in which goods are stored together with those of other enterprises (for the purpose of storage, display or delivery).

*c) The maintenance of a stock of goods or merchandise belonging to the enterprise*

[39] See commentary on article 5 of Model Convention, paragraph 21

[40] Ripa, G. 2004, *La stabile organizzazione delle imprese*, CEDAM, Padova

[41] See commentary on article 5 of Model Convention, paragraph 25

*solely for the purpose of processing by another enterprise*

It covers the case in which a stock of goods or merchandise belonging to the non-resident enterprise is processed by a second enterprise, on behalf of, or for the account of, the previous enterprise.[42]

*d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise*

The key element to take into account is not the final destination of the goods bought by the non-resident entity, but circumstance that the place of business is involved only in the purchasing activity. As for the collection of information, it requires that information are simply collected and not re-elaborated, such transformation would lead to a PE.[43]

*e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character*

This subparagraph provides a generalized exemption to the general definition of paragraph 1. It makes unnecessary to produce an exhaustive list of exemptions, which would have been too long and uselessly strict. It enables to exclude the PE status to a wide range of form of business, which are carried on trough a fixed place of business.[44]

*f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*

The first requirement of this last subparagraph consists in the "uniqueness" of the place of business where the combined activities (subparagraph a to e) are carried on.

[42] See commentary on article 5 of Model Convention, paragraph 22

[43] See commentary on article 5 of Model Convention, paragraph 22 d) is intended to include the case of the newspaper bureau which has no purpose other than to act as one many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".

[44] See commentary on article 5 of Model Convention, paragraph 23 Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

In the case in which, the non-resident enterprise avails itself of several fixed places of business, each one must be considered separately and in isolation to evaluate whether a PE exists. The only exception provided by the commentary is when the places of business are not separable from each other locally and organisationally.[45]

The second requirement states that all the activities carried on by the place of business are within the meaning of subparagraph a) to e).

Going back to the general rule, the commentary provides two basic criteria to determine whether the activities carried on by the place of business are of auxiliary or preparatory nature.

The decisive criterion is whether or not the activity of the fixed place of business forms an essential and significant part of the activity of the parent company.

The evaluation has to keep into account the qualitative aspect (essential), relative to the nature of the activity carried on by the agent, and of the quantitative aspect (significant), attaining to the importance of the activity carried on compared to the business as whole of the parent company (Viviano 2007).

The second criteria consists in the ability to generate an independent and direct profit for the service they perform. Nevertheless, each individual case will have to be evaluated on its own merit.

The benefit of exclusion of a PE (for auxiliary and preparatory activities) is conferred only if such activities are carried on only for the purpose to serve parent company's needs: in the case such exclusivity does not hold, even in the hypothesis in which the beneficiaries of the service are companies of the same group, the activities of the fixed place of business do not fall within the exemption provisions and, as consequences, a PE is deemed to exist.

A fixed place of business used both for activities of auxiliary nature and for other activities able to constitute a permanent establishment, these latter prevail on the former.

[45] See commentary on article 5 of Model Convention, paragraph 27.1 Places of business are not "separated organisationally" where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc.

## 2.6 Permanent establishment by agency

The second way in which a permanent establishment may be created is when a nonresident enterprise carries out its business activity in a foreign country through an agent who acts on behalf of the company. Thus, the agency clause represents an enlargement of the scope of the PE criterion, meaning that a PE risk should be analyzed under both fixed place of business test and under the agency test.[46] These two PE forms are treated in the same way (for fiscal purposes) in order to keep the choice of the manner to operate in a foreign country neutral. In this way, there are not disparities in the tax treatment of formally different situations with the same economic relevance.
Paragraphs 5 and 6 of art. 5 of the OECD MC deal with agency PE, respectively with the concepts of “dependent agent” and “independent agent”.

### 2.6.1 Dependent agent

Art. 5(5) states as follow:

*“Notwithstanding the provisions of paragraphs 1 and 2, 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, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.”*

Paragraph above-quoted is a product of the fusion of juridical terms of common law and civil law translated for the purpose of the convection. This has been a source of issues since the different meaning of the concept of agency in the two legal frameworks. In both civil law and common law, the results of agent’s activities affect the principal, nevertheless, the way in which the result is reached differs depending on the legal system.

[46] Persico, G. 2000, "agency Permanent Establishment under article 5 of the OECd Model Convention", *Intertax,* vol. 28, no. 2, pp. 66-81

In the civil law countries, there are two kind of representation:

- Direct representation: the agent acts in the name of the principal and the principal is bound to the third party;
- Indirect representation: the agent acts in his own name, binding himself to the third party. The agent is then obliged to transfer to the principal the legal rights and obligations arising from his activity.

In the common law, by contrast, there is not such a difference. There is just a single rule, where the activity of the agent acting on behalf of a principal binds the principal to third parties, no matter if the agent acted in his own name or in the name of the principal. So the expression on paragraph 5 stating "acting in the name of" is, for common law countries, meaningless and irrelevant.[47]

The commentary, for the sake of clarity, states that the paragraph applies equally to an agent who concludes contracts which are binding on the principal even if those contract are not in his own name.[48]

The commentary doesn't focus on the specific juridical minor detail of the law system, but prefer to determine the existence of an agency PE based on the analysis of the legal and economic relationship between agent and enterprise (principal).[49]

The aforementioned paragraph 5 sets up 3 requirements for defining the "dependent agent" and as consequence to deem the existence of an agency PE:

- being a person;
- having the authority to conclude contracts in the foreign state in the name of the enterprise;
- habitually exercise such authority.

The agent must be a person, as described by article 3[50] of the convention.

The dependence of the agent may be both legal and commercial, so it's not a requirement for the agent being an employee of the enterprise and no relevance has the underlying labor link.

In order to constitute an agency PE, the agent must have the authority to conclude contracts on behalf of the principal. The mere negotiations of contracts to be approved from abroad do

[47] Persico, G. 2000, "agency Permanent Establishment under article 5 of the OECd Model Convention", *Intertax,* vol. 28, no. 2, pp. 66-81

[48] See commentary on article 5 of Model Convention, paragraph 32.2

[49] See commentary on article 5 of Model Convention, paragraphs 32-38

[50] The term "person" includes an individual, a company and any other body of persons.

not constitute an agency PE. Moreover, the agent must act in a way binding upon the principal and is doing so with respect to the business proper of the principal.[51]
As far as the habitual exercise, it means that the authority to conclude contracts should be more than transitory. The habitual exercise should be understood as a requirement of regularity or frequency.[52]
Notwithstanding, an individual judgment is necessary to take into account commercial practices and differences in industries.
The case of mere reiteration of a contract does not mean that the agent is exercising his power of attorney and the habitual exercise requirement would not be met.[53]

In the commentary can be found an anti-avoidance provision stating that a PE is deemed to exist in the case the agent has the authority to negotiate all details of the contract in manner which is binding on the principal, even if the signing is performed by someone else abroad.[54]
In the case in which the nonresident enterprise avails itself of a PE (as defined by paragraph 1 and 2), the agency PE is absorbed by “fixed place of business”, revealing its predominance.[55]

### 2.6.2 Independent agent

The independent agent status is governed by paragraph 6 of art.5. In particular, the commentary[56] states that a person will not constitute a PE of the enterprise on whose behalf he acts only if:

- he is independent from the enterprise both legally and economically,
- he acts in the ordinary course of his business

[51] Skaar, A.A.: Erosion of the Concept of Permanent Establishment: Electronic Commerce. Intertax, vol. 28, no. 5 (2000), p. 194
[52] Hence, an agent who is active on behalf of the principal for two years without habitually making use of his power of attorney, does not constitute a PE, although he has been authorized to conclude contracts for the principal for a sufficiently long period of time. Another agent may be authorized to conclude contracts for a few months and may be exercising the authority frequently. Such an agent will not constitute an agency PE because the permanence test is not met. Skaar, A.A.: Erosion of the Concept of Permanent Establishment: Electronic Commerce. Intertax, vol. 28, no. 5 (2000), p. 194.
[53] Ibid
[54] See commentary on article 5 of Model Convention, paragraph 33. “A person who is authorized to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority “in that state”, even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation.”
[55] See commentary on article 5 of Model Convention, paragraph 35
[56] See commentary on article 5 of Model Convention, paragraph 37

