



Are the Current Treaty Rules for Taxing
Business Profits Appropriate for E-Commerce?
Final Report

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TECHNICAL ADVISORY GROUP ON MONITORING THE APPLICATION OF EXISTING TREATY
NORMS FOR TAXING BUSINESS PROFITS

**ARE THE CURRENT TREATY RULES FOR TAXING BUSINESS PROFITS
APPROPRIATE FOR E-COMMERCE ?**

FINAL REPORT

INTRODUCTION

1. The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits was set up by the OECD Committee on Fiscal Affairs in January 1999 with 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 detailed mandate and the list of persons who participated in the meetings of the TAG appear in annex 1).

2. At its first meeting in September 1999, the TAG agreed on a work programme that contained the following six elements:

1. Consideration of how the current treaty rules for the taxation of business profits apply in the context of electronic commerce, with particular emphasis on four issues:
 - a) The “place of effective management”,
 - b) The concept of a Permanent Establishment (PE),
 - c) The attribution of profit to a server PE,
 - d) Transfer pricing.
2. A consideration of the pros and cons of applying the existing treaty rules taking into account anticipated developments in electronic commerce.
3. The development of criteria to facilitate the evaluation of existing treaty rules in the context of electronic commerce.
4. An assessment of whether, and if so, how the current treaty rules should be clarified in the light of electronic commerce.
5. The identification of alternatives to the current treaty rules for determining the taxing rights of source and residence countries and to the current treaty rules for the allocation of profit between the taxing jurisdictions.
6. An assessment of the alternatives to the current rules on the basis of the evaluation criteria.

3. Work related to the first element of the work programme has resulted in discussion drafts on “Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions”, which was released in February 2001, and “Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention”, released in May 2003.¹ This report deals with the remaining elements of the work programme and is divided as follows:

1 That last document followed a previous discussion draft entitled “The Impact of the Communications Revolution on the Application of ‘Place of Effective Management’ as a Tie Breaker Rule”, released in February 2001.

- section 1 examines some of the new business models that have served as background for the TAG’s analysis;
- section 2 summarizes the existing treaty rules for taxing business profits;
- section 3 presents a critical evaluation of the current treaty rules;
- section 4 examines some alternatives to the current treaty rules for taxing business profits;
- section 5 presents the conclusions and recommendations of the TAG.

4. The final version of this report was prepared after a first draft was released for comments. In inviting comments, the TAG did not put forward any proposal for changes but merely identified and analysed alternatives that had been brought to its attention.

5. A number of changes were made to the report based on the comments that were received on that draft and the TAG wishes to thank the following groups which provided these comments:

- Business and Industry Advisory Committee to the OECD (BIAC);
- Confédération fiscale européenne
- The PE Coalition
- Centre for European Economic Research
- Electronic Commerce Tax Study Group (ECTSG)
- Information Technology Association of America

1. BACKGROUND: THE EMERGENCE OF NEW BUSINESS MODELS

6. The Internet has changed how business is conducted in local, national, and multinational environments. Through the development of various information and communication technologies, the Internet offers a reliable, consistent, secure, and flexible communications medium for conducting business. Whilst the use of the Internet as a marketing and sales tool receives the most publicity, the more significant economic consequences of the Internet arise from the ability of enterprises (including those in traditional sectors) to streamline various core business functions over the Internet. Business functions such as product innovation, production (including delivery of services), administration, accounting and finance, and customer service have all been made more efficient through the use of new communications technologies.

7. The following is an illustrative list of various categories of business models and functions enabled or impacted by the advent of Internet-related technologies. A number of examples of such models and functions are described in detail in annex 2. These examples provided the background for the work of the TAG, which took them into account when discussing how the existing treaty rules for taxing business profits, as well as various possible alternatives, would apply to electronic commerce.

- *Outsourcing*: new communications technologies allow enterprises to outsource the provision of services and to reach new suppliers of components and materials. A principal effect of outsourcing is to reduce costs for the enterprise, as the outsourcing service provider normally can provide the services, components and materials at lower cost than the enterprise, due to greater functional specialization, lower wage costs, or other factors. Another goal frequently is to improve quality, as functions are outsourced to enterprises which perform that function as a core competency.

- *Commodity suppliers:* The supply of raw materials is greatly facilitated by web-based systems that streamline the ordering, selling and payment systems for both small and large sellers/purchasers. These systems also extend the market for such products and ensure more competitive and transparent pricing.
- *Manufacturing:* New information technologies allow manufacturers to substantially reduce procurements costs. In turn, this allows their suppliers to access new customers or markets and reduce their transaction costs. These technologies also enable manufacturers to increase their direct sales to consumers, for instance by facilitating custom ordering of products. Similarly, they facilitate the outsourcing of non-core activities, such as manufacturing, of many product suppliers. Traditional manufacturers themselves can outsource manufacturing of components to lower cost locations.
- *Retail distribution:* Through their web sites, enterprises may provide low cost products with a high degree of convenience and customization for their customers. Many business functions (e.g. procurement, inventory management, warehousing, shipping etc.) may be automated. This reduces costs for the consumer and allows him to have access to new customized services. This can be done by new businesses or by traditional retailers which want to supplement their traditional sales channels or improve services to their customers. Electronic marketplaces (e.g. online consumer auctions, electronic marketplaces operated by content aggregators or online shopping portals) allow consumers new ways to buy products or compare prices.
- *Delivery:* Shipping enterprises benefits from new technologies (e.g. online parcel order and tracking systems), which allow quicker and more accurate deliveries. This allows their business customers to outsource order fulfillment functions in order to concentrate on core activities.
- *Marketing and customer support:* Through the Internet, enterprises can present information about their products or services to a larger audience in a more efficient and cost-effective manner. This allows small and remote businesses to enter new markets. Customer support also greatly benefits from new technologies, which allow worldwide access to call centers and customer-related operations, which can be provided by any jurisdiction that offers an educated and highly skilled employment base or presents cost-effective opportunities.
- *Information:* New technologies have made possible a vast array of new approaches to the delivery and treatment of information. Computer networks such as the Internet allow worldwide and almost instantaneous delivery of information in various forms to individuals and businesses. Some countries get access to information not previously available and the costs of accessing and searching information are substantially reduced for all. E-learning and interactive training allow a more generalized access to education and training, whether general or labour-oriented. The treatment of information is greatly facilitated, for instance through data processing, information storage systems and application service providers.
- *Financial Services:* Financial services, such as banking, brokerage and life insurance, are now routinely offered through the Internet. This can be done by traditional financial institutions or by new businesses, which can now enter markets without incurring the enormous expenses of setting up a brick-and-mortar branch network. Further, financial institutions can now offer new functions related to the security of e-commerce transactions.

- *Other services*: Various other types of services have greatly benefited from web-based network. This has been the case, for instance, in the areas of travel (e.g. flights booking, car rental and hotel reservations) and health-care (better information on health issues and products, greater access to health specialists, improved treatment of health expenses and patient information).
- *Digital products*: Various digital products (e.g. software, music, video, games, news, e-books, etc.) can be marketed and, in some cases, distributed through web-based systems in direct purchase, rental, or pay-per-use transactions.

8. These examples show that new information technologies create opportunities and benefits for business and private consumers, even though businesses have so far made a greater use of these technologies. Indeed, all available data show that e-commerce at the consumer retail (BtoC) represents, at the present time, only a fraction of e-commerce between businesses (BtoB). The new information technologies create and facilitate business opportunities for traditional as well as high-tech enterprises, and for enterprises in all economies. For example, those opportunities include outsourcing non-core functions to related or unrelated entities enjoying cost advantages (which is a main advantage of new information technologies for business). Similarly, some businesses have gained the flexibility through the Internet to structure production, service, administration, financial or other operations in the most cost-effective and efficient manner. As a result, businesses have located personnel and other value producing activities in those places which yield the greatest return on investment. For other businesses, barriers to entry have been significantly reduced so as to allow them to conduct new profit seeking activities and/or to compete on an international scale. Finally, businesses have also been able to decentralize major business functions so as to address and provide for the needs of customers in remote jurisdictions. In most instances, such local presence has remained a necessity to maintain a competitive advantage and to provide the desired product or service to the recipient in the quickest and most cost-effective manner.

9. Whilst the development of such new business models based on new information technologies illustrates the significant changes in the way that business is carried on, the question is whether and to what extent the existing tax treaty rules can deal appropriately with these changes or will require modification.

2. DESCRIPTION OF THE CURRENT TREATY RULES FOR TAXING BUSINESS PROFITS

10. Whilst there are significant differences between bilateral tax treaties, the principles underlying the treaty provisions governing the taxation of business profits are relatively uniform and may be summarized as follows.

A. Liability to a country's tax: residents and non-residents

11. Under the rules of tax treaties, liability to a country's tax first depends on whether or not the taxpayer that derives the relevant income is a resident of that country. Any resident taxpayer may be taxed on its business profits wherever arising (subject to the requirement that the residence country eliminate residence-source double taxation) whilst, as a general rule, non-resident taxpayers may only be taxed on their business profits to the extent that these are attributable to a permanent establishment situated in the country (see below for the exceptions to that general rule).

12. Residence, for treaty purposes, depends on liability to tax under the domestic law of the taxpayer. A company is considered to be a resident of a State if it is liable to tax, in that State, by reason of factors (e.g. domicile, residence, incorporation or place of management) that trigger the widest domestic tax liability. Since the reference to domestic factors could result in the same company being a resident of the

two countries that have entered into a treaty, treaties also include so-called “tie-breaker” rules that ensure that a taxpayer will have a single country’s residence for purposes of applying the treaty. The tie-breaker rule of the OECD Model Tax Convention provides that a company that is considered to be a resident of two countries is a resident only of the country in which its place of effective management is situated.²

B. Permanent establishment: the treaty nexus/threshold for taxing business profits of non-residents

13. Treaty rules for taxing business profits use the concept of permanent establishment as a basic nexus/threshold rule for determining whether or not a country has taxing rights with respect to the business profits of a non-resident taxpayer. That threshold rule, however, is subject to a few exceptions for certain categories of business profits (see below). The permanent establishment concept also acts as a source rule to the extent that, as a general rule, the only business profits of a non-resident that may be taxed by a country are those that are attributable to a permanent establishment.

14. The basic treaty definition of “permanent establishment” is “a fixed place of business through which the business of an enterprise is wholly or partly carried on”. That definition incorporates both a geographical requirement (i.e. that a fixed physical location be identified as a permanent establishment) as well as a time requirement (i.e. the presence of the enterprise at that location must be more than merely temporary having regard to the type of business carried on).

15. In order to be able to conclude that part or the whole of the business of an enterprise is carried on through a particular place, that place must be at the disposal of that enterprise for purposes of these business activities. The treaty definition of permanent establishment provides, however, that if the place is only used to carry on certain activities of a preparatory or auxiliary character, that place will be deemed not to constitute a permanent establishment notwithstanding the basic definition.

16. The basic definition of permanent establishment is supplemented by a rule that deems a non-resident to have a permanent establishment in a country if another person acts in that country as an agent of the non-resident and habitually exercises an authority to conclude contracts in the name of the non-resident. That rule, however, does not apply to independent agents acting in the ordinary course of their business.

17. The interpretation of the current treaty definition of permanent establishment in the context of e-commerce has raised some questions. The OECD has now clarified how it considers that the definition should be applied with respect to e-commerce operations. The main conclusions that it has reached in that respect are as follows:

- a web site cannot, in itself, constitute a PE;
- web site hosting arrangements typically do not result in a PE for the enterprise that carries on business through the hosted web site;
- except in very unusual circumstances, an Internet service provider will not be deemed (under the agent/permanent establishment rule described above) to constitute a permanent establishment for the enterprises to which it provides services;

2 The impact of e-commerce on this tie-breaker rule was the subject of the discussion draft referred to in paragraph 3 above.

