

# Clarification on the application of the permanent establishment definition in e-commerce – Changes to the Commentary on the Model Tax Convention on Article 5

OECD Committee on Fiscal Affairs  
22 December 2000

## Introduction

1. This document contains the changes to the Commentary on the OECD Model Tax Convention adopted by the Committee on Fiscal Affairs on 22 December 2000 concerning the issue of the application of the current definition of permanent establishment in the context of e-commerce. It follows two previous drafts which were released for comments by Working Party No. 1<sup>1</sup> in October 1999 and March 2000.
2. The Committee wishes to thank the individuals, organizations and non-member countries that have sent comments on the previous drafts. These comments have helped the Working Party to draft the changes to the Commentary on Article 5 which are included in this document. The comments that were received from non-member countries lead the Committee to believe that these changes reflect interpretations that have wide support both among OECD and non-OECD countries.
3. The conclusions reflected in this document have been reached after a thorough analysis of the various conditions underlying the current treaty definition of permanent establishment having regard to work done over the last few years by the Working Group on Permanent Establishments. When drafting the changes included in this document, the Working Party has taken care to ensure that its interpretation of these conditions in the context of e-commerce remained fully consistent with the views of its Member countries on the application of these conditions to more traditional business operations.
4. The Committee wishes to stress that the changes included in this document deal exclusively with the permanent establishment definition as it currently appears in Article 5 of the OECD Model Tax Convention. The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits in the Context of Electronic Commerce has been given the general mandate “to examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules.” The Committee looks forward to receiving the views of the TAG on the more important issue of whether any changes should be made to that definition or whether the permanent establishment concept should be abandoned. The work of that group will assist the Committee in deciding whether changes need to be made to the Model Tax Convention to address this broader issue.
5. The Committee also looks forward to receiving the views of that TAG and the conclusions of the Working Party No. 6 on the Taxation of Multinational Enterprises on the issue of how much income should be attributed to electronic commerce operations carried on through computer equipment in circumstances where there would be a permanent establishment.
6. As this document shows, the Committee has been able to reach a consensus on the various issues concerning the application of the current definition of permanent establishment in the context of e-commerce (subject to the two dissenting views described at the end of this paragraph and of paragraph 14 below). This consensus includes the important views that a web site cannot, in itself, constitute a permanent establishment, that a web site hosting arrangement typically does not result in a permanent establishment for the enterprise that carries on business through that web site and that an ISP will not, except in very unusual circumstances, constitute a dependent agent of another enterprise so as to constitute a permanent establishment of that enterprise. However, Spain and Portugal do not consider that physical presence is a requirement for a permanent establishment to exist in the context of e-commerce, and therefore, they also consider that, in some circumstances, an enterprise carrying on business in a State through a web site could be treated as having a permanent establishment in that State. That is the reason why Spain and Portugal look forward to the results of the work of the TAG on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Prof-

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

its in the Context of Electronic Commerce (see paragraph 4) as regards the issue of whether changes to the definition of permanent establishment should be made to deal with e-commerce.

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

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

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

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

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

“The definition, therefore, contains the following conditions:

[...]

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

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

13. The same applies as regards to paragraph 10. According to the Committee, the example provided in that paragraph clearly supports the conclusion that no human intervention is required for a permanent establishment to exist. Also, the first sentence (“The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel)”) is still an accurate statement of how business operates but, again, does not rule out that a business may be at least partly carried on without personnel. Finally, the Committee believes that a requirement of human intervention could mean that, outside the e-commerce environment, important and essential business functions could be performed through fixed automated equipment located permanently at a given location without a permanent establishment being found to exist, a result that would be contrary to the object and purpose of Article 5.

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

establishments of e-tailers and intends to make an observation to that effect when the changes to the Commentary on Article 5 are included in the Model Tax Convention.

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

## **Changes to the Commentary on Article 5**

*[Follows the text of the heading and paragraphs 42.1 to 42.10 which have been reproduced in the OECD Commentary on Article 5 immediately following the existing paragraph 42 of that Commentary]*