These two conditions must be verified jointly to prove the independence status of the agent.
With respect to the legal independence, it's necessary to evaluate the underlying contract in force within the agent and the principal, since there shouldn't be any limitations, constraint or detailed instructions required and the discretionary of the power of attorney shouldn't be limited.
Any interference of the principal in terms of authorization necessary to execute tasks, making inspections and levy fines may indicate whether or not the agent is independent in terms of agency clause.[57]
As for the commercial independence, the agent must sustain its own entrepreneurial risk and the remuneration must be consistent with that risk and with his working skills. Any principal support of agent's business (coverage of expenses, guarantees for the agent's liabilities, predetermined wage, sharing of risk) are elements that potentially exclude the independent status.
Another indicia of lack of independence is when the enterprise is the only principal of the agent. Nevertheless, the commentary states that this fact is not by itself determinative, since all facts and circumstances must be taken into account (risk undertaken, reward, skills…).[58]
The second requirement consists that the agent has to "act in the ordinary course of its business".
Acting in the ordinary course of his business means that the independent agent shouldn't perform activities which, economically, belong to the sphere of the enterprise rather than to that of his own business operations. In particular, when a commission agent[59] concludes contracts in the name of the principal, he exceeds the threshold of ordinary course of its business, thus establishing a PE.[60] The commentary reports as example "*a commission agent that not only sells the goods of the enterprise in his own name, but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts*".[61]

[57] See commentary on article 5 of Model Convention, paragraph 38.3
[58] See commentary on article 5 of Model Convention, paragraph 38.6
[59] Reference is made here to the civil law commissionaire, who concludes contracts in his own name. The commentary appears to be the result of a compromise between common law and civil law approach.
[60] Persico, G. 2000, "agency Permanent Establishment under article 5 of the OECd Model Convention", *Intertax,* vol. 28, no. 2, pp. 66-81
[61] See commentary on article 5 of Model Convention, paragraph 38.7

## 2.7 Current PE requirement in the digital economy: Server as PE

The notion of PE defines the physical connection of the foreign enterprise with the territory of the source-state and such element entitles the source-state with the power to tax those earnings arising from the local "fixed place of business".

Nowadays, the globalization and characteristics of e-commerce allow to easily overcome national borders and the typical concepts of traditional economy: the territoriality and the physical presence.

These elements have eroded the traditional concept of both residence and PE by making hard to detect where effectively the business is run and, as consequence, where to tax the income produced.

To deal with such an issue, the concept of PE has been adapted to the digital era by introducing new provisions tailored for the e-commerce.

The commentary of article 5 of the OECD Model Tax Convection has been modified in the 2000 introducing ten new paragraphs related to electronic commerce describing when a PE exists in such a contest. The choice to work on the commentary was judged as preferable since it let to introduce substantial amendments without the burden of modifying the existing treaty network with consequences in terms of time to renegotiate and potential inconsistencies.[62]

The OECD's Committee on Fiscal Affairs (CFA) focused specifically on three points:

- Web site
- Web server and human presence
- The role of the Internet Service Provider (ISP)

The Web site can't deemed to be a PE since it cannot constitute itself a "place of business" as there is no tangible element[63]. The possibility of an agency PE is also excluded in the case the web site is equipped with a software able to conclude contracts, since the web site can't be identified as a "Person" provided for by art. 3 of OECD MC.[64]

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[62] Carlo Garbarino 2009, "Stabile organizzazione (nel diritto tributario)", *Gruppo Wolters Kluwer,*

[63] See commentary on article 5 of Model Convention, paragraph 42.2

[64] See commentary on article 5 of Model Convention, paragraph 42.10

On the contrary, a server, as physical object potentially suited to serve as the basis for a business activity can represent a "place of business"[65]. The principle stated by the OECD, in fact, is that a server[66] is deemed to be, if some requirements are met, a PE of the nonresident taxpayer, thus the profits generated by it are taxable in the country where the server is located (the source state), in the light of the rule set forth by article 7(1) of the MC[67].
In particular, a server must be fixed[68], at disposal[69] of the non-resident enterprise and the tasks carried out through the server have to be significant and essential to the business activity and not mere preparatory or auxiliary. In order to constitute a permanent establishment no human intervention is required.[70]
As auxiliary activities, you make reference to the negative provisions covered by paragraph 4 previously explained. Paragraph 42.7 of the OECD commentary lists some examples related to e-commerce:

1. providing a communications link;
2. advertising of goods or services;
3. relaying information through a mirror server for security and efficiency purposes;
4. gathering market data for the enterprise;
5. supplying information.[71]

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[65] Skaar, A.A. 2000, Erosion of the concept of permanent establishment: electronic commerce, Kluwer Law International

[66] "The server is a physical object. If it is substantial it may qualify as PE-constituting 'machinery or equipment'. Substantial in this respect would be all computers that are not portable or otherwise easy to carry away by hand. Thus, portable equipment does not qualify as a 'place of business'. However, even if the server is not considered to be a PE-constituting place of business, the room or office in which the server is located would qualify for this purpose." Skaar, A.A.: Erosion of the Concept of Permanent Establishment: Electronic Commerce. Intertax, vol. 28, no. 5 (2000), p. 189.

[67] "The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."

[68] Pursuant to paragraph 42.4 of the Commentary on Article 5 of the Model Convention, "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."

[69] The key element to establish a PE is the direct management of the server by the nonresident enterprise (Ripa, 2004). At disposal may be understood as "available if and when needed", which seem to suppose that "no other person has a legal right to prevent such a use". Skaar, A.A.: Erosion of the Concept of Permanent Establishment: Electronic Commerce. Intertax, vol. 28, no. 5 (2000), p. 190.

[70] See commentary on article 5 of Model Convention, paragraph 42.6

[71] For completeness, see paragraph 42.8 of the Commentary on Article 5 of the Model Convention, "where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities [of preparatory and auxiliary nature] and if the equipment constituted a fixed place of business of the enterprise…there would be a permanent establishment."

In the case in which, through a web-hosting contract, the nonresident taxpayer avails itself of an Internet Service Provider (ISP) that supplies the technical platform hosting the web site and providing free access by means of a software: even though the consideration is paid proportionally to the space occupied by the web-site on the server, the contract does not confer to the content provider any "power of disposal" on the server or on part of it, so no PE exists.

It has also been suggested that the ISP could be considered an agent of the content provider (nonresident enterprise) which has a web site on the server. The reason why of such interpretation is that contracts are normally concluded by means of the software on the server. However, the internet service provider doesn't have the authority to represent the web-site owner in relation to its the customers. Even in the uncommon case in which the ISP has the authority to conclude contracts in the name of the content provider, the fact that he hosts different web sites of many different enterprises is a sufficient requirement to exclude the existence of a "dependent agent".[72]

## 2.8 Main policy challenges raised by the digital economy

The evolution of business model, the growth of the digital economy and its key features have enabled non-resident enterprises to operate in a way to avoid the establishment of a taxable presence in the source jurisdiction.
In analysing the tax challenges raised by digital economy, consideration should be given to growing reliance on data and the attribution of value from data, the characteristics that impact on the taxation of active business profits by source countries under the PE threshold, as well as the effect of electronic commerce on passive income, which may be taxed on a withholding basis.

Thus, in the area of direct taxation, the main challenges raised by digital economy can be grouped into three main categories:

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[72] Carlo Garbarino 2009, *Stabile organizzazione (nel diritto tributario)*

- Nexus: The reduced need for physical presence, combined with the increase role of network effect, as well as the reduced need for intermediaries (both physical and human), raise questions on the way source is defined in the case of active business profits.
- Data: ICT has permitted digital companies to gather and use information to an unprecedented degree. This raises questions of how to treat value created from data and how to characterize for tax purpose the supply of data in a transaction (i.e. free supply of goods, barter transaction).
- Characterization: Digitalization, enabling the delivery of a growing number of goods and services in an intangible form, creates uncertainties related to the proper characterization of payments for the underlying transaction.

Below, these three characteristics will be analysed separately, though they may overlap with each other and lead to double non-taxation, for example due to the lack of PE in the market jurisdiction coupled with lack of taxation in the income recipient's jurisdiction and of that of the ultimate parent company.[73]

### 2.8.1 Nexus and the ability to participate to the economic life of a country without being liable to tax

The above analysis shows that the only possible finding of permanent establishment in the broad contest of digital economy would be on the basis of infrastructure in the form of a server, assuming such a server is at disposal of the non-resident enterprise and then only if core business activities are conducted through it. No PE is deemed to exist through a web site and through an ISP agent of the content provider.