- whilst a place where computer equipment, such as a server, is located may in certain circumstances constitute a permanent establishment, this requires that the functions performed at that place be such as to go beyond what is preparatory or auxiliary.

18. As already mentioned, there are a number of exceptions to the permanent establishment nexus/threshold general rule as regards some categories of business profits.

19. On the one hand, some categories of profits may be taxed in a country even though there is no permanent establishment therein. This is the case of:

- profits derived from immovable property (e.g. hotels, mines etc...), which, in all or almost all treaties, may be taxed by the country of source where the immovable property is located;
- profits related to the performance of entertainers and athletes, which, in all or almost all treaties, may be taxed by the country of source where the performance takes place;
- profits that include certain types of payments which, depending on the treaty, may include dividends, interest, royalties or technical fees, on which the treaty allows the country of source to levy a limited tax based on the gross amount of the payment (as opposed to the profit element related to the payment);
- under some treaties, profits derived from collecting insurance premiums or insuring risks in the source country;
- under some treaties, profits derived from the provision of services if the presence of the provider in the country of source exceeds 183 days in a 12-month period.

20. On the other hand, all or almost all treaties also provide that profits from the operation of ships and aircraft in international traffic may not be taxed by the source country even though there is a permanent establishment situated in that country. Most treaties also provide that capital gains (except on immovable property and business property of a permanent establishment) may not be taxed by the country of source.

C. Computation of profits: the separate entity accounting and arm's length principles

21. The treaty principles for computing the business profits that may be taxed by a country are similar whether a country has taxing rights over business profits because these profits are those of a resident taxpayer or because these business profits are attributable to the permanent establishment of a non-resident taxpayer. In both cases, the rules for computing the business profits that may be taxed by the source country are based on the separate entity accounting and arm's length principles. Thus, each legal person or permanent establishment is generally treated as a separate taxpayer regardless of its relationship with other entities or parts of an entity. Each branch or subsidiary that is part of a multinational enterprise is therefore treated separately for purposes of the computation of profits under tax treaties, with the important proviso that, for purposes of determining the profits of each such branch or subsidiary, the conditions (i.e. primarily the price) of intra-group transactions may be readjusted to reflect those that would prevail between independent enterprises (the arm's length principle). The OECD, in its *Transfer Pricing Guidelines* (1995, in paragraphs 5 and 6 of the preface), identifies the "separate entity approach as the most reasonable means for achieving equitable results and minimizing the risk of unrelieved double taxation," notes that, "to apply the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act at arm's length in dealing with each other," and concludes, "To ensure the correct application of the separate entity approach, OECD Member Countries have adopted the arm's-length principle..."

22. The “traditional” methods of determining arm’s length prices (contained in Chapter II of the OECD *Transfer Pricing Guidelines*) are a) comparable uncontrolled prices (CUP), b) resale price (minus a margin), c) cost plus (a mark-up). In recent years, reflecting problems in applying the traditional methods, two additional “transactional profits methods” have been added to the OECD *Transfer Pricing Guidelines*: the “profit split method” and the “transactional net margin method.”

23. *Profit split method.* The profit split methodology first identifies the combined profit to be split between the affiliated enterprises from controlled transactions and then seeks to divide that profit based on the functions performed, assets used and the risks assumed by each. The profits to be split may be either the total combined profits from the controlled transactions or the residual profits that cannot be easily assigned to any of the enterprises on some appropriate basis, after providing a basic return to each entity for the activities performed.

24. *Transactional net margin method.* The transactional net margin method examines profit margins, relative to an appropriate base such as costs, sales, or assets. Thus it operates in a manner similar to the cost plus and resale price methods.

25. The OECD notes at paragraph 3.49 of the Transfer Pricing Guidelines that traditional transaction methods are to be preferred over transactional profit methods. It is however recognised at paragraph 3.50 that there are cases of last resort where traditional transaction methods cannot be applied reliably or exceptionally at all and so where transactional profit methods have to be applied. The paragraph concludes that as a general matter the use of transactional profit methods is discouraged. Since 1995, however, there has been a much wider use of profit methods by both taxpayers and tax administrations, especially to deal with the integration of functions within a multinational group (see the 1998 OECD Global Trading Report) and with unique and highly valuable intangibles. Further, the OECD is currently reviewing the treatment of profit methods as part of the process of monitoring the Transfer Pricing Guidelines.

D. The treaty rules for sharing the tax base between States where there is nexus

26. Since tax treaty rules allow for business profits to be taxed by both the source and residence countries in some cases, the same business profits may be subject to competing claims by these countries. Such competing claims are addressed by giving priority to source taxation. This priority is ensured by rules that either provide for the exemption from residence taxation of items of income with respect to which a tax treaty grants source taxation rights to the other State or that allow the source country’s tax to be credited against the residence tax on such items.

27. As treaty rules also allow certain categories of profits to be taxed by a source country where there is no permanent establishment (see above), there can be, in certain cases, taxation in the State of source, in the State where the permanent establishment to which such profits are attributable is located and in the State of residence of the taxpayer to which that permanent establishment belongs. Tax treaties provide for the elimination of such triple taxation by giving priority (through the exemption/credit rules described above) to source taxation, then to taxation in the State where the permanent establishment is located, with residual taxation rights being given to the State of residence.

3. A CRITICAL EVALUATION OF THE CURRENT TREATY RULES WITH RESPECT TO E-COMMERCE

28. For the purpose of evaluating the current treaty rules, as well as various possible alternatives for taxing business profits arising from e-commerce, the TAG found it useful to first examine a number of alleged pros and cons of the existing rules. The discussion of these pros and cons allowed the TAG to assess these rules against a number of criteria for the evaluation of the existing rules and of possible

alternatives. These criteria were derived from a set of principles, referred to as the Ottawa framework conditions,³ that were developed at a 1998 high-level meeting on the taxation of e-commerce in which OECD and non-OECD countries as well as business representatives participated.

A. Consistency with the conceptual base for sharing the tax base

29. Arguments in favour or against the existing rules (and their alternatives) are often based on certain assumptions regarding where business profits ought to be taxed. The TAG therefore spent a considerable time discussing what was the most appropriate conceptual base for the inter-country allocation of taxing rights over business profits.

30. As regards tax treaties, the consideration of that issue in a multilateral setting goes back to the work of the International Chamber of Commerce and the League of Nations in the 1920s,⁴ and in particular to a 1927 report of an international Committee of Technical Experts which lead to the adoption of the major rules which are now reflected in the OECD Model Tax Convention and on which most current tax treaties are based.⁵

31. The question of the allocation of taxing rights over business profits may be divided in two separate, but intertwined, issues:

- in what circumstances should a country have a legitimate claim to tax the business profits of a foreign enterprise (i.e. the jurisdiction or nexus issue);
- what is the appropriate basis for deciding which part of the business profits of a foreign enterprise should be taxed in a country (i.e. the measurement of profits issue).

Jurisdiction or nexus issue

Residence versus source taxation of business profits

32. A number of theoretical arguments can be used to argue that income should generally be taxed exclusively in the State of residence.⁶ This approach, among others, was reviewed and rejected by a group

3 OECD, Committee on Fiscal Affairs, “Electronic Commerce: Taxation Framework Conditions”, Directorate for Financial, Fiscal and Enterprise Affairs, October 8, 1998.

4 “The search for principles in international revenue and tax-base allocation is nothing new” R.A. Musgrave and P.B. Musgrave, “Inter-nation Equity”, in *Modern Fiscal Issues – Essays in honor of Carl S. Shoup*, (R. M. Bird and J. G. Head, editor), page 63, at 64. As an example, these authors referred to the 13th century discussions, between Italian theologians, of the allocation of property as a tax base between situs and owner’s domicile.

5 See *Double Taxation and Tax Evasion. Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, 1927 (C.216.M.85.1927.II)* (the “1927 Technical Experts’ Report”). It is in the Draft Convention presented in the 1927 Technical Experts’ Report that the basic permanent establishment Article of today is first introduced.

6 See, for instance, U.S. Treasury, *Blueprints for Basic Tax Reform* (1977). One such argument is based on the ability-to-pay principle: “...the principal normative justification for income taxation is that it allocates the costs of government among taxpayers on the basis of comparative well-being, or ability-to-pay. The conventional view holds that ability-to-pay always should be measured in terms of worldwide income, not income restricted to particular geographical sources. A source taxation regime, however, only reaches income earned within the source country. Consequently such a regime usually does not take the taxpayer’s full income into account and, according to the prevailing orthodoxy, cannot be grounded on an ability-to-pay principle. For some analysts, this fact makes source-based income taxation illegitimate.” Stephen E. Shay, J. Clifton Fleming Jr. and Robert Peroni, “What’s Source Got to Do With It? Source Rules and

of economists (the “Economists”) appointed by the League of Nations to study the question of double taxation from a theoretical and scientific point of view.⁷ In place of these theories, the 1923 Economists Report posited that taxation should be based on a doctrine of *economic allegiance*: “whose purpose was to weigh the various contributions made by different states to the production and enjoyment of income.”⁸ The Economists identified four factors comprising economic allegiance, and classifying wealth into seven overall categories, identified the relative significance of the different factors with respect to each class of wealth. In general, the Economists concluded that the most important factors (in different proportions depending on the class of income at issue) were (i) the origin of the wealth (i.e., source) and (ii) where the wealth was spent (i.e., residence). The origin or production of wealth was defined for these purposes as all the stages involved in the creation of wealth.⁹ As noted by the Economists, “these stages up to the point

International Taxation”, The David R. Tillinghast Lecture, 56 *Tax Law Review* (2002), 81 at 92 (this article, however, does not endorse that reasoning and supports source taxation).

⁷ See Report on Double Taxation, submitted to the Financial Committee by Professors Bivens, Einaudi, Seligman and Sir Josiah Stamp, League of Nations Doc E.F.S.73 F.19, (the “1923 Economists Report”). The 1923 Economists Report presented an overview of the historical use of “cost” and “benefit” theories to justify taxation. Both theories stem from the notion that there is a “social contract” between a state and taxpayer. The 1923 Economists Report then described the “faculty” or “ability to pay” theory of taxation which supplanted the exchange theory of taxation (under either the cost or benefit theories). Under the faculty theory, taxation is based according to the total resources of the individual, leading to a purely residence based and progressive-type of tax. With respect to an exclusive residence based taxation system, the 1923 Economists Report stated:

“A third possible principle is that of *domicile or permanent residence*. This is a more defensible basis, and has many arguments in its favour. It is obviously getting further away from the idea of mere political allegiance and closer to that of economic obligation. Those who are permanently or habitually resident in a place ought undoubtedly to contribute to its expenses. But the principle is not completely satisfactory. For, in the first place, a large part of the property in town may be owned by outsiders: if the government were to depend only on the permanent residents, it might have an insufficient revenue even for the mere protection of property. In the second place, most of the revenues of the resident population may be derived from outside sources, as from business conducted in other States: in this case, the home government would be gaining at the expense of its neighbour.” The 1923 Economists Report, at Part II, Section I.A. The Basis of Taxation. The Principle of Ability to Pay.

⁸ Micheal J. Graetz & Michael O’Hear, “The ‘Original Intent’ of U.S. International Taxation,” 46 *Duke Law Journal*, 1021, at 1076-1077 (1997).

⁹ “When we are speaking of the origin of wealth, we refer naturally to the place where the wealth is produced, that is, to the community the economic life of which makes possible the yield or the acquisition of the wealth. This yield or acquisition is due, however, not only to the particular thing but to the human relations which may help in creating the yield. The human agency may be:

- (1) The superintendent or management of the labour and organisation at the situs, e.g., the local manager of a tea plantation;
- (2) The agencies for transport over sea or land touching various territorial jurisdictions, which assist in bringing worthless objects to points at which they begin to be near their market;
- (3) The seat and residence of the controlling power that decides the whole policy upon which finally depends the question whether the production of the wealth will ever be a profitable production or not. It chooses the local management, decides the character of the expenditure of capital and the times and methods of cultivation, decides the markets that are to be utilised and the methods of sale and, in short, acts as the co-ordinating brain of the whole enterprise;
- (4) The selling end, that is, the place where the agents for selling ply their calling and where the actual markets are to be found.

It may be said that no one of these four elements can be omitted without ruining the efforts of the other three and spoiling the whole apparatus for the production of wealth. These have no relation whatever to the place where the final owner enjoys his income from the labours of the four elements. The four of

where wealth reaches fruition, may be shared in by different territorial authorities.”¹⁰ This “origin of wealth” principle has remained a primary basis for source taxation through the many committees and draft conventions prepared under the auspicious of the League of Nations.¹¹

33. The members of the TAG adopted a pragmatic approach and, noting the wide international consensus (reflected in bilateral tax treaties) that countries can tax business profits on both a residence¹² and source basis (subject generally to the permanent establishment threshold), did not question the right of countries to tax on the source basis. The OECD itself had previously recognized that reality:

“It is generally accepted that source countries are entitled to tax income originating within their borders, including income accruing to foreigners. One justification for this entitlement is that the foreign-owned factors of production usually benefit from the public services and the protection of property rights provided by the government of the host country. A source-based tax like the corporation tax may also serve to prevent foreign investors from capturing all of the “economic rent” which may arise when foreign capital moves in to exploit the host country’s production opportunities, e.g. its natural resources.”¹³

The TAG also accepted the fact that residence taxation rights should be residual, i.e. when the countries of residence and source both have the right to tax, the onus to relieve double taxation is on the country of residence.

The source issue: where do business profits originate?

them are thus in different measures related to the origin of the wealth, that is, its production as a physical product.

The origin of the wealth therefore may have to be considered in the light of the original physical appearance of the wealth [e.g., the seed that gets planted], its subsequent physical adaptations, its transport, its direction and its sale.”

¹⁰ The 1923 Economists Report at 23.

¹¹ See, e.g., Double Taxation and Tax Evasion, Report and Resolutions submitted by the Technical Experts to the Financial Committee, February 1925 (F.212); Draft of a Bilateral Convention for the Prevention of Double Taxation and Tax Evasion, Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, April 1927 (C.216.M.85.1927.II); Double Taxation and Tax Evasion, Report presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, October 1928, (C.562.M.178.1928.II); Leagues of Nations, Fiscal Committee, Report to the Council on the Work of the First Session of the Committee, October, 1929 (C.516.M.175.1929.II); Report to the Council on the Work of the Second Session of the Committee, League of Nations, Fiscal Committee May, 1930 (C.340.M.140); League of Nations, Fiscal Committee, Report to the Council on the Fifth Session of the Committee, Purposes of Taxation, June, 1935 (C.252.M.124); League of Nations, Fiscal Committee, London and Mexico Model Tax Conventions, Commentary and Text, November 1946 (C.88.M.88.1846.II.A); The Elimination of Double Taxation, The First Report of the Fiscal Committee of the O.E.E.C, September 1958.

¹² Since cross-border business profits are mostly earned by companies, which can be created at will and the residence of which is legally determined on the basis of incorporation, place of effective management or similar criteria, the type of residence taxation that actually takes place is different from that which is theoretically envisaged and which would allow a proper determination of the ability-to-pay of the taxpayer. This provides another justification for allowing source taxation.

¹³ *Taxing profits in a global economy – Domestic and International Issues*, OECD, Paris, 1991, at 36-37.

34. The conclusion that source taxation of business profits should be allowed requires logically to determine when business profits should be considered to have its source within a jurisdiction. Economic principles provide some guidance in this respect.

35. The two issues of when, and how much of, business profits should be taxed by the source country can be addressed from the different angles of economic efficiency (i.e. what is the least distorting, and therefore welfare maximising, allocation of taxing rights) or equity between taxpayers or between countries.¹⁴

36. In the case of international taxation, economic efficiency is normally discussed in terms of capital export neutrality and capital import neutrality. Capital export neutrality “is said to prevail when the tax system provides no incentive to invest at home rather than abroad, or vice-versa” and “[t]his is achieved when investors are taxed on accrued worldwide income and receive full credit against the domestic tax liability for all taxes paid abroad”.¹⁵ Capital import neutrality “prevails when domestic and foreign suppliers of capital to any given national market obtain the same after-tax rate of return on their investment in that market” and “[p]rovided that source countries do not practice tax discrimination between domestic and foreign investors, capital import neutrality will thus be attained if residence countries exempt all income from foreign sources from domestic tax”.¹⁶ Whether preference should be given to either capital export neutrality or capital import neutrality is a debatable issue but one that is not relevant in the present context. Taking into account the existing practical consensus that source and residence taxation should co-exist, policies of capital export neutrality or capital import neutrality do not depend, in practice, on whether or not a source country has taxing rights over a particular type of income but rather on issues related to non-discrimination and relief of double taxation.

37. The conclusion is similar as regards equity (or fairness) between taxpayers. In the case of taxation by the residence country, the equal treatment of taxpayers will depend on the country’s rules for taxing foreign income and for relieving double taxation, which should ensure that a similar amount of tax is paid on income whether earned domestically or abroad. As regards the source country, the issue is primarily one of similar treatment of domestic and foreign taxpayers (effective non-discrimination). Thus, the issue of equity between taxpayers depends primarily on how the source country taxes foreigners and how the residence country taxes foreign income of its residents.

38. The issues of when, and to what extent, a source country should tax the business profits of foreigners is therefore primarily an issue of inter-nation equity.¹⁷ The difficulty, however, is that there are no universally agreed principles for dividing the tax pie between the source and residence countries, which makes it difficult to determine what is a “fair” allocation of taxing rights between these two countries.

39. One approach is to start from the dual nature of business profits. Business profits, as computed in almost all countries, include a normal return on equity capital (unlike interest, which is the return on debt capital, the return on equity capital is not deductible in computing business profits and is therefore included in these profits). The rest of the profits (which may be referred to as “pure” or “economic” profits) correspond to what the enterprise earns from particular competitive advantages (the “economic rents” referred to in paragraph 33) which may be related to advantageous production factors (such as natural resources that are easily exploitable or low labour costs) or advantages related to the market in which the products will be sold (e.g. a monopolistic position).

¹⁴ See Musgrave and Musgrave (note 4).

¹⁵ OECD Taxing profits in a global economy (note 13) at 39.

¹⁶ Ibid.

¹⁷ Musgrave and Musgrave (note 4) at 68.

40. Economic literature suggests that there are two possible approaches to determining a proper allocation of business profits: the supply-based and supply-demand based views. Under the supply-based approach, profits originate from where the factors that produce the profits operate and the source of the “normal” return of equity capital should therefore be identified “to the location in which the actual operation of the capital occurs”;¹⁸ “[p]ursuant to this approach, the mere consumer market does not represent a factor contributing to the added value of the company.”¹⁹ “As regards economic profits, the supply-based approach would suggest that these should be related to the situs of the locational rents that generate these profits. Under the “supply-demand” view, however, the interaction of supply and demand is what creates business profits. This view would therefore require to take account of the fact that the demand of the products arise from the consumer market.

41. A large majority of the TAG members implicitly rejected the “supply-demand” approach. For them, the mere fact that the realization of business transactions requires an interaction between the supply of goods or services by an enterprise and the demand in a market state has not historically been considered by countries to provide a sufficient link for considering that the profits of the enterprise arising from these transactions should, for purposes of income taxation, be sourced in the market state.

42. The TAG’s approach was therefore in line with the supply-based approach of considering that business profits should be viewed as originating from the location of the factors that allow the enterprise to realize business profits. It therefore rejected the suggestion that the mere fact that a country provides the market where an enterprise’s goods and services are supplied should allow that country to consider that a share of the profits of the enterprise is derived therefrom.

43. The members of the TAG disagreed, however, on an important related issue: i.e. whether a supplier which is not physically present in a country may be considered to be using that country’s legal and economic infrastructure and, if that is the case, whether and to what extent, such use of a country’s legal and economic infrastructure should be considered to be one factor which, under the supply-based view, would allow that country to claim source taxing rights on a share of the enterprise’s profits.

44. For some members, source taxation is justified in such a case because the business profits of the foreign enterprise derive partly from the enterprise’s use of important locational advantages provided by that country’s infrastructure which make the business operations profitable. These may include, but are not limited to means of transportation (such as roads), public safety, a legal system that ensure the protection of property rights and a financial infrastructure.²⁰

45. Other members, however, disagreed. For them, business profits derive from the carrying on, by the enterprise, of business activities and a country is only justified to consider that profits originate from its territory if the enterprise carries on activities thereon. They do not regard an enterprise which may have access to a country’s market as necessarily “using” that country’s infrastructure and, even if that were the case, they consider that such mere use of a country’s general infrastructure would be too incidental to the business profit-making process to consider that a significant part of the profits are attributable to that country.

¹⁸ Id. at 83.

¹⁹ Anne Schäfer and Christoph Spengel, *ICT and International Taxation: Tax Attributes and Scope of Taxation*, Discussion Paper no. 02-81, Centre for European Economic Research, December 2002, at 11.

²⁰ Thus the benefit principle, which provides a justification for rejecting exclusive residence taxation (see above) can also be put forward as a principle for determining the source of the business profits. The same reasoning has also been articulated in terms of the “principle of economic allegiance.” Id. at 12.

46. That disagreement prevented the TAG from articulating a single comprehensive conceptual base for evaluating the current rules for taxing business profits and the alternatives to these rules. One such alternative would be nexus rules that would allow a country to tax a foreign enterprise if the enterprise made use of that country's infrastructure even if it did not carry on activities (at least in the traditional sense) in that country. Members disagreed on whether economic principles could support such nexus rules.

47. The TAG agreed, however, with the clear principle that source taxation should be non-discriminatory²¹ (as indicated above, this is also required by economic efficiency and horizontal equity). Thus, income derived from a particular country should ideally be taxed as if it were earned by a resident of that country. The practical application of that principle is restricted, however, by enforcement considerations. For example, it is very difficult for a source country to properly take account of a taxpayer's worldwide income and expenses for purposes of applying progressive rates to the taxpayer's net domestic source income.

Evaluation of the current nexus rules

48. Historically, it can be argued that, to a large extent, the existing treaty rules that determine when a source country may tax business profits did not emerge from economic principles but from a negotiation process which took place in the 1920s and in which one of the primary factors was enforcement considerations (these considerations arise from the territorial limitations to the countries' capacity to determine, verify and collect tax from foreign enterprises). These enforcement considerations are important in explaining what the rules are or should be. For instance, such considerations related to administrative feasibility may justify not allowing source taxation even where the above economic principles would arguably suggest that a part of the business profits should be considered to originate from a country (e.g. by adopting a taxation threshold such as the permanent establishment). A strict adherence to source principles is not always possible when these principles must be translated into practical source rules.