The permanent establishment was an effective criterion in pre-digital age when cross-border transactions largely consisted on bulk goods trading and business activities requiring a physical presence in the local market.[74] In this contest, the reliance on a physical presence is sensible and the PE threshold can therefore be met with certainty, under which business

[73] OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* Organisation for Economic Co-operation and Development

[74] Hoffart, B. 2007, "Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through and Access to markets Proxy Approach", *Nw.J.Tech.& Intell.Prop.,* vol. 6, pp. 106

profits would only be attributed to substantial presence of the corporation in the jurisdiction and not to the mere temporary presence that would not satisfy the required threshold. Those days are now long gone. Globalization, European integration, digitalization and e-commerce and the increased economic importance of intangibles have led to a substantial changing world. A local physical presence is not necessary anymore to get access to a foreign market and the non-resident entity can earn profits without the necessity of establishing a permanent establishment in that jurisdiction.[75]

The US Treasury states in this contest:

*"Electronic commerce…may be conducted without regard to national boundaries and may dissolve the link between an income-producing activity and a specific location…Persons engaged in electronic commerce could be located anywhere in the world and their customers will be ignorant of, or indifferent of, their location. Indeed, this is an important advantage of electronic commerce in that it gives small businesses the potential to reach customers all over the world."*[76]

Thus, the way in which countries tax company profits no longer seems to align with economic reality. In the way in which source is currently defined under PE threshold, those profits may not be taxed by source states in the contest of digital economy, unless a server is maintained in the country where such profits are earned.[77]

Taxing business profits in source jurisdictions on the basis of the location of the computer server is an unsatisfactory basis for attributing tax jurisdiction for several reasons. First at all, the location of a server is simply not a good proxy for where economic activity takes place and would lead to a largely arbitrary tax standard offering tax planning opportunities for multinational firms.[78] The US Treasury has noted that *"Computer servers can be located anywhere in the world and their users are indifferent to their location. It is possible that such*

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[75] De Wilde, M.F. 2015, "'Sharing the Pie'; Taxing Multinationals in a Global Market", *Taxing Multinationals in a Global Market (January 15, 2015),*

[76] Department of the Treasury, Office of Tax Policy 1996, "Selected Tax Policy Implications of Global Electronic Commerce",

[77] Pinto, Dale.,International Bureau of Fiscal Documentation., 2003, *E-commerce and source-based income taxation*, IBFD, Amsterdam

[78] Singh, M.K. 2014, *Taxing E-Commerce on the Basis of Permanent Establishment: Critical Evaluation*, Kluwer Law International

*a server, or similar equipment, is not a sufficient significant element in the creation of certain types of income".*[79]

Because the location of a server is irrelevant from technical prospective, shifting servers outside the source-country where e-commerce goods and services are purchased would be a safe way to minimize tax liabilities. Additionally, the location of a server could be moved either at regular intervals between different servers in different countries and mirror sites can be created to direct customers to different servers depending on the level of traffic at any time. Furthermore, the possibilities that electronic commerce provides for functions to be spread and disaggregated between servers and combined through server grids, would allow underlying electronic commerce transactions to be considered preparatory in nature, but when linked via the internet may establish a viable business that may not be subject to tax in any jurisdiction.[80]

Another issue challenging the actual foundation of source-based taxation is the disintermediation offered by internet. Internet is sometimes referred as the agent of disintermediation, since it enables a reduced need for human intermediaries, such as broker, distributors or representatives. Before the development of internet, activities like purchasing airline tickets or booking travel were conducted by dependent agent or employees physically present in the market jurisdiction to conclude contracts and look for business opportunities. Such intermediaries could have trigger tax nexus under the agency provision[81] of the PE threshold.[82]

In conclusion and based on the analysis of this chapter, it's now clear that the way in which source is actually defined for business profits taxation under the PE threshold may need to be reconceptualised in the contest of digital economy.

The permanent establishment principle set up as a tax rule at the end of the 19$^{th}$ century, may no longer represent a sound tool for taxing active business profits.

Skaar denotes that: *"The future is likely to prove that the permanent establishment principle has lost its force for new and mobile industries, whether tax treaties are renegotiated for this*

[79] Department of the Treasury, Office of Tax Policy 1996, *Selected Tax Policy Implications of Global Electronic Commerce*

[80] See note 76

[81] See article 5 of the OECD MC

[82] Pinto, Dale.,International Bureau of Fiscal Documentation., 2003, *E-commerce and source-based income taxation*, IBFD, Amsterdam

*purpose or not. An enterprise's economic connection to the soil, its permanent establishment, is no longer a reliable evidence of economic allegiance".*[83]

### 2.8.2 Data and the attribution of value

Digital technologies (and cloud computing operators in particular) have the ability to collect, store and use data remotely and from a great distance from the place in which they are gathered. Data can be provided voluntarily by users, derived from the systematic monitoring of user activity, or involuntarily left behind while surfing on the web. Such data is the key input into the process of value creation in the digital economy. Data can be exploited in many ways: to provide target advertising, to make purchase recommendations, to better customise a product, to increase customer loyalty and trust, or to apply price discrimination - all activities that might lead (directly or indirectly) to greater customer satisfaction and higher profitability.[84]

Data collection raises challenges for direct taxation in the sense of nexus and the impact this would have on the application of transfer pricing and profit attribution principles, which require an analysis of functions performed, assets used and risks assumed.  Indeed, the value of data can affect tax liabilities if attributable to a PE if held by a local subsidiary and sold to a foreign enterprise, but not if collected directly by an enterprise resident abroad, but not if gathered directly by a foreign enterprise with no PE, place pressure on the nexus side and raises issues regarding the location of data collection and characterization of transactions involving data as well.[85]

### 2.8.3 Income characterization derived by digitalization

Digitization is the process of converting information into a sequence of number. It has permitted to deliver goods and services in an intangible way and this particular feature has raised questions about how to characterize certain transactions and payments for tax purpose.

[83] Skaar, A.A. 1991, *Permanent establishment : erosion of a tax treaty principle*, Kluwer Law and Taxation Publishers, Deventer; Boston

[84] De Filippi, P. (2013). Taxing the cloud: introducing a new taxation system on data collection?. Internet Policy Review,[online] 2(2). Available at: http://policyreview.info/articles/analysis/taxing-cloud-introducing-new-taxation-system-data-collection.

[85] OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, Organisation for Economic Co-operation and Development

The question for tax purpose is whether such payments should be considered as royalties[86], fess for technical services or business profits. Differences in the characterization has broader implications for the allocation of taxing right, in the case in which the source country apply a positive withholding rate on royalties. In case of royalty classification, the source-country may have the right to tax royalties on a withholding basis, whereas in case of business profit, to tax such profits there must be a permanent establishment therein, otherwise taxation will be limited to the country of residence.

The OECD's report on income characterization states a conservative interpretation of "use" in article 12 defining royalties by adopting a commercial exploitation threshold, concluding that "use" as referred to in the OECD MC is limited to use by an acquirer who seeks to exploit commercially the intellectual property of another, leading to considering business profits the large majority of digital transactions and thus exempting them from source-taxation.[87]

This suggest that the way source is defined for passive income arising from digital transaction may need to be updated considering the increasing size of the phenomenon.

[86] See article 12 of the OECD MC: payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematographic films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

[87] OECD 2001, "Tax treaty characterization issues arising from e-commerce",

# Chapter 3 Potential solutions to address the tax challenges raised by the digital economy

Since the discussion of the previous chapter, the theoretical foundation of source-based taxation, the main features and given the new developed business models in the digital economy, the current PE definition provided by article 5 of the OECD Model Convection no longer fits with such a new scenario. Thus, there is a real need to reconceptualise the way source is defined under current tax rules for digital transactions. Such a new reformulation of the criteria for source-based taxation will need to take into account of possible alternative solutions for tax nexus under the permanent establishment threshold for business profits.

The focus of this chapter will be to present possible alternatives to the actual PE threshold proposed by major tax scholars, governments and international institutions. In particular, in this context will be discussed the possible introduction of:

- new nexus based on the significant digital presence;
- withholding tax on digital transactions;
- formulary apportionment;
- unilateral measures.