49. The members of the TAG who argued that business profits should only be taxed in the country where an enterprise carries on business activities going beyond what some view as the use of that country's infrastructure consider that the current nexus rule found in treaties, which is based on the existence of a permanent establishment in a country, is in line with that principle. They consider that the purpose of the permanent establishment standard is to define when a foreign enterprise has sufficient nexus with the state to warrant the enterprise being subject to a local income tax. Under the current rules, nexus is determined by whether the foreign enterprise or its agents actually conduct core business income-producing activities in the state. Historically, it has been accepted that the conduct of such activities normally requires the foreign enterprise to have some physical presence in the state, by way of labour and/or property. For some members, this reflects a traditional distinction between an enterprise that participates "in" the economic life of a country and one that merely interacts "with" the economic life of a country.

50. Looking at the particular case of e-commerce, these members also argued that the integration of e-commerce efficiencies and/or solutions into a business enterprise does not undermine the soundness of the existing nexus rules in light of the principle that business profits should be taxed where business activities take place. The "new" economy, just as much as the "old" economy, requires an enterprise to utilize capital, labour and other property in its core income-producing activities to develop, market and deliver its products and services. Even if the nature of those inputs and outputs may differ somewhat under the "new" economy (e.g., from manufacturing capacity to knowledge workers on the input side; and tangible property to services on the output side), the essential fact remains the same: physical activity

²¹ Some observers have argued, however, that a principle of effective reciprocity in source country tax rates would be more appropriate than that of non-discrimination (as discussed in OECD "Taxing profits in a global economy" (note 13) at 37).

somewhere, as reflected by an entrepreneur's risk assumption, labour deployment, and property investments, remains a necessary component to an enterprise's creation of products and services. Nothing in the "new" economy changes the proper justification for a state to impose an income tax on an enterprise.

51. Other members, however, questioned to what extent it is appropriate to rely on whether or not business activities are carried on in a jurisdiction as a nexus in the case of modern business models. They argued that new technologies mean that enterprises can readily participate in geographically distant markets, and it may no longer be appropriate to focus only on the activities of the enterprise in determining where functions are performed; enterprises can therefore undertake a substantial level of commerce in another country without establishing the kind of physical presence that was required in the early 20th century. Where the functions require the interaction of the customer (such as in sales and many service transactions), they argue that the functions are at least partly carried out where the customer is located. Thus, for these members, an enterprise may participate to a significant degree in the economic life of a country through automated functions (such as on-line trading) without the need for a human or physical presence that would result in a permanent establishment.

52. Also, even if one accepts the principle that business profits should only be taxed in the country where an enterprise carries on business activities going beyond what some view as the use of that country's infrastructure, it is difficult to reconcile that principle with the existing exceptions, incorporated in the OECD Model and in most tax treaties, for certain business activities such as purchasing or activities that do not take place at a fixed location (e.g. services provided without a permanent establishment). Again, however, it could be argued that such exceptions are justified by enforcement considerations. Thus, it could be argued that whilst the permanent establishment threshold might not allow a country to tax all situations where income originates from its territory, it is a threshold which primarily addresses the issue of whether there is enough business profits to justify the administrative burden of source taxation.²²

Measurement of profits

53. As already noted, the issues of jurisdiction to tax and measurement of profits are intertwined. Once it has been established that a share of an enterprise's profits can be considered to originate from a country and that the country should be allowed to tax it, it is necessary to have rules for the determination of the relevant share of the profits which will be subjected to source taxation.

54. One would expect a logical link between the principles used to determine whether a part of the business profits originates from a country and the principles on the basis of which that part should be measured since "presumably, the objective is to divide up the tax base in line with the territorial origin of the profits."²³ However, the same administrative considerations that lead to source rules that do not strictly follow the source principles discussed above may require measurement rules that will deviate from these principles.

55. For those who argue that, under the supply-based view, a country is only justified to consider that profits originate from its territory if the enterprise carries on activities thereon, the existing treaty rules for the measurement of profits, which are based on the separate accounting and arm's length principles, may be considered to be broadly in line with that view because they accurately measures the profits attributable to the activities performed at each location. Under the current arm's length transfer pricing rules, a state's

²² Recent developments in the area of international exchange of information and assistance in the collection of taxes (e.g. the addition of a new article on assistance in collection of taxes in the OECD Model) may contribute to gradually reduce the importance of these administrative considerations.

²³ Musgrave and Musgrave (note 4) at 82.

share of that profit directly reflects the value of the functions performed in that state, taking into account assets used and risks assumed.

56. For those, however, who adopt a different view of the supply-based approach and consider that a share of the business profits originate from a foreign enterprise's use of locational advantages provided by a country's infrastructure, the existing treaty rules for measuring the profits derived from the source country may under-estimate the profits of the source country.

57. Also, under either view, it could be argued that since the existing rules for the measurement of profits taxable in a given jurisdiction rely on the separate accounting and arm's length principles, they encounter a fundamental and conceptually intractable difficulty. Economic interdependence and synergy between various parts of the corporate group produces profits that would not exist if unrelated firms engaged in similar activities, and it is conceptually impossible to allocate those profits scientifically. For those who make that argument, the arm's length principle is based on an underlying assumption that denies the very *raison d'être* of the modern corporation — that affiliated entities behave like unrelated ones and engage in similar transactions on similar terms. The advent of electronic commerce may exacerbate the problem since intangible products, the return from which is very difficult to attribute to particular activities having taken place in a given country, are at the heart of many e-commerce business models. A counter-argument, however, is that the growing recognition and use of profit-based methods by tax administrations and taxpayers (see paragraph 25) makes it possible to take account of the integration of functions within a multinational when applying the arm's length principle. Also, it could be argued that the principal effect of many e-commerce business models is to create cost economies in distribution, procurement or other functions, the economic effects of which would seem to be measurable under the arm's length principle.

58. Finally, it was noted that under existing treaty rules, business profits may be subject to tax on a gross basis in certain circumstances. This is true, for example, of interest received by banks and other financial institutions in cases where the income is not attributable to a permanent establishment in the source state. Many treaties (including those based on the OECD Model) allow the source country to tax such interest on a gross basis. A gross basis tax does not, by definition, take into account the deductions incurred in earning the income. A financial institution is usually highly leveraged. As a result, a tax imposed on a gross basis will in many cases exceed not only the normal net income tax that would be imposed on such income in the home state, but may actually exceed the amount of income earned with respect to the particular transaction. Similar concerns arise with respect to royalties, since the developer of intangible property in most cases incurs significant costs.²⁴ Thus, the current rules that allow taxation of business profits on a gross basis in certain circumstances do not appear to be consistent with a conceptually sound measurement of business profits.

59. That led some members of the TAG to question whether the classic distinction between active and passive income, which underlies the current treaty rules, is still appropriate in light of evolving business practices. For these members, that distinction has become increasingly blurred, particularly in an electronic commerce environment. For the members who shared that view, this blurring between the active and passive ways of deriving income raises some issues about the appropriateness of the current treaty rules which provide for different tax treatment for business profits and passive income, and, in particular, the appropriateness of an all-or-nothing tax threshold for taxing business profits versus shared taxing rights for passive income.

24 It has been argued that treaty provisions that allow taxation of some types of business income on a gross basis take indirectly account of the deductions attributable to the relevant income by providing a lower rate than that provided by domestic law. It is difficult, however, for any tax treaty that allows taxation at source to provide enough different withholding tax rates to take account of the different cost structures of different taxpayers.

B. Neutrality

60. Neutrality is clearly an important tax policy objective and was specifically identified, in the Ottawa framework conditions, as an important consideration for purposes of taxation of e-commerce. In this regard, it is important to note that the current rules do not have special rules for e-commerce. These rules therefore deal with e-commerce as they do with most types of activities (as was shown by the conclusions reached by the OECD on the issue of the application of the permanent establishment concept to e-commerce). When the TAG discussed whether special rules could or should be designed for e-commerce, many members argued that there would be no fundamental basis for distinguishing between “traditional” businesses and those utilizing advanced communications technology in their business models. The most “traditional” of business enterprises (*e.g.*, the automotive and airline industries, distributors, retailers, etc.) continue to incorporate e-commerce business models. Whilst e-commerce has created new products and services, it also has changed the way “traditional” business activities are being conducted by all enterprises (*e.g.*, by introducing efficiencies into the procurement of supplies, collaborative R&D efforts, delivery of products and services to customers, performance of back-office functions such as accounting & finance, etc.). Accordingly, it would not be appropriate, nor possible, to design one set of nexus rules for “e-commerce” companies, and another for non-e-commerce companies.

C. Efficiency

61. It is generally agreed that the compliance burden that tax rules impose on taxpayers, as well as the administrative costs of applying these rules for tax administrations, should be minimised as far as possible.

62. Through the permanent establishment concept, the current treaty rules for taxing business profits generally provide that unless a foreign enterprise has employees or assets at a given location in a State, that State will not be able to tax the business profits of the foreign enterprise. These rules probably achieved international consensus primarily because of practical considerations related to the determination and the collection of taxes. Indeed, it is probably right to assume that when this consensus emerged, most permanent establishments involved a number of employees working at a particular location with assets and accounting records²⁵ being kept at that location. Domestic access to accounting records and employees allows tax authorities to obtain and verify the necessary information for taxing business profits on a net basis whilst the presence of assets in the State provides a guarantee for the collection of taxes.

63. It could be argued, however, that the development of international exchange of information and assistance in the collection of taxes have made these practical considerations less important. The fact is, however, that recourse to international exchanges of information and assistance in collection for purposes of taxing business profits is still the exception rather than the rule, especially for developing countries.

64. The current international rules are aimed at allocating business profits to the jurisdiction in which the profits are earned and then taxing these profits on a net basis. Paragraph 3 of Article 7, for example, requires a jurisdiction in which a permanent establishment is located to allow a deduction for expenses incurred in earning the income attributable to that permanent establishment. If tax authorities do not have appropriate access to the information necessary to determine the revenues and expenses, the risk is that they will find an alternative basis (such as withholding taxes on gross business payments, as is often the case for interest and royalties) for collecting the tax.

25 The view that separate accounting records would be maintained for most permanent establishments is still found in paragraph 12 of the Commentary on Article 7, which was drafted more than 40 years ago.

65. Whilst this suggests that the permanent establishment concept provides a nexus rule that does not impose undue compliance or administrative burden on taxpayers and tax authorities, many members have argued that the current rules for measuring the profits that are taxable in a jurisdiction create important administrative difficulties. The main problem that was identified in that respect was the difficulty to find comparable transfer prices. Comparable prices simply may not exist. Perhaps the most important deviation from the state of affairs assumed to underlie the use of transfer prices based on comparable transactions is the existence of intangible assets, the “crown jewels” that lie at the heart of the modern corporation.²⁶ As already noted, however, the wider use of profit methods by both taxpayers and tax administrations suggests that this criticism may be addressed in the context of the existing rules.

D. Certainty and simplicity

66. Ideally, tax rules should be clear and simple to understand. Certainty also implies that tax rules should minimize disputes and provide appropriate ways to solve them when they arise.