The last point presented by this section is the new reformulation of Permanent Establishment adopted under BEPS Action 7 by the OECD in order to deal with artificial avoidance of PE status.
The purpose of these proposals is to achieve a sharing of revenues between source and residence jurisdictions, as well as to avoid double-taxation and unintended non-taxation of cross-border business profits.

## 3.1 Nexus based on significant digital presence

One of the option discussed in BEPS Action 1 "Addressing the tax challenges of the digital economy" is focus on setting up a new nexus in order to face situations in which certain business activities are conducted wholly digitally. The final goal of the new PE nexus is not to strengthen source-taxation, but rather to rebalance the sovereignty on the taxation of business income of those enterprises conducting activities through digital means.

Such new nexus is based on the "significant digital presence" in order to establish a taxable presence in source jurisdictions for those corporations engaged in certain "fully dematerialised digital activities", creating a new linking rule suitable to guarantee a fair and balanced allocation of taxing rights in line with the characteristics of the digital economy.[1]

For "fully dematerialized digital activities", the report targets those enterprises that require minimal or no physical presence in the source jurisdiction for carrying on their business, regardless of the fact that a physical "place of business" may be present to conduct auxiliary or preparatory functions.

The following elements are introduced by the OECD in order to detect whether an activity is fully dematerialized:[2]

1. The core business of the enterprise relies completely or in a considerable part on digital goods or digital services.
2. No physical elements or activities are involved in the actual creation of the goods or of the services and their delivery other than the existence, use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialisation of location-relevant data.
3. Contracts are generally concluded remotely via the Internet or by telephone.
4. Payments are made solely through credit cards or other means of electronic payments using on-line forms or platforms linked or integrated to the relative websites.
5. Websites are the only means used to enter into a relationship with the enterprise; no physical stores or agencies exist for the performance of the core activities other than offices located in the parent company or operating company countries.

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[1] Hongler, P. & Pistone, P. 2015, "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy", *IBFD,*

[2] OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* Organisation for Economic Co-operation and Development

6. All or the vast majority of profits are attributable to the provision of digital goods or services.
7. The legal or tax residence and the physical location of the vendor are disregarded by the customer and do not influence its choices.
8. The actual use of the digital good or the performance of the digital service do not require physical presence or the involvement of a physical product other than the use of a computer, mobile devices or other IT tools.

According to the OECD report, specific threshold for digital presence could involve number of users, overall level of consumption and number of contracts for digital goods and services. Setting substantial thresholds should be required to avoid an excessive fragmentation of the worldwide taxable income.[3]

Together with the introduction of this new tax-nexus, transfer-pricing guidelines should be amended as well, in order to allocate income to PE based on digital presence, since the current TP rules based on risk, functions and assets would lead to no income allocation to the market jurisdiction.

Another source of potential issues, due to the lack of any physical presence, is the tax enforcement by the source state in which a significant digital presence is deemed to exist.[4] Hongler and Pistone suggest that the problem could be solved with the introduction of an extraterritorial tax enforcement (on the model of MOSS enforcement system within the EU for VAT purposes), where the tax liabilities due to digital presence are collected by one state on behalf of the others.

## 3.2 The withholding approach

The withholding tax has been proposed as an alternative to the permanent establishment threshold for source tax nexus. This solution has been analysed by major tax-scholars, leading

[3] Hongler, P. & Pistone, P. 2015, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*

[4] Hellerstein, W. 2014, "Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments", *Bull. Intl. Tax.,* , no. 6/7

to different outcomes. For example Doernberg[5] proposed a withholding system called "base erosion approach" aiming to withhold on any payment that has the effect of "eroding" the tax base of the source-country, so on payment that are deductible by a source-country purchasers, leading to withholding only on business-to-business transactions.

Another well-known proposal is the "refundable withholding approach" by Dale Pinto. Such approach would introduce a system of withholding to be applied by source jurisdictions at a uniform rate to all digital transactions, which will be refundable if the total gross sales of a non-resident firm remain below a *de minimis* threshold for a relevant period of time.

A strict definition of digital transactions is a key requirement for the success of the withholding mechanism, since otherwise a not clear defined target may lead to over or under-withholding.[6]

The innovative element under Pinto approach is the introduction of a quantitative threshold as a proxy for "economic allegiance", for the purpose to prevent an enterprise from being taxed in every country in which it operates unless its business activities exceed a certain high threshold and apply it to all incomes irrespective of the characterization.[7] Since the withholding tax would apply to gross sales, which are not correlated with net income, the mechanism should include the option to file for net taxation in order to avoid any distortive effect on international trade.

As far as tax collection, Pinto proposes that tax be collected by the purchaser in case of a business or by a financial intermediary involved with those payments. This would require the involvement of financial institutions, credit card companies (Visa, MasterCard) and online payment system agents (such as PayPal) in the fulfilment of the withholding mechanism and in remitting it to the tax authority of the purchaser. Pinto argues that, once an automated withholding process is put in place, from the perspective of a customer, the whole process would be instantaneous and seamless.[8]

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[5] Doernberg, Richard L.,Hinnekens, Luc., 1999, *Electronic commerce and international taxation,* Kluwer Law Internat., The Hague [u.a.]

[6] Brauner, Y. & Baez, A. 2015, "Withholding Taxes in the Service of BEPS Action 1: Address the tax Challenges of the Digital Economy", *IBFD,*

[7] Pinto, Dale.,International Bureau of Fiscal Documentation., 2003, *E-commerce and source-based income taxation,* IBFD, Amsterdam

[8] Ibid "T*he intermediary would then process the payment ($ 100), deducting the withholding tax ($ 5) and remitting the net amount ($ 95) to the online retailer in country Y. of the $ 5 withheld, $ 1 would be retained to cover their intermediaries costs, and the balance $ 4, along with the details of the gross sales ($ 100) would be transmitted on-line to country X revenue authority, who would record the transaction and retain the amount withheld until the end of the accounting period, where a determination as to whether the on-line seller's total gross sales in country X exceed the de minimus threshold."*

This proposal is not exempt from criticisms: in particular, the principle of tax neutrality could be infringe by the proposed mechanism. It may be argued that the system is not neutral since the withholding will only involve foreign sellers and may affect the ability to trade of small businesses whose total gross sales fall below the numerical threshold, as they would have to wait until the end of the financial period to lodge a tax refund on the amount withheld. Additionally, the Pinto approach could lead to a significant compliance burden for non-resident sellers, in those cases in which the enterprise may have to fill income tax return to obtain a tax refund or be taxed on a net basis in multiple jurisdictions, even if such effect could be minimized with a sufficiently high sales threshold, low withholding tax rate and tax relief by residence states.[9]

## 3.3 Formulary apportionment

An alternative form of income taxation of global business profits requires the apportionment of income among related companies based on a stipulated formula. This system opposes with transfer-pricing regulations and actual residence/source-based taxation.

Under formulary approach, affiliated entities engaged in common enterprise are treated as a single taxable entity. The worldwide income of the group is allocated by a predetermined formula (based on factors like payroll, property and sales) among all of the countries where the enterprise runs meaningful economic activity and each country applies its tax rate and collects the amount of tax resulting from this calculation.[10] By using a formulary apportionment to distribute profits across locations, the company does not need to calculate the profits earned by each member of the group in each location.[11]

The main argument in favour of formulary taxation is that the system better address the economic reality of multinational firm behaviour. Under such a system, transfer prices are irrelevant, physical presence (PE) in a jurisdiction is no essential and cross-border loss compensation is done automatically.[12]

[9] Pinto, Dale.,International Bureau of Fiscal Documentation., 2003, *E-commerce and source-based income taxation,* IBFD, Amsterdam

[10] Li, J.,Canadian Tax Foundation 2003, *International taxation in the age of electronic commerce : a comparative study,* Canadian Tax Foundation, Toronto

[11] Joann Martens Weiner 2005, "FORMULARY APPORTIONMENT AND GROUP TAXATION IN THE EUROPEAN UNION: INSIGHTS FROM THE UNITED STATES AND CANADA", *Taxation paper, European Commission,*

[12] Terra, B.J.M. & Wattel, P.J. 2008, *European tax law,* Kluwer Law International, Alphen aan der Rijn