67. Although the current permanent establishment definition and the relevant Commentary arguably require some subjective judgment in their application, taxpayers and tax administrators appear to have reached a general (although certainly not unanimous) consensus about what does and what does not constitute a PE, leaving the middle ground open for dispute. Many multinationals are proactively creating locally taxable legal entities when they feel they have crossed the line between what is definitely not a permanent establishment and the “middle ground”. To illustrate the decision process, it is commonly understood that if a taxpayer has no office, employees, or dependent agents in a jurisdiction, and all sales orders, contracts, etc., are required to be approved outside of a jurisdiction, then that taxpayer will not have a permanent establishment in that jurisdiction. If a taxpayer has an office, employees, or dependent agents in a local jurisdiction, and that presence is expected to be more than transitory, the taxpayer will generally decide that it has “crossed the line” into the middle ground and will establish some form of taxable presence in the jurisdiction. Even if the taxpayer’s employees or dependent agents are arguably performing preparatory or auxiliary activities, many taxpayers will generally choose to have a taxable presence to avoid the risk of being found to have a permanent establishment in circumstances where they considered that they did not have one.

68. The issue is, then, whether the advent of e-commerce is a sufficient reason for challenging the current permanent establishment environment and risking the introduction of more uncertainty and controversy. E-commerce clearly changes the nature of the physical requirements necessary to conduct business in a local jurisdiction. One possible argument might therefore be that, whilst e-commerce businesses that do not have a physical presence in a country may not be benefiting from local services, they may be benefiting from the local economy to the point that they should be subject to local direct taxation of their business profits.

69. A contrary argument, however, is that it is unlikely that a non-resident vendor will obtain significant economic benefits from a local market prior to establishing a locally taxable presence in that market. A non-resident vendor typically begins contributing to the local economy, and local tax base, by

26 "Several national reports identified the task of locating comparable transactions as the most difficult transfer pricing challenge arising from new economy transactions. [...] In general, the national reports suggested that the evolution of business models towards more dispersion of high value-added activities across jurisdictions, more integration of transactions among related entities, and greater specialization of functions all could make identification of comparables more difficult." [...] "The increased utilization of intangible properties in electronic commerce businesses also will complicate the location of appropriate comparables." Gary D. Sprague and Michael P. Boyle, "Taxation of Income Derived from Electronic Commerce – General Report", in *Cahiers de droit fiscal international*, vol. LXXXVIa (International Fiscal Association), Kluwer, 2001, at 41-42.

hiring locally taxable resources even before making a single sale into the market. To reach the breakeven point, the vendor typically has to invest enough direct local resources in the jurisdiction to cross over the line into the grey area between what is definitely not, and what definitely is, a permanent establishment. At that point, the vendor will generally be advised to create a taxable branch or subsidiary in the local market. If the market grows rapidly, accelerating the vendor's breakeven point, that growth will fund the acceleration of the taxable branch or subsidiary presence to support distributors and customers in that market.

70. Another aspect of certainty deals with the way through which disputes are resolved. Currently, disputes concerning the application of treaty rules for the international allocation of taxing rights over business profits are ultimately solved through the domestic court system of the country that imposes the tax in dispute or through the mutual agreement procedure. This dispute resolution mechanism is essentially the same for all tax-treaty disputes. In the vast majority of cases, this system appears to work well. It could be argued, however, that it is deficient both as regards recourse to domestic courts and to the mutual agreement procedure. On the one hand, recourse to the domestic courts of the State of source to solve disputes concerning tax imposed by that State does not prevent the same issue from being decided differently by the courts of the State of residence (which carries risks of double taxation or non-taxation).

71. The mutual agreement procedure (MAP), on the other hand, offers no guarantee that the dispute will be solved. That procedure provides a mechanism by which a taxpayer can seek assistance from the competent authority of the country of which the taxpayer is a resident in resolving double taxation cases with the competent authority of another country. The majority of such cases involve transfer pricing issues where profit allocation issues arise between related parties or in respect of a permanent establishment. The MAP provisions only require that the competent authorities "endeavour to resolve by mutual agreement" such cases. The Commentary to Article 25 of the OECD Model Tax Convention recognises that "the competent authorities are under a duty merely to use their best endeavours and not to achieve a result"²⁷. If, for any reason, the competent authorities fail to reach agreement, the treaties do not provide for further mechanisms for dispute resolution. Although in practice the vast majority of MAPs are resolved without the need for further dispute resolution processes, the current rules can leave an enterprise which operates cross-border in the position of having unrelieved double taxation, or taxation which is not in accordance with the treaty. The current rules also set no time limits for competent authorities to reach agreement, with the result that taxpayers can be left with uncertainties in relation to their tax liabilities for many years. These issues become more important as countries put more emphasis on the verification of transfer prices.²⁸

E. Effectiveness and fairness

72. For the TAG, the principles of effectiveness and fairness have two important practical consequences: taxation should produce the right amount of tax at the right time and the potential for evasion and avoidance should be minimised.

73. Administrative practicality and convenience were among the factors that were taken into account when the permanent establishment provision was designed. It is generally acknowledged that a country's jurisdiction to tax should not extend beyond its power to impose a tax. Therefore, if a taxpayer is not

27 Commentary on Article 25, paragraph 26.

28 The OECD, however, is currently working on improving the mutual agreement procedure and examining alternative dispute resolution mechanisms (e.g. arbitration), see *OECD Launches Project on Improving the Resolution of Cross-border Tax Disputes*, <http://www.oecd.org/oecd/pages/home/displaygeneral/0,3380,EN-document-22-nodirectorate-no-27-40795-22,00.html>

physically present in a country, it may arguably be better if the income of that taxpayer is not subject to tax in that country. The reasons for this view are twofold. First, as a matter of principle it is generally inappropriate for a country to assert jurisdiction over persons or matters beyond its actual power of enforcement. Second, as a practical matter, a country should not seek to impose taxes that it cannot collect. A system of taxation is only perceived to be fair if it can be applied in accordance with its terms. If there is a class of taxpayers (*e.g.*, foreigners with no physical connection to the jurisdiction) that are technically subject to a tax, but as a matter of administrative practice are never required to pay the tax, then the taxpaying public will perceive that the system of tax is unfair and discriminatory. Therefore, the requirement of a fixed place of business serves the interests of fairness and administrability. A counter-argument, however, is that source taxation may effectively be collected without the taxpayer being physically present in the jurisdiction, *e.g.* by withholding tax on payments such as interest and royalties (in that case, however, one can question whether the tax collected is really a tax on business profits as it is typically imposed on gross business payments and not on profits).

The potential for evasion and avoidance should be minimised

74. Some members of the TAG expressed the view that the current rules leave room for manipulation as regards both the measurement of profits and the permanent establishment threshold.

1. *Measurement of profits*

75. The arm's length principle, which is the basis for the current rules for the measurement of profits related to international transactions, assumes independent transfer prices. It has been argued that transfer prices can be determined so as to shift income to low-tax jurisdictions, including tax havens. This is, of course, something that independent parties would not do.²⁹ Where there are relatively few transactions in homogeneous products that are widely traded at known prices, such as petroleum or wheat (of given types and grades), manipulation of transfer prices is relatively easy to detect and correct. Where transactions occur frequently, where products are not homogeneous, where they are not widely traded, and where prices are not easily known, it is difficult to apply the traditional methods of transfer pricing. If transactions occur frequently, it may be impossible to engage in transactional analysis. If products are not homogeneous, it may be necessary to infer prices from those of similar products. If products are not widely traded, ostensibly comparable prices may not accurately reveal appropriate transfer prices to use in valuing transactions. If prices are not known, comparison of transfer prices is not possible.

76. Where a strict comparison of transfer prices is not possible, however, the arm's length principle can be applied through transactional margin methods (*i.e.* cost-plus or resale-minus) or profits-based methods. Also, the EU Commission has recently cited both a survey of large EU taxpayers that suggests that transfer prices are not systematically arranged to shift profits and evidence from the United States that suggests that a widespread tax-induced determination of transfer prices does not occur.

2. *Permanent establishment*

77. It has also been argued that the permanent establishment concept, which is the primary nexus rule for allocating taxing rights on business profits derived by foreign enterprises, is vulnerable to tax planning.

78. Clearly, it can be difficult and maybe impossible in the electronic commerce environment to trace the location from which e-commerce transactions are effected. It is also fairly easy to locate a server in a low-tax jurisdiction, to split various business functions related to a commercial transaction between

29 To the extent independent parties collude to misstate the value of transactions on the books of at least one of the parties they probably engage in fraud; that possibility is not examined further.

different servers and to have web sites hosted by ISPs. This has led some members to argue that this offers attractive tax avoidance opportunities to e-commerce business. However, to the extent that very little profits would be attributed to functions performed through a server (see the TAG discussion draft on Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions) or web site, such planning involving the location of servers and the hosting of web sites would have little consequences on tax revenues.

79. The exception for preparatory or auxiliary activities has also been identified as being particularly prone to tax planning.

80. Under paragraph 4 of Article 5 of the treaty definition of permanent establishment included in the OECD Model Tax Convention, a permanent establishment is deemed not to include the use of facilities or premises solely for the purposes of:

- a) storage, display and delivery of merchandise of the enterprise;
- b) purchase of goods, or collecting information;
- c) maintenance of goods of the enterprise for the purpose of processing by another enterprise;
- d) a combination of the above activities where the overall activity resulting from this combination is of a preparatory or auxiliary character.

81. For some members of the TAG, these exceptions enable foreign enterprises involved in e-commerce to participate in the economic activity of a country to a substantial extent without crossing the permanent establishment threshold. For example, purchases and sales of goods could be made in a country through the internet by a foreign enterprise which would also rent a warehouse for the storage and eventual delivery of these goods to customers in the same country without that enterprise being found to have a permanent establishment in the country.

82. The following more detailed example was presented to the TAG. A non-resident enterprise conducts activities in country S through three separate operations i.e. a distribution centre, a purchasing office and a market research office. E-commerce sales are concluded through a server located in another country. Payments are made through credit cards and a bank account is maintained in country S to pay for operating expenses. Under paragraph 4 of the definition of permanent establishment, the use of facilities in country S solely for the purpose of storage, display and delivery as well as the maintenance of a stock of goods will not constitute a PE. If all these activities were carried on at the same location, they would likely constitute a permanent establishment as they would go beyond what is preparatory or auxiliary. For some members, the fact that the result would be different if the enterprise carried on each activity at a different location is difficult to understand. This problem is perceived to be more acute in the context of e-commerce as the nature of e-commerce may allow a number of automated functions to be carried on from separate locations. These members therefore consider that the exceptions of paragraph 4 are particularly open to tax planning by non-resident enterprises which could thus avoid tax in a country and yet derive significant profits from economic activities carried on in these countries. Clearly, however, technical reasons related to the efficient conduct of business activities limit the extent to which enterprises can do so.

Residence rules

83. It has been argued that the current concept of residence, which determines the country which has residual taxing rights on business profits, is also prone to tax planning.

84. The residence of companies (legal entities) is usually determined on the basis of two different tests: where the company was incorporated and where the company is managed and controlled. Countries will normally use either one of these tests or both.

85. It could be argued that new information technologies facilitate the unintended application of the concept of residence by making it easier to have decisions related to the control and management of an enterprise taken almost anywhere in the world. What constitutes management and control is essentially a question of fact and is generally identified with the place where the decisions of the board of directors, or other similar body vested with the superior directing authority and policy formulation, are taken. Whilst some planning concerning the place of management and control would hardly be a new development, it is argued that new communication technologies (e.g. the advent of video conferencing) would make it possible, for instance, to have board meetings held simultaneously in different countries (this issue is dealt with in the TAG discussion draft on “Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention”).

86. As for incorporation, it has long been recognized that the ability to set up a new company in almost any jurisdiction makes residence almost elective in the case of new business organizations (once an enterprise has been in existence for some time, however, various factors could contribute to make it more difficult for that enterprise to change its residence merely by transferring assets to another company newly incorporated in another jurisdiction). In practice, it is a fairly common tax planning technique to seek the incorporation of a new legal entity in a particular jurisdiction in order to take advantage of different rules for residence taxation.