In turn, the main deficiency of the arm's-length principle is that the system artificially attempts to draw lines between related aspects of a firm where no line actually exists and it is often not possible to find comparable transactions with unrelated parties, in particular when it comes to the so called "hard-to-value assets".[13]

In this way, multinational enterprises would have no incentive to shift income from intangible property across countries through legal and accounting devices, as tax liabilities would be calculated on total world income as well as the share of a firm's sales that occur in each jurisdiction.[14] Unlike the arm's length approach, it does not require any relief mechanisms to avoid double taxation, because source rules are implicitly incorporated into the apportionment formulas.[15]

The most obvious barrier to the adoption of formulary taxation at global level is that it would require a degree of cooperation among governments and tax authorities that may not be possible in the current political environment. The OECD rejected formulary apportionment because it "*would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation*".[16]

Countries would need to reach agreements over a set of common rules at international level that would determine the amount of taxable income each state would collect from cross-border transactions. In particular, it would require to define: a common shared formula to distribute tax-bases among countries, harmonization of corporate tax bases, common currency, common company law, common accounting standard and common expertise in the tax administrations.[17]

In the next future, the European Union is going to adopt a type of formulary apportionment called "Common Consolidated Corporate Tax Base" (CCCTB). This new system for business income taxation aims to share the tax base of corporations conducting business activities within the Union in order to deal with characteristics of the digital economy and to fight against aggressive tax planning involving European countries. Such an approach within the

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[13] Arthur J., C. 2004, "Formulary Taxation Versus the Arm'sLength Principle: The Battle Among Doubting Thomases, Purists, and Pragmatists",

[14] Reuven S., Av i-Y onah, Kimberly A., C. & Michael C., D. 2009, "Allocating Business Profits for T ax Purposes: A Proposal to Adopt a Formulary Profit Split",

[15] Arnold, B.J. & McIntyre, M.J. 2002, *International tax primer,* Kluwer international law, The Hague etc.]

[16] See Organization of Economic Co-operation and Development, *Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD)

[17] Arthur J., C. 2004, *Formulary Taxation Versus the Arm's Length Principle: The Battle Among Doubting Thomases, Purists, and Pragmatists*

EU for European groups of companies would rid European businesses of at least three major nuisance in terms of tax compliance:

- transfer pricing and related problems of transaction-based profit attribution;
- having to deal with 28 different tax systems and tax authorities;
- the very limited possibility for cross-border loss compensation.

## 3.4 Unilateral response: the UK's diverted profit tax

The diverted profit tax (DPT) is an entirely new and free-standing tax aimed at technology companies with business activities in the UK who enter into contrived arrangements to divert substantial profits from the UK to preferential-tax jurisdictions and it will apply at the rate of 25% (rather than the corporation tax rate of 20%).
The DPT applies in two distinct circumstances:

1. where foreign company's affair are designed in such a way as to avoid a UK permanent establishment (PE),
2. where a UK resident company or a UK PE of a foreign company erodes its tax base by engaging in transactions with related companies which lack of economic substance, even if the arrangement is at arm's length.[18]

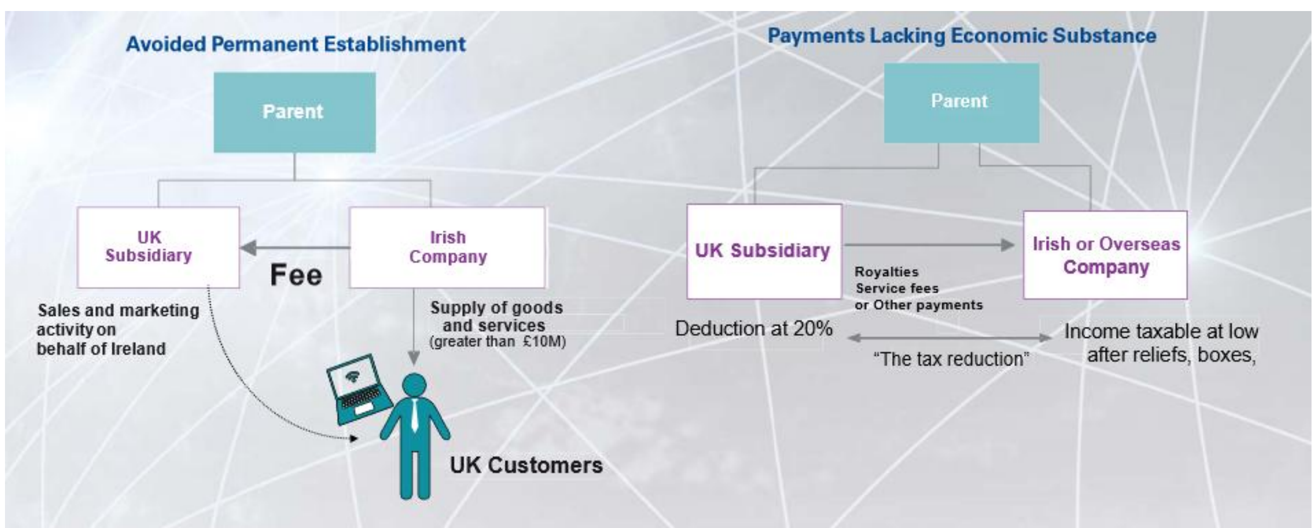


*Table 3.1: Two pillar of DPT targeting business arrangements in UK. Source: KPMG*

[18] Dan, N. 2015, "Diverted profits tax: flawed by design?",

### 3.4.1 Avoidance of a UK taxable presence

The first rule is intended to apply where: there is a non-UK resident company carrying on a trade; another person (the "avoided PE") is carrying on activity in the UK in connection with the foreign company's supplies; it is reasonable to assume that the activity of the avoided PE or the foreign company (or both) is designed to ensure that the foreign company does not formally carry on that trade in the UK for income tax purposes.[19]

This provision is aimed at situations where significant sales activities take place in the UK but fall short of the conclusion of contract in the UK. An example are US multinational technology companies (e.g. Google, Facebook, Apple) making supplies of software or downloading to UK customers without creating an office or other taxable PE within the UK territory in respect of the business activities carried on through a foreign entity based in low-tax jurisdiction. Often activities in UK are limited to those auxiliary in nature like the provision of technical, sales and other support for the foreign company though a representative office or subsidiary which has no authority to conclude contracts so that it gives rise to a low tax base.

However, there is a de minimums exclusion if sales related to UK activity (by the foreign company and connected persons) in 12 month accounting period do not exceed £10 million, or expenses related to foreign company's (and all connected companies) total UK-related expenses do not, in aggregate, exceed £1 million. The £1 million annual expenses threshold is said to have been introduced to help address low risk situations where for example a group has employees who occasionally visit UK for business.

### 3.4.2 Entities or transactions lacking economic substance

The basis for the application of the second rule arises where there is a UK resident company (or UK PE) and there are arrangements between such UK entity and a related person that give rise to an "effective tax mismatch" outcome between these entities and the "insufficient economic substance condition" is also met.

The innovative elements of this rule are the "effective tax mismatch outcome" and "insufficient economic substance".

[19] Dan, N. 2015, "Diverted profits tax: flawed by design?",

The effective tax mismatch arises where the material provision result in an increase in expenses or deductions or a reduction in taxable income for the UK entity and such a reduction in UK tax liability is greater than the corresponding increase in the foreign company's total liability to corporation tax, income tax or any non-UK tax. This reduction is subject the "80% payment test" which states that there will not be an effective tax mismatch outcome where the amount paid by the second party is at least 80% of the amount of the resulting reduction in the UK entity's tax liability.

The insufficient economic substance condition will be satisfied whether the financial benefit of the tax reduction exceeds the non-tax financial benefit of the transaction and whether it is reasonable to assume that either:

- the transaction was designed to secure the tax reduction;
- the entity's involvement in the transaction was designed to secure the tax reduction.

This provisions is clearly intended to catch situations where, for instance, a UK PE pays for the use of intangibles held by a related non-UK resident company in a low tax jurisdiction where the IP holding company undertakes no R&D activities and has insufficient staff and substance in that jurisdiction.

### 3.4.3 Compatibility with the UK's double tax treaties

Scholars and tax-specialists suggested that UK's network of double tax treaties might provide taxpayer with arguments to challenge the new law.

DPT is stated to be a separate tax from income or corporation tax and payments of DPT is ignored for the purposes of defining income tax or corporate tax.[20] Therefore, DPT is not covered by double tax treaties as it is a new tax and is not substantial similar to an existing tax like corporation tax, which is covered under tax treaties. The additional argument is that treaty benefits are not available for abusive arrangements targeted under the DPT, in line with paragraph 9.4 of the commentary to article 1 of the OECD MC.[21]

[20] Taylor, W. 2015, "Diverted Profit Tax",

[21] See commentary on article 1 of Model Convention, paragraphs 9.4-9.5

### 3.4.4 Compatibility with EU law

Some commentators have extensively discussed regarding the compliance of the DPT with the principles of EU law. In the case in which an unilateral tax measure (by a member state) hinders or limits the exercise of a freedom guaranteed in the Treaty on the Functioning of the European Union (TFEU), that tax measure is unlawful, unless it can be justified by special purpose allowed by the EU law.[22] DPT, in particular, seems to constitute a restriction on the freedom of establishment, free movement of capital and on the provisions of goods and services.

Freedom of establishment is governed by article 49 TFEU that states: *"restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited."*[23]

This freedom involves the right to take up and carry on business activities as a self-employed person and to set up and manage undertaking, and the right to equal treatment in the Member State involved.[24]

The direct result of the application of the DPT is the non-UK companies incorporated in another Member State could carry out businesses in the UK which are taxed at a higher rate than a UK company carrying out the same trading activity. Moreover, the discrimination goes beyond the tax rate, since DPT is payable on an accelerated timescale on the basis of estimates and discretion by the HMRC.[25]

The other freedom to be affected by DPT is the free movement of goods and services. Article 56 TFEU provides that: *"restrictions on freedom to provide services within the Union shall be prohibited in respect of nationals of Member States who are established in a Member State other than that of the person from whom the services are intended"*. Potentially, DPT may deter EU businesses from providing goods and services in the UK and could change businesses' behaviour in the way they provide their services.

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[22] *"it follows … from Court's ease law that national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions:*

- *They must be applied in a non-discriminatory manner;*
- *They must be justified by imperative requirements in the general interest;*
- *They must be suitable for securing the attainment of the objective which they pursue; and*
- *They must not go beyond what is necessary in order to attain it"*

See case C-55/94 (Reinhard Gebhard v.Consiglio dell'ordine degli avvocati e procuratori di Milano), 1995 ECR I-4165

[23] See article 49 of the Treaty on the Functioning of the European Union

[24] Terra, B.J.M. & Wattel, P.J. 2008, *European tax law,* Kluwer Law International, Alphen aan der Rijn

[25] Dan, N. 2015, "Diverted profits tax: flawed by design?",

The thing that DPT may restrict TFEU freedom does not automatically render the DPT unlawful for the purposes of EU legislation. The key factors are "whether a restriction is justified by an overriding reason of public interest and whether such a restriction is proportionate to the objective."[26] Cases like "*Cadbury Schweppes"* demonstrates the Court of Justice of the European Union (CJEU) has established principles that make DPT compliant with EU TFEU.

The sentence held that: *"a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned…the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory."*[27]

The determinative concept of the sentence is the "wholly artificial arrangements" and DPT does not specifically target this purpose. Indeed, the DPT seems to bring a much broader range within the charge and does not provide any express exemption for companies established in a foreign jurisdiction and carrying on genuine business activities there.[28]

Additionally, DPT must comply with the proportionate and legal certainty criteria set by SIAT and Itelcar cases.[29] Under such criteria, a restriction to be justified, it has to be narrowly tailored, so that its scope is determined with sufficient precision and its effects are predictable.

In summary, the DPT seems to have various weaknesses under EU law as TFEU freedoms, including the freedom of establishment, the free movement of capital and the freedom to provide services. Given the above discussion, it may be doubtful that the DPT would survive to potential EU law infringement proceedings by the EUCJ.

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[26] See note above

[27] Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v IRC (C-196/04) [2006] ECR I-7995; [2006] STC 1908 (EUCJ)

[28] Dan, N. 2015, "Diverted profits tax: flawed by design?",

[29] SIAT Case C-318/10, Itelcar Case C-282/12

## 3.5 The new Italian proposal of Digital Tax

Just after the introduction of the UK DPT, even the Italian government is going to introduce new legislations in order to tackle those profits of US big techs firms arising within Italian borders. The new proposal is based on the bill presented to the parliament on April 2015.

The bill proposed is entirely different from the UK DPT (known to the public as "Google Tax") even if they have basically the same purposes.

Such a new proposal is framed in two directions[30]:

1. First, it reconceptualises the concept of permanent establishment in the national legislation (amending art. 162 TUIR), by introducing the notion of "virtual PE". This new concept is applied when:
   - there is a service supplier which supports the foreign enterprise's business and such a supplier is a dependent agent which concludes contracts in name and on behalf the foreign entity; or
   - there is a server located in the jurisdiction which performs significant and essential functions for the non-resident enterprise.

2. Secondly, it suggests a specific anti-avoidance provision, for which a PE is deemed to exist (regardless from the previous paragraph) whenever a non-resident enterprise has a "significant digital presence"[31] for a period longer than 6 months with the ability to generate flows of payments higher than €5 million. Once that threshold is met, a withholding tax of 25% (30% for natural persons) is applied on payments to non-resident entities for digital goods and services. Financial intermediaries will be liable to collect such a withholding tax on behalf of the government.

The clear purpose of this new "Digital Tax" is to force the non-resident enterprises carrying on business related to the supply of digital services, to establish an Italian permanent establishment in compliance with article 162 TUIR in order to avoid the high withholding tax.[32]

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[30] Quintarelli, G.S., Sottanelli, G.C. & Melilla, G. 2015, *Proposta di legge, atto camera n. 3076*

[31] Concept introduced in (OECD 2015)

[32] Perrone, V. 2015, "Possibili forme di tassazione dell'economia digitale, tra nuovi criteri di collegamento e ridefinizione del concetto di stabile organizzazione", *Convegno annuale AIPDT,*

This new rule is totally ineffective to fight the artificial avoidance of PE and other tax-avoidance strategies. The first reason is the incompatibility with treaty provisions: the new definition of permanent establishment in national legislation will not be applicable when there is a treaty based on the OECD MC between Italy and the country in which the foreign enterprise is resident, because the treaty's definition of permanent establishment[33] prevails over national's one (treaties' relief nature).[34]

Moreover, the bill is in conflict with TFEU freedoms (in particular freedom of establishment, free movement of capital and on the provisions of goods and services) at a much higher level than the DPT, because there is not reference to "artificial arrangements", instead it seems to be a "basic" attempt to unilaterally enlarge the scope for source-based taxation.

## 3.6 Lowering the PE threshold for tax nexus: BEPS Action 7

The OECD's base erosion and profit shifting (BEPS) project is likely to spur the most significant changes to the taxation of cross-border business income in nearly 30 years. The action plan is composed by 15 action points aiming to equip governments with the domestic and international instruments needed to tackle BEPS. For the purpose of this thesis, BEPS Action 7 will be object of analysis as its focus is on the prevention of the artificial avoidance of PE status.

This Action Plan proposes amendments to article 5 of the OECD MC in order to deal with two situations:

- Artificial avoidance of PE status through commissionaire arrangements and similar strategies;
- Artificial avoidance of PE status through the specific exceptions in art. 5(4).

[33] See article 5 of the OECD MC

[34] Ricci, C. 2015, "Nuove forme di tassazione delle prestazioni di servizi online. La proposta per una nuova "Google tax" e l'annunciata "Digital Tax"", *Convegno annuale AIPDT,*

### 3.6.1 Artificial avoidance of PE status through commissionaire arrangements and similar strategies

A commissionaire arrangement is defined by the report as *"an arrangement through which a person sells products in a State in its own name but on behalf of a foreign enterprise that is the owner of these products"*.[35] Through this arrangement, a foreign enterprise can sell its products in a State without having a taxable presence to which the profits arising from those sales may be attributed and taxed.

Commissionaire arrangements does not lead to "Agency PE" because the contracts concluded by the person acting as a commissionaire are not binding on the foreign enterprise.

Since Art. 5(5) relies on the formal conclusion of contract in the name of the foreign enterprise, MNEs avoid the application of that paragraph by changing the terms of contracts without material changes in the functions performed in the market jurisdiction.