F. Flexibility

87. Another important principle is that tax rules should be flexible and dynamic to ensure that they keep pace with technological and business developments.

88. The current rules incorporated in the OECD Model Tax Convention, which have largely remained unchanged since they were first drafted more than 40 years ago, have evolved over the years to take account of new business developments. For some members, the existing rules have therefore shown that they are sufficiently flexible to accommodate the development of “new” economy business models, as well as capable of adaptation where specific aspects of the rules need to be revisited in light of such development.

89. For instance, various modest adjustments have been made over time to the Commentary on Article 5 to better facilitate or clarify the application of the Model Convention to new business realities and innovative and evolving technologies (including enterprises’ use of advanced communication technologies) without the need to change the permanent establishment definition. Some of the more salient modifications have included:

1. supplementing and/or clarifying the categories of activities that could give rise to a permanent establishment (e.g., the 1992 addition to paragraph 8 that a lessor could be treated as having a permanent establishment in a foreign jurisdiction if the lessor’s personnel “operate, service, inspect and maintain” the leased equipment in the foreign jurisdiction);
2. adding exceptions to the creation of a permanent establishment with respect to certain types of equipment and/or activities (e.g., the 1992 addition of paragraph 9 to provide that special rules may apply to the leasing of containers);
3. amending and adding paragraphs restricting certain activities or granting states additional rights in light of a history of taxpayer abuses of certain provisions (e.g., the 1992 addition

of an anti-abuse provision to paragraph 18 (formerly paragraph 17) relating to the “twelve month” threshold test); and

4. last, but far from least, the recent additions to the Commentary to provide that under certain circumstances, a place where business activities are carried on exclusively through computer equipment such as a server can constitute a permanent establishment (see section 2 above).

90. Similarly, the arm’s length principle, as expressed in the OECD Transfer Pricing Guidelines and in national legislation which incorporates the arm’s length principle, seems flexible enough to fairly measure the value added by an enterprise’s property (tangible and intangible) used, functions performed, and risks assumed in each jurisdiction in which it operates. Over the years, the arm’s length principle has worked effectively across a broad range of industries, old and new. Accordingly, whilst business models may change, the same legal and economic framework can be used to properly allocate profit to the constituent elements of an Internet-enabled business enterprise.

91. The arm’s length principle seeks to determine the relative values contributed by different parts of an enterprise to the overall business profits of the enterprise through a functional analysis. For the members who consider that the existing rules are flexible enough to accommodate the new business models, this functional analysis can be applied to an Internet-based business in the same way it can be applied to one based on more traditional elements. There is nothing in e-commerce business models that would undermine the effective use of the functional analysis or the arm’s length principle to determine the profits to be allocated to different parts of an enterprise based on the relative risks they have assumed, property used, and functions performed. As noted in the OECD Transfer Pricing Guidelines, the arm’s length principle is sound in theory since it provides the closest approximation of the workings of the open market. A move away from the arm’s length principle for any category of transaction (such as e-commerce) or type of company (such as those which use the Internet) would threaten the current international consensus on transfer pricing matters.

92. Some members of the TAG, however, have taken a different view as regards the capacity of the existing rules to adapt to e-commerce.

93. These members observed that the communication and technology revolution, and the advent of rapid transport, mean that, in many cases, enterprises can undertake a substantial level of commerce in another country without establishing the kind of physical presence that was required in the early 20th century. Conversely, situations can arise where enterprises may have the kind of physical presence that would give rise to a permanent establishment, but have little or no economic presence in the host jurisdiction. They note that the modern environment is characterized by:

- changes to the functions performed by enterprises and/or the way in which they are performed;
- changes in the distribution of functions performed by those enterprises; and
- changes to the need for face-to-face contact in undertaking trade or services.

94. The last decade has seen a significant shift in the types of functions performed by many enterprises. Many functions previously performed by people can now be replaced by software or automated equipment. An enterprise now has the ability to electronically project a business presence to almost any corner of the globe and to deliver many products and services electronically. Enterprises no longer need to establish branch offices, staffed with people who can provide local services or face-to-face contact, in each of its major markets. The need for a human presence (and supporting physical

infrastructure) in diverse locations may be much reduced. In these circumstances, these members questioned whether a taxing threshold built on physical presence of an enterprise remains appropriate.

95. Some members also questioned the extent to which the principle of separate entity accounting, which underlies the current rules for the measurement of profits, is adapted to modern ways of doing business.

96. It was observed that, in many cases, enterprises no longer operate on a business model which relies on the establishment of discrete economic units within each jurisdiction. More and more multinational enterprises are moving towards global business models where their business operations are globally integrated to increase their overall competitiveness. Locations tend to be functional rather than jurisdictional. For example, an enterprise's headquarters, research and development, production, customer service, procurement, warehousing, inventory management, administration and financing functions may be located in different countries and linked electronically to produce a seamless integration of business functions. The dissemination of the output of these functions from the location where they are developed or performed to where they are "used" by the enterprise is instantaneous and global using modern communication techniques.

97. The current rules require that multinational enterprises recognise intra-group transactions across borders and seek to place a value on these transactions in order to measure the profits that each country is allowed to tax. Whilst intra-enterprise transactions may be recognised for some purposes (e.g. to assess the viability of each component or function of a business), the fact still remains that the nature and value of the transactions are often not determined by the market. Instead, an attempt must be made to characterise and value these transactions solely in order to comply with the tax rules.

98. Furthermore, the separate entity approach means that it is possible for a country to tax profits where a multinational makes overall losses. This approach may be appropriate where a multinational enterprise's operation is managed around separate profit centres for each jurisdiction. However, as mentioned above, multinational enterprises operate on a global basis and often choose to group their operations and profit centres based on similar business activities or functions such as finance, research and development, inventory etc. Therefore the separate entity approach for attributing income to a jurisdiction is not only artificial but difficult to apply in practice. For the members who share that view, this further highlights how the existing rules no longer complement the business models of today and tomorrow.

G. Compatibility with international trade rules

99. It is important that any set of rules for the taxation of cross-border business profits be fully compatible with existing international trade rules. The existing rules incorporated in tax treaties, which predate the development of international trade rules, do not give rise to particular concerns in that respect. As will be shown later, however, some of the suggestions for alternatives to the existing rules do raise such concerns.

H. The need to have universally agreed rules

100. In order to avoid double taxation or non-taxation of business profits, any set of rules for the inter-country allocation of taxing rights over business profits needs to be agreed to by as many countries as possible. This is why treaty rules that are basically uniform have gradually emerged to replace the different domestic source and allocation rules.

101. One of the clearest advantages of the current treaty rules for taxing business profits is that they are widely accepted internationally. Almost all tax treaties currently use the permanent establishment concept, even though that concept is substantially modified in the United Nations Model and in a number of bilateral treaties, primarily as regards business profits derived from the provision of services.

102. In light of this high degree of universal acceptance, any suggestion of alternative rules would raise the following questions:

- how likely it is that such new rules could reach the same level of acceptance?
- what transition issues would arise from the replacement of the current rules? How likely is it that new rules could be agreed to?

103. In the absence of an international rule-making body that can impose its views, any change to the current international norms for taxing business profits would require a large degree of consensus before it could be applied universally.

104. Looking at the domestic law of many countries, it is clear that even developed countries have different views as to when business profits should be subjected to source taxation. Many countries, such as Germany and the Netherlands, use a domestic law concept of permanent establishment which is broadly similar to that used in treaties. The United Kingdom, however, has long used the general concept of trading *within* the country. The United States rules refer to taxable income which is effectively connected with the conduct of a trade or business within that country. Under French rules, a business is considered to be carried on in France if there is an “establishment” or a “complete cycle of operations” (*cycle complet d’opérations*) in France. Canadian tax law provides that non-residents who carry on a business in Canada are liable to tax on the income from that business; whilst certain activities are deemed to constitute carrying on business in Canada, that concept is not defined exhaustively in the legislation. Finally, some countries, such as Australia, do not have a specific threshold for taxation of business profits but such a threshold may be considered to derive from their sourcing rules.

105. Most countries would probably evaluate any suggestion to change the current treaty norms on the basis of their current domestic law and the impact that this would have on their tax revenues. On that basis, it is likely that the process of reaching an international agreement concerning new rules for taxing business profits would be long and difficult.

106. Most of the substantive rules in tax treaties, however, have their origin in the domestic law treatment of international transactions. The concepts of residence and permanent establishment, the schedular limits for taxing income and the methods for eliminating double taxation that are found in tax treaties originated in domestic laws of different countries. It is only after these rules found sufficient support among countries that they were elevated as international norms in the various model conventions.

107. In the absence of a consensus with respect to the appropriate rules for taxing business profits, it is therefore certainly possible that some countries could decide to adopt unilateral solutions and hope that, with time, these become the new international norm. Whilst these countries may consider that this is the only way to adapt the international norms to changing circumstances, this would certainly increase the risks of double taxation and non-taxation as well as compliance burdens.

108. These countries may feel, however, that such risks are the price to pay to change rules that they consider inadequate. Clearly, any set of rules for the inter-country allocation of taxing rights must remain politically acceptable if these rules are to continue to prevail.

109. It was argued by members of the TAG that this political acceptability could be jeopardized if

- some countries felt that the development of e-commerce resulted in an unacceptable division of tax revenues between residence and source countries, or
- e-commerce resulted in significant tax revenue losses for some countries.

1. *Will the development of e-commerce result in an unacceptable division of tax revenues between residence and source countries?*

110. Clearly the TAG cannot address the issue of whether or not some countries may find that e-commerce has or will have an unacceptable effect on the international sharing of tax revenues. Apart from the fact that no precise measurement of the effect of e-commerce on direct tax revenues of countries has yet been done, the question of what is an acceptable effect relates exclusively to the subjective judgment of each country.

111. If, however, the question is asked in relation to any objective benchmark for the division of tax revenues between countries, it simply becomes an alternative formulation of the question of what constitutes the most appropriate conceptual basis for the inter-country sharing of the tax revenues (see section a) above).

2. *Will e-commerce result in significant revenue losses for some countries?*

112. Unsurprisingly, there does not appear to be any evidence yet of a significant reduction of the direct tax revenues of a country that could be attributed to e-commerce. The TAG agreed that it would not be advisable to suggest any tax policy change on the basis of perceived losses of tax revenues that have not been established but it also agreed that there was a need to monitor the evolution of the impact of e-commerce on tax revenues.

113. The TAG, however, was invited to consider the anticipated effects of the development of e-commerce on the tax revenues of some countries. Under the existing rules for the taxation of cross-border business profits, the following conditions would have to be met in order for the tax revenues of some countries to be negatively affected

- the growth of e-commerce would have to be very important;
- a substantial part of that growth of e-commerce would have to be at the expense of traditional commerce;
- a substantial part of that growth would need to represent a shift from purely domestic to international commerce;
- residents of the affected country would not develop enterprises engaging in reciprocal e-commerce businesses; and
- that growth and the resulting reduction of domestic traditional commerce would not be compensated by other benefits and business opportunities created by e-commerce, such as the transfer of manufacturing and services jobs.

114. It is far from clear why e-commerce, in itself, would have such effects. The TAG was asked, however, to broaden its discussion and to examine how the new business models made possible by the development of information technologies could have a negative impact on the international sharing of tax revenues under the existing rules.

115. Rather than to draw purely speculative conclusions as to how new information technologies could impact the direct tax revenues of countries, the TAG decided that it would rather examine whether some possible scenarios would require changing the existing rules.

116. As already mentioned, new information technologies impact various traditional business functions not only at the distribution stage but at all stages of production. The new technologies open the door to a new distribution of the value chain, because it allows a geographical redistribution of the functions performed by the enterprise.

117. It was argued that, under the existing international tax rules, this could have the following consequences:

- a) The new technologies could result in a disintermediation or new intermediation process through which certain intermediary functions would disappear or be replaced. One example that was given was that of the travel agency (although this seems an unrealistic assumption in the short term). If these functions disappear, the tax on the profits from these functions will also disappear. The supplier will now directly interact with the consumer which, under the current rules, means that there may be no tax payable in the State where the consumer is located.
- b) Similarly, the new technologies could result in the centralisation or decentralisation of certain business functions. To the extent that this happens, the present rules of attribution of profits will lead to a smaller attribution of profits, and less tax, to the jurisdictions that lose the business functions.
- c) E-commerce will allow e-tailers to replace traditional retailers. Since traditional retailers have physical presence in the destination country whilst e-tailers would not have such presence, this will result in a loss of tax revenues for the destination country under the rules of Articles 5 and 7 of the OECD Model.

118. Depending on where the disappearing functions were previously performed, a country's tax base could either benefit or lose from these changes. More likely than not, each country's tax base will gain and lose to some extent and it is impossible, at this time, to predict what will be the net effect for any given country. Also, whilst the three scenarios above would have a negative impact on the tax revenues of the country where functions previously performed disappear, this impact is not the result of the tax rules themselves but rather of a shift in business activities. No member of the TAG argued that tax rules should be modified to shield countries from the effect of technological developments on their tax base. Countries do not have a right to a particular level of tax revenues regardless of where business profits originate.³⁰

119. Some members, however, argue that a distinction should be made between case b) above and cases a) and c). In the latter cases, they consider that enterprises with physical presence in the destination country have a disadvantage, under the existing rules, vis-à-vis foreign enterprises that use new information technologies and do not have the physical presence that would trigger taxation in the country of destination. In that case, it is important to consider whether or not some of the functions of these foreign enterprises are performed in the destination country, since that could justify source taxation.

120. These members consider that it is possible to argue that the automation of certain functions does not mean that these functions have been transferred to the country where the relevant equipment or

30 The question was asked, however, whether or not maintaining a balance in the sharing of the tax revenues should be a general principle that the rules should promote. This, however, raises issues of international politics rather than tax policy which the TAG did not consider.

software has been developed or is operated. In an interactive relation with the customer, they consider that the location of the customer is a strong indication that some functions take place in the country of destination. For them, it is important that the business operations are conducted through the computer of the customer, which is located in the country of destination. Based on that analysis, they suggest that the existing rules that prevent taxation in that country might need to be reconsidered.

121. This led the TAG to discuss the issue of the effect of new information technologies on the sharing of tax revenues between developing and developed countries. It concluded that, even if one were to make the assumption that new information technologies would result in a shift from source to residence taxation, it would be impossible, at this point, to determine which countries would experience an erosion of their tax base because of that shift. It could be wrong to assume that the present international allocation of Internet businesses and consumers would be mirrored in a mature system. As Internet technology becomes more stable and widespread, it should be expected that Internet businesses will develop everywhere. UNCTAD, in its "Report on Electronic Commerce and Development 2001", raised two possible scenarios without indicating a preference for one over the other. In the first, the technological breach would increase the gap between developed and developing countries; in the second, the developing countries would be able to use new information technologies to reduce this gap. The report emphasised the opportunities created in certain market segments, especially in the tourist sector, but it recognised that the technology has to be paralleled with a modification of the culture and the business practices to achieve a positive impact in developing countries.

122. The increased international adoption of internet-based communications will, in a large number of circumstances, cause a shift in various wealth-creating activities to developing countries, such as manufacturing, research and development, marketing, and sales. For instance, the telecommunications revolution will allow companies to better utilize the abundance of skilled workers, professionals and technicians available in developing jurisdictions, almost certainly increasing the tax revenue in those jurisdictions (as evidenced by the development of the software industry in India). Thus, the ultimate effect of enhanced communication efficiencies on the global allocation of tax revenue is unclear at the moment, and there is reason to believe that the capital importing countries eventually could be net beneficiaries.

Transition issues

123. One clear advantage of the existing rules over alternatives is the simple fact that these rules are the current international norm. Experience with tax reforms has shown that changing familiar tax concepts is rarely an easy proposition.

124. Changing the present treaty rules for the taxation of business profits would probably be more difficult and would take longer than changing a purely domestic set of rules. Assuming that a sufficiently large number of countries agreed to replace the existing rules, one would need to consider how that change could be effected. Apart from the domestic law changes that would be required in many countries, there would obviously be a need for amending or replacing treaties.

125. If the change were to take place through a renegotiation of bilateral tax treaties, that would take a long time. Treaties between OECD countries have, on average, remained unchanged for almost 15 years; changing bilateral treaties one by one could thus require a long period of time. During the period of time that would be needed for the changes to be effected, the new rules would need to co-exist with the existing ones. There could be increased risks of double and non-taxation during that period of transition. Indeed, since the rules for determining whether, and how much of, a taxpayer's business profits should be subject to tax in particular country would vary from country to country, the total amount that would be taxed would bear no relationship with the overall profits of the taxpayer. Also, since the State of residence would be required to apply the existing rules as regards a taxpayer who has operations in some countries but

apply new alternative rules as regards the operations of the same taxpayer in other countries, it would have difficulties in allocating expenses between different sources.

126. Another alternative would be to implement the necessary changes through a multilateral agreement or process. That approach, however, would be unprecedented and it should not be lightly assumed that countries would be willing to adopt that approach even in the unlikely hypothesis that there would be general agreement on the substance of the changes to be made.

127. This is not to say that replacing or substantially amending the current rules for taxing cross-border business profits would be impossible. Such changes are possible but would likely take a long time to be implemented. Any alternative to the permanent establishment must therefore be assessed not only on its own merits but also with respect to the transition issues that would arise from any change to the current rules.

4. SOME ALTERNATIVES TO THE CURRENT TREATY RULES FOR TAXING BUSINESS PROFITS

128. Having assessed the current rules for taxing business profits, the TAG examined and compared various alternatives to these rules. These alternatives ranged from relatively minor changes to the existing rules to the adoption of complete new principles for determining a country's right to tax or measuring profits that can be taxed in a country.

A. Changes that would not require a fundamental modification of the existing rules

a) *Modification of the permanent establishment definition to exclude activities that do not involve human intervention by personnel, including dependent agents*

i) *Description of the alternative*

129. The TAG first examined an option to modify the permanent establishment definition to expressly exclude from that definition the maintenance of a fixed place of business used solely for the carrying on of activities that do not involve human intervention by personnel, including dependent agents. This exclusion would clearly cover automated equipment used in electronic commerce operations (see paragraphs 41.1 – 42.10 of the Commentary on article 5), but it would not be restricted to that. It would also apply, for example, to cables, pipelines and automated pumping equipment used in the exploitation of natural resources (this would not preclude, however, the possibility that income derived from such equipment could constitute income from immovable property covered by Article 6).

130. The proposed exception would depend on whether or not there is human intervention, in a fixed place of business of the foreign enterprise, by personnel, including dependent agents, of the enterprise. In other words, in order to have a permanent establishment in a country, an enterprise would need to have personnel present at a fixed place of business in the country in order to carry on the business activities of the enterprise at that location. The mere setting up and (incidental) maintenance of equipment by personnel of the enterprise would not prevent the application of the exclusion. Similarly, the exception would still apply if the operation and/or maintenance of the (automated) equipment was contracted to a third – independent – party, and the personnel of that third party was present for that purpose at the location.

131. The option would only be relevant where there would otherwise be a permanent establishment (i.e. a fixed place of business where business activities go beyond the preparatory or auxiliary activities described in paragraph 4 of the permanent establishment definition). In that respect, the option could be extended to cover a fixed place of business used to carry on a combination of activities some of which are carried on through automated equipment that does not require human intervention by personnel of the

enterprise and the rest of which are activities that are currently covered by paragraph 4 of the permanent establishment definition.

ii) Justification

132. The proponents of this option have argued that where a permanent establishment is used solely for the purposes of carrying out e-tailing activities through the automated operation of a server (without human intervention), a functional and factual analysis will in general reveal that the functions performed, assets used and risks assumed are similar to those of a service provider who provides low-value services for the head office and/or other permanent establishments (see the TAG's Discussion Draft on the Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions). They consider that the same conclusion will generally be reached for other activities that do not involve personnel since the lack of human intervention would imply that only limited functions can be performed and that only restricted risks can be assumed where only automated equipment is used (also, in most cases, only limited assets would be used at such locations, with a possible exception for pipelines and the like). For these reasons, in general only little - if any - profits could be attributed to a permanent establishment where no personnel of the enterprise is involved. From a practical point of view, therefore, an explicit exclusion for such a case would arguably have significant advantages in terms of certainty, compliance burden and administrative costs. It would also seem in line with the principles of excluding activities that have a preparatory or auxiliary character.

iii) Assessment of this alternative in light of the evaluation criteria

Consistency with the conceptual base for sharing the tax base

133. The proponents of this alternative argued that, in the absence of personnel, in general only very limited profits should be considered to originate from the country where only automated equipment is used. The proposed exclusion, therefore, would not unduly disturb the existing overall balance in the division of taxation rights. It was recognized, however, that this might be different in some cases where high-value assets would be used to perform automated functions.

134. Other members, however, argued that, regardless of one's approach to the supply-based view, the proposed exception would not be consistent with the conceptual base discussed in the previous section to the extent that it would create a distinction between business activities performed through automated equipment and those performed by personnel and would exclude from source taxation situations where an enterprise clearly makes use of assets located in a country. Thus, the exception could only be justified if it addressed cases where the amount of profits that would otherwise be subject to source taxation was too small to justify the administrative burden of a source tax. It was noted, however, that this would not be the case if the automated equipment involved high-value assets and significant operation risks.

Neutrality

135. Whilst it may be argued that the proposed exception would be neutral since the same rules would apply to both e-commerce and other activities, it could also be considered that it would introduce a unjustified distinction between functions performed by human personnel and functions performed by automated equipment.

136. Many members considered that the proposed exception would make sense in the case of functions performed through servers but may not be appropriate for other types of automated equipment. A more restricted option applicable only to servers is discussed in section 4 A b) below.

Efficiency

137. The proponents of the proposed exception argued that the most important advantage of the option lies in the reduction of the compliance costs for business and the administrative costs for tax administrations.

138. Many members however, considered that a test based on the presence of human personnel could be very difficult to monitor in some cases. They also expressed the view that it would give rise to uncertainty and tax planning to the extent that a significant distinction would need to be made between activities of dependent and independent agents. For them, that distinction is already a source of practical difficulties in the limited context of paragraphs 5 and 6 of the Article 5.

Certainty and simplicity

139. Under the present rules, the existence of a permanent establishment, as regards automated activities carried on in a country, will often depend primarily on whether those activities go beyond the activities listed in paragraph 4 of the permanent establishment definition (the preparatory or auxiliary exception). This requires examining the relevant facts and circumstances of each case, which may be difficult to do. In the case of mirror web sites hosted on servers located in different locations, it may be almost impossible to determine whether the functions performed at a particular location go beyond the preparatory or auxiliary threshold and, also, how much profit should be attributed to the location. The proposed exception would avoid these difficulties and make it simpler for taxpayers and tax administrations to deal with such cases.

140. It was argued, however, that a number of practical problems would arise from the proposed exception and that these would create uncertainty and other practical difficulties. For instance, what would happen in the case of occasional human intervention (e.g. for setting up or maintenance purposes)? Also, as noted above, when would agents be considered to be dependent as opposed to independent?

Effectiveness and fairness

141. As noted above, the proposed exception could create tax planning opportunities. It must be recognized, however, that if an enterprise arranges its business in such a way that actually only very little profit-generating activities take place in a country, the taxing rights of that country should be affected.

142. It was also noted that the proposed exception would prevent tax-motivated transfers of automated activities to low-tax jurisdictions to take advantage of the exemption method that some States apply to foreign business income.

Flexibility

143. It was argued that the proposed exception would reduce flexibility of the existing rules as it would preclude source taxation in cases where substantial value would be added by automated equipment operated in a country, something which technology could eventually make possible.

The need to have universally agreed rules

144. A number of government representatives expressed the view that many countries would be unlikely to agree to the proposed exception.

145. As regards transition issues, it was generally considered, however, that given the limited scope of the exclusion, no particular transition issues would be expected since new or renegotiated treaties that would include the option could co-exist with “old” treaties that would not include the provision.

b) Modification of the permanent establishment definition to provide that a server cannot, in itself, constitute a permanent establishment

i) Description of the alternative

146. The TAG examined a more limited option put forward by some members of the TAG who suggested that the permanent establishment definition should not cover situations where a fixed place of business is used merely to carry on automated functions through equipment, data and software such as a server and web site. Whilst the option was discussed in relation to all servers, some members considered that option should be restricted to servers of e-tailers.

147. Some proponents of that option argued that this result could be obtained through a change to the Commentary on paragraph 4 of Article 5 of the OECD Model Convention. For these members, the recently-added paragraphs 42.1 to 42.10 of that Commentary, which deal with the interpretation of the definition of "permanent establishment" in the electronic commerce environment, should be re-examined and amended to narrow the reliance merely on computer servers, to indicate the importance of assistance provided by human personnel taking part in the over-all income creation process and to expand the discussion and guidance in that matter. Other members, however, thought that the option could not be accommodated without changes to the OECD Model and bilateral treaties.

ii) Justification

148. The alternative to amend the Commentary to obtain that result has been justified as follows.

149. Many factors are taken into account before deciding to carry on business activities in a country (e.g. market availability, legal aspects, tax aspects, infrastructure and availability of human and other resources). These factors do not change in the short term and the business decision to set up at a particular location is therefore taken for a period of time that is sufficiently long for the location to be considered to be "fixed".

150. Businesses that primarily use automated equipment such as servers may be different. The necessary equipment can be easily set up at a given location and, once the operations have started, there may not be a need for the presence of the enterprise's personnel at that location. A distinction may need to be made, however, between various types of automated businesses. For example, the traditional businesses of oil extraction by automatic pumps or the operation of vending machines are obviously considered as fulfilling the “permanent establishment” requirements where such equipment is located. These businesses also require the contribution of workers who will perform background operations without which the business will simply halt but, for these businesses, the automated equipment will often be difficult to relocate and will normally stay at the same location for a prolonged period.

151. The same is true for automated electronic commerce businesses, which also require the contribution of human personnel in the income-creation process. However, modern technology allows the use of several computer servers located in different countries and the use of remote controlling applications which enable a shift of business activities from one computer server to another. Thus the contribution of the human personnel should be given greater weight in order to decide whether or not the period of time in which a business was present at any place answers the requirement of permanence.

152. Thus, when dealing with the application of the permanent establishment concept in the e-commerce environment, the importance of the human contribution to the setting up, operation and maintenance of the business will be greater and the contribution of the places where the automated equipment is located will be smaller.

153. Paragraph 10 of the Commentary on Article 5 of the Model Convention attempts to describe how the business of an enterprise is carried on. It provides that "... a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment...". This means that it is necessary to examine the overall activities of the enterprise, whether performed by automatic means or human personnel, in order to determine whether they are core business activities or preparatory or auxiliary activities that fall within paragraph 4 of Article 5. The latter activities will constitute "exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of business".

154. Paragraphs 21 to 30 of Commentary of Article 5, which are meant to clarify the meaning of the phrase "preparatory or auxiliary activities" do not remove the uncertainty concerning automated activities. Paragraph 21 provides that paragraph 4 of Article 5 is intended to prevent taxation of an enterprise of one Contracting State by the other Contracting State if the enterprise conducts in that other State activities of purely preparatory or auxiliary character. The distinction between core business activities and activities of a purely preparatory or auxiliary character remains vague. Also, paragraph 23 indicates that the wording of sub-paragraph e) of paragraph 4 makes it possible to avoid the creation of an exhaustive list of exceptions. By doing so, it creates a wide and general exception. Paragraph 24 also confirms the uncertainty by providing that "It is often difficult to distinguish between activities, which have a preparatory or auxiliary character, and those, which have not". The human personnel activities combined with the automated equipment activities of an automated business play a much larger role and are more important than is the case for a traditional business. Thus an activity that might have appeared as a core activity may be classified as preparatory or auxiliary in the case of automated business. For these reasons, in general, a computer server should not, as such, be considered a permanent establishment.

iii) Assessment of this alternative in light of the evaluation criteria

Consistency with the conceptual base for sharing the tax base

155. Like the previous option, this option can only be justified, in light of the conceptual base for sharing the tax base, to the extent that very limited business profits originate from the country where servers are used. Indeed, to deny source taxation where an enterprise uses business assets in a country would not appear to be consistent with the nexus principles articulated in section 3 but could be justified under a *de minimis* rule applicable in measuring profits to be taxed by the source country.

Neutrality

156. Again, there are two possible views as to whether the option complies with the principle of neutrality. First, it could be argued that the option is neutral as it seeks to remove differences between enterprises that sell via traditional or electronic channels. The counter-argument, however, is that the option actually creates such differences since it provides that physical presence through servers of e-commerce enterprises will be subject to different rules than those applicable to other forms of physical presence. Many members also considered that to have an option restricted to servers (whether or not it is further restricted to servers of e-tailers) would clearly be difficult to justify as regards neutrality between different forms of business. As noted by one member, whilst the existing exceptions included in paragraph 4 of the permanent establishment definition all focus on the nature of functions performed at a place of

business, the option would introduce an exception based on the nature of the equipment used at such a place.

Efficiency

157. The proponents of the option argued that one of its main advantages is that it would avoid the need to register a permanent establishment in multiple countries and the need to allocate arbitrary and minimal profits to permanent establishments which only perform a communication function. Many members however, considered that these advantages would come at the cost of a departure from the basic principles underlying the permanent establishment. They also expressed the view that the option would give rise to many of the practical difficulties identified in relation to the previous option.

Certainty and simplicity

158. For the reasons explained above, it may be argued that this option would increase certainty and simplicity. It was noted, however, that the option would have such limited application that, as a practical matter, it would not have much effect in this respect. Those who adopted that view noted that there are relatively few cases where a location would be used exclusively to host a server without any human intervention.

The need to have universally agreed rules

159. It was suggested that as long as the option could be implemented by simply amending the Commentary on Article 5, the option would be easy to put in place as it would avoid the need to renegotiate all tax treaties.

160. Many officials from OECD countries, however, disagreed with that view. For them, the option would require a change to the provisions of tax treaties as it would not correspond to an acceptable interpretation of the existing rules. They considered that whilst the existing exception for preparatory or auxiliary activities could apply in many cases, it would be impossible to state that, in all cases, a location where automated functions are carried on through a server would not be a permanent establishment. They also expressed the view that many countries would be unlikely to agree to the proposed change to the Commentary.

161. As regards transition issues, it was generally considered, however, that given the limited scope of the exclusion, no particular transition issues would be expected to arise.

c) Modification of the permanent establishment definition/interpretation to exclude functions attributable to software when applying the preparatory or auxiliary exception

i) Description of the alternative

162. Paragraph 4 of Article 5 of the OECD Model Tax Convention would be modified by adding a new subparagraph (g) which would read as follows:

“(g) For purposes of making the determinations required by sub-paragraphs (a) – (f), the functions attributable to software shall be excluded from the determination of whether the functions performed at the location in the other Contracting State are of a preparatory or auxiliary character.”

163. Whilst it was suggested that the option could be limited to applications software, it was decided that the distinction between operation and application software was not necessary for the purposes of the discussing the merits of the option.

ii) *Justification of the alternative*

164. The proponents of this option have argued that to the extent that e-commerce is considered an extension of current and prior traditional commercial business models, e-commerce should be subject to the same taxation rules as conventional commerce. This recognition is a foundation for the Commentary on Article 12 of the OECD Model Tax Convention addressing the taxation of transactions in computer programs. Conventional commerce has long used electronic and non-electronic tools to support its physical business activities yet the existence of the tools, according to the proponents of this option, are generally excluded from the analysis of business activities for purposes of determining the existence or absence of a permanent establishment.

iii) *Assessment of this alternative in light of the evaluation criteria*

Consistency with the conceptual base for sharing the tax base

165. The current permanent establishment threshold requires both a permanent physical presence and the conduct of a minimum level of business activities at the physical location in order for the source country to be able to obtain jurisdiction to tax a portion of the business profits. These indicia are considered determinative with regard to whether or not a business is actively participating in the economy of the source jurisdiction as well as providing some foundation for facilitating assessment and collection of the tax. Certain functions are specifically excluded from the definition of a permanent establishment. Since the proposed alternative would indirectly expand the list of functions that are excluded from the definition of a permanent establishment, it has been argued that it is therefore consistent with the current conceptual definition of permanent establishment.

166. As is the case for the two previous options, however, this option can arguably only be justified, in light of the conceptual base for sharing the tax base, to the extent that very limited business profits originate from an enterprise's use of software in a country. A distinction between business activities performed through software and those performed by personnel or automated equipment that does not use software would not appear to be consistent with the nexus principles articulated in section 3 and can only be justified under a *de minimis* rule applicable in measuring profits to be taxed by the source country. It has been argued, however, that the option would be justified since the acquisition and use of a software program is analogous to the acquisition and use of other capital assets, for purposes of both determining the presence of a permanent establishment and for profit attribution. In particular, some members argue that the only profit which could be attributed to the deployment of the software program itself would be that appropriate for the deployment of a capital asset, and could not include any profits attributable to functions which might be automated through the use of such software program. This would be true regardless of how "intelligent" or "core" the computer program might be which is being executed on the server in the local jurisdiction.

Neutrality

167. The main argument that has been made to defend the view that this option would be neutral is that the use of non-electronic tools is generally excluded from the analysis of business activities for purposes of determining the existence or absence of a permanent establishment and that, since software is generally used as a tool to support business activities conducted by an enterprise's employees, ignoring the function performed by software would be consistent with the treatment accorded to other business tools.

168. Many members, however, did not agree with the argument that the use of non-electronic tools is generally excluded from the analysis of business activities for purposes of determining the existence or

absence of a permanent establishment. On the contrary, they considered that a rule that would seek to create an exception to the permanent establishment concept based on the means through which some functions are performed would create a distortion between different ways of carrying on similar functions. For instance, such a rule could result in excluding from the permanent definition places of business where core business functions are performed simply because these are performed through software rather than through personnel.

Efficiency

169. It was argued that the option would promote efficiency because the presence of software at a particular physical location is of no consequence – the nil cost of replicating software to a particular server creates no disincentive to a broad distribution regardless of whether or not the software would ever be used at that particular location. Modern computer networks also make it possible for a particular transaction to be processed, in whole or in part, at any