Other similar strategies adopted by MNEs that seeks to avoid the "Agency PE" provision, involves situations where contracts which are substantially negotiated in a State are not formally concluded in that State because they are signed or authorized abroad, or where the person that habitually exercise an authority to conclude contracts constitute an "independent agent" to which the exception of art. 5(6) applied even if it is closely related to the foreign enterprise on behalf of which is acting.[36]

As a result, the report provides changes to the rule on dependent and independent agents with the goal to address commissionaire and other undisclosed agent arrangements by:

- Tightening the agency PE rules in order to include not only contracts in the name of the non-resident enterprise but also contracts for the transfer of, or the granting of the right to use, property, or the provision of services by the non-resident where *"a person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise"*[37] and

[35] OECD 2015, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report,* Organisation for Economic Co-operation and Development

[36] Ibid

[37] OECD 2015, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report,* Organisation for Economic Co-operation and Development

- Narrowing the requirements for an agent to be considered "independent", such that this will not be the case where the agent acts exclusively or almost exclusively for one or more enterprises to which it is closely related.

The new conceptual phrase of the new proposed paragraph 5 "playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" is better described by the commentary. The commentary notes that this phrase will "*typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise*". For example, it includes a person who "*solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions*". [38]

The new commentary states that key aspect to look at is the "direct result" of the in-country activity (solicitation) and contract conclusion, suggesting that the way customer made its buying decision is a legally relevant analysis.

One context the rule is meant to describe is when the local "sales force" is given the autonomy to negotiate the terms of the contracts. In the case in which an enterprise authorizes a person to engage in negotiation over material terms normally would not renegotiate such conditions after the agent has performed his/her work. These would result in "routine conclusion" by the non-resident entity.

On the other hand, it is also clear that the new rule will cover cases involving standardized contracts, including on-line contracting. Normally, the terms and conditions of standard contracts are set in advance by the non-resident and the sales-force has no power to negotiate at all. As the previous example, this case would fall in the routine conclusion of contracts without material modifications by the enterprise. Thus, this new provision of art.5(5) seems to apply both to situations where a dependent person has full power to negotiate and to those cases where the person has none.[39]

This new standard may encourage groups to relocate some negotiating power into regional centers to ensure that the non-resident enterprise can be seen as actively participating in negotiations rather than "routinely concluder".[40]

[38] See proposal of new commentary on article 5 of Model Convention, paragraphs 32.5-32.6

[39] Gary D. Sprague, Baker & McKenzie 2015, "Playing the Principal Role in creating a Permanent Establishment", *Premier International Tax Library,*

[40] Ibid

The commentary illustrates two principal examples providing additional insight to the legal principal of "playing the principal role" test.

The first one focuses on the actions of employees to convince the customer to purchase, the fact that employees are remunerated by commissions, responsible for "large account" and they have "relationship building skills". All these indicators seem to be circumstances that the new rule attributes of persons who perform the role of convincing customers to purchase.[41]

The second example shows the conflicting case of a person who "merely promotes and market goods" in such a way that does not directly result in the conclusion of contract.[42]

Tax specialists will face the challenge to interpret these two examples to determine whether a permanent establishment is deemed to exist or not under the new threshold.

Baker & McKenzie identifies the following themes that should trigger taxable presence under the new proposed rule:

- Nature of activity: it relates to the activity of convincing a customer to purchase (playing the principal role), opposed to promoting goods and services, even when such activity leads to an increase in sales.
- Identify of counterparty: the commercial capacity of the counterparty with whom the local sales force is interacting is essential. The PE risk is reduced when the promotional activity is aimed at someone other than the final customer.
- Temporal: the promotion in the pharma case does not result in a direct conclusion of contracts, indeed it requires further steps be taken by the doctor and the patient.

Group that are affected by this new provision could avoid a PE by withdrawing relevant sales personnel from the jurisdiction and establishing a so called "low-risk distributor" (LRD) therein. Buy-sell distributors are not covered by the new threshold since they do not act on behalf of the principal enterprise and do not sell property owned by that enterprise since the property that is sold to the customers is owned by the distributor itself. The same applies to LRD only if the transfer of the title of property sold by that distributor passed from the enterprise to the distributor and from the distributor to the final customer (regardless if the

[41] See proposal of new commentary on article 5 of Model Convention, paragraph 32.6

[42] "*Where, for example, representatives of a pharmaceutical enterprise actively promote drugs produced by that enterprise by contacting doctors that subsequently prescribe these drugs, that marketing activity does not directly result in the conclusion of contracts between the doctors and the enterprise so that the paragraph does not apply even though the sales of these drugs may significantly increase as a result of that marketing activity*." See proposal of new commentary on article 5 of Model Convention, paragraphs 32.5

legal title transfer is done in "a flash"), in a way that the distributor would derive profits from the transaction rather than a remuneration in form of commission.[43]

As concern the independent agent status, the new proposed paragraph 6 introduced to the concept of "closely-related enterprises". Such a provision is then broadly defined on the vote and value of a company's share ("directly or indirectly more than 50%") or on de facto control.[44]

### 3.6.2 Artificial avoidance of PE status through the specific exceptions

Another area that has got a lot of attention and has links to Action 1 on the Digital Economy is the exemption from PE status for preparatory and auxiliary activities.
Art. 5(4) of the OECD MC includes a list of specific activity exemptions in which a PE is deemed not to exist where a place of business is used solely for those activities listed in that paragraph. The OECD has expressed concern that those specific activity exemptions that were previously preparatory and auxiliary in the contest of conventional business models ("brick and mortal") may have become core functions of certain businesses and have been object of international tax planning aimed at eroding the sovereignty of the market country. Since those exemptions to the PE definition seem to no longer serve their intended purposes, the OECD has introduced revisions to the commentary of paragraph 4 by providing a new clear definition of preparatory and auxiliary activities. The proposed revision states that activities have a preparatory character if *"they are carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole"* and auxiliary if *"they are carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole"*.[45] The revised commentary adds that auxiliary activities are not meant to include "*any activity that requires a significant proportion of the assets or employees of the enterprise"*.[46]

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[43] See proposal of new commentary on article 5 of Model Convention, paragraph 32.12
[44] Deloitte 2015, , OECD Tax Alert, BEPS action 7: Preventing the artificial avoidance of PE status. Available: <a href='https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-oecd-7-october-2015.pdf' target='_blank'>https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-alert-oecd-7-october-2015.pdf</a>
[45] See proposal of new commentary on article 5 of Model Convention, paragraphs 21-21.2
[46] See proposal of new commentary on article 5 of Model Convention, paragraph 21.2

A number of useful examples are included in the revised commentary e.g. storing and delivering goods to fulfil online sales may not be considered preparatory or auxiliary in character if such activities are an essential part of the company's sale/distribution business and requires important asset and number of employees.[47]

The proposed revisions also provides a far-reaching anti-fragmentation rule, which aims to prevent the artificial fragmentation of cohesive business operations between group companies to meet the preparatory and auxiliary exemption. The actual anti-fragmentation provision[48] prevents the fragmentation of cohesive operating business into several small operations undertaken by a single enterprise. Given the ease with which MNEs may establish subsidiaries, the logic of paragraph 27.1 should not be restricted to cases where the same enterprise maintains different places of business in a country but should be extended to cases where these places of business belong to closely related enterprises.[49]
The final proposal prevent the exemption from applying where there is an existing PE in the local country or *"the overall activity resulting from the combination of the activities carried on…by the same or closely related enterprises…is not of preparatory or auxiliary character."* In both cases, for the rule to be applied, the activities must "*constitute complementary functions that are part of a cohesive business operation"*.[50]

### 3.6.3 Treaty network and commentary amendments: the interpretative challenges

All the previously discussed changes (under BEPS Action 7) to the OECD Model Treaty requires that countries renegotiate virtually all their existing treaties with their foreign partners in order to make the new amendments enforceable under international law.

[47] See proposal of new commentary on article 5 of Model Convention, paragraph 22;
*"If proximity to customers and the need for quick delivery to clients are key components of the business model of an online seller of physical products".* OECD 2015, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report,* Organisation for Economic Co-operation and Development
[48] See commentary on article 5 of the Model Convention, paragraph 27.1
[49] OECD 2015, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report,* Organisation for Economic Co-operation and Development
[50] See revised paragraph 4 of article 5 of Model Convention

An element of great controversy relates the interpretative role of the OECD commentary and, in particular, its ability to be an effective mean of interpretation once amended, in relation with treaties signed before the revision.

The interpretation of tax treaties is governed by customary international law, as embodied under article 31-33 of the Vienna Convection on the Law of Treaties. Vienna Convention is binding on all nations (even those not signing the convention) because those provisions represent a codification of customary international law.[51]

Article 31(1) of the Vienna Convection provides the basic interpretative rule, which states: "*A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose*".[52]

The context includes the text of the treaty and any agreements between the parties made in connection with the conclusion of the treaty and any instrument made by one of the parties and accepted by the other party.[53] In addition, under paragraph 3 subsequent agreements between parties and subsequent practice with respect to the interpretation of the treaty and any applicable rules of international law must be take into account together with the context.

In the cases in which article 31 provides an ambiguous, obscure, absurd or unreasonable result, article 32 enables the recourse to supplementary means of interpretation, like preparatory work and the circumstances of treaty conclusion.

In the doctrine, there is not clear definition of the legal status of the commentary under the Vienna Convection. At first glance, the commentary appears to be a supplementary mean of interpretation under article 32, but other scholars think that its function falls within the purpose of article 31.

This controversial topic among tax scholars is not a simply doctrinal debate, but it has a substantial importance in the practice, since it involves a different function and value once applied.[54] In the case the commentary is treated as a supplementary mean of interpretation (article 32), it is relevant only to confirm the meaning otherwise established by the application of the principles of interpretation in article 31 or to establish the meaning if the interpretation

[51] Arnold, B.J. & McIntyre, M.J. 2002, *International tax primer,* Kluwer international law, The Hague etc.]

[52] See article 31(1) Vienna Convection on the Law of Treaties

[53] See article 31(2) Vienna Convection on the Law of Treaties

[54] Bracco, P. 2004, "CFC legislation e trattati internazionali: le recenti integrazioni al commentario OCSE e il loro valore ermeneutico", *Riv. dir. trib.,* , no. 2

under article 31 is ambiguous, obscure, absurd or unreasonable.[55] This legal definition does not seem the one intended by the OECD since its limited relevance.[56]

The other source of uncertainty is whether the future revisions of the commentary are effective to the interpretation of the treaties entered into force before the amendments. This is not just about the relation between the commentary and the provisions of Vienna Convection, but it has much broader scope in term of the nature of the amendments and the constitutional requirements of the signing states. Scholar seems to agree that the revised-commentary has a retroactive effect in the case in which the amendments to the OECD commentary are merely formal in nature, in order to better explain a concept in the model convection.[57]

The dynamic interpretative nature of the OECD commentary is also affected by the relation between national authorities in charge to negotiate tax treaties and the components of the “committee on Fiscal Affair” in charge of commentary drafting. This is particularly important in circumstances in which the Constitution of the signing state requires the “statutory reserve”[58]. Indeed, it states that tax treaties ratification is subject to the approval by the parliament, while members of the committee on Fiscal Affair are specialists of national tax authorities.

Therefore, in those cases where it is necessary to change the substance of an article, scholars suggest that would be much more desirable to change the treaty in order to adapt to the new formulation of the commentary. In this way, the revised commentary would be an effective interpretative tool, even of treaties previously negotiated.[59]

Since the above discussion and the difficulties in updating existing tax treaty network, the OECD (trough Action 15) has proposed the introduction of a multilateral instrument that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties.

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[55] Arnold, B.J. & McIntyre, M.J. 2002, *International tax primer*, Kluwer international law, The Hague etc.]

[56] See paragraph 29 of the introduction OECD MC: "*as the Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of Member countries, they are of special importance in the development of international fiscal law. Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes*."

[57] Guglielmi, S. 2004, "Il ruolo del commentario OCSE nella interpretazione delle Convenzioni contro le doppie imposizioni", *Il Fisco,* vol. 44

[58] Example: article 23 of the Italian Constitution

[59] Guglielmi, S. 2004, "Il ruolo del commentario OCSE nella interpretazione delle Convenzioni contro le doppie imposizioni", *Il Fisco,* vol. 44

Such a tool would “synchronize” the model tax convention with the current treaty network, with the final purpose to tackle efficiently and timely BEPS concerns and to provide an innovative approach to international tax manner.[60]

[60] OECD 2015, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, Action 15 - 2015 Final Report,* Organisation for Economic Co-operation and Development

# Conclusions

Digital economy, the flexibility of its business models and the increasing ability of business relying on technology to perform significant and profitable economic activities permit to participate to a country's economy, supplying goods and services to local customers, without triggering taxable presence therein in form of a permanent establishment. For this reason, the PE does not appear anymore to be the appropriate evidence for economic allegiance entitling the source-country to tax business income. Anyway, it is clear that, at the OECD/G20 level, countries did not reach any consensus for an alternative threshold for cross-border corporate income taxation. Rather, Action 7 of BEPS Action Plan adds patches to old rules in a desperate attempt to keep PE alive.[1] Indeed, BEPS Project has taken a conservative resolution, working toward increasing source taxation, yet keeping the fundamental structure of the international tax regime intact, including the reliance on the residence versus source paradigm and remaining stuck to PE threshold and arm's length principle.[2]

In amending article 5 and its commentary, the OECD has considered the major strategies adopted by digital enterprises to avoid the taxable presence in source jurisdiction and has shaped the new PE threshold in a way to address the new business models developed in connection with the digital economy.

Unfortunately, the amended article 5 will not be able to bring the PE concept back to its original conceptual framework where it ensures a fair allocation of taxing rights between source and residence jurisdictions. This is because there are still plenty of cases that would not create any tax liability in market jurisdiction, for example, when there are no connections with the market country in form of physical presence (i.e. warehouses or other preparatory/auxiliary facilities) or in form of agents in charge of "convincing" customers. Moreover, MNEs could avoid taxable presence by moving to low-tax jurisdictions the sale-related functions and by using third-party distributors.

The additional critical point of Action 7 relates to the profits allocation to the new defined PE.

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[1] Eva, E.L. 2015, "An opportunistic, and yet Appropriate, Revision of the Source Threshold for the Twenty-First Century Tax Treaties", *Intertax,* vol. 43

[2] Brauner, Y. & Baez, A. 2015, "Withholding Taxes in the Service of BEPS Action 1: Address the tax Challenges of the Digital Economy", *IBFD,*

Especially, it is doubtful whether there will be substantial additional profits attributed to some of the newly created PEs, particularly where there are no significant people functions and assets invested in the local country.
The OECD, in this respect, will implement new guidelines on profit attribution by the end of 2016. Another measure that will potentially affect profit attribution to new PEs are Actions 8-10, whose main purpose is to better allocate value to activities along with value creation, with a special focus of profit allocation associated with the transfer and the use of intangibles.

Despite the great efforts of the OECD committee to achieve a strong package, the lack of clear direction, political concerns to preserve tax breaks considered to be beneficial to national competitiveness, and the need for international consensus, "*have led to a package tending to the lowest denominator*".[3] This result within the BEPS proposals is going to add to the international tax framework complexity, sophistication and higher compliance burden, especially in relation to transfer pricing.
The delivered approach does not restore the so-called "level playing field" among big tech players and SMEs operating only in domestic markets. Furthermore, tax competition between countries to attract foreign direct and indirect investments will not cease to exist, together with the related distortions on international investment decisions, leading to inefficient capital allocation and redistribution of the tax burden away from capital to less mobile factors.
Critics have also argued that since multinationals are single economic entities, keep treating them as if they were made of separate legal entities is an unsatisfactory criterion to allocate profits to different jurisdictions. Thus, the introduction of a "formulary apportionment" would be a much more desirable outcome since it reflects the highly integrated nature of business activities conducted by multinational enterprises, moreover such solution would potentially tackle tax avoidance schemes in a simple and straightforward way.

Although the BEPS project itself can only be said to have been at best a partial success, it is submitted that the perfect should not be the enemy of the good, since at the end of the day, the approach does carry attractive advantages by potentially increasing the taxable income by source jurisdictions and providing national tax authorities with additional means to fight against aggressive tax planning.

[3] The BEPS Monitoring Group 2015, *Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project*. Available: https://www.globalpolicy.org/home/272-general/52817-overall-evaluation-of-the-g20oecd-base-erosion-and-profit-shifting-beps-project.html [2016, 02/12].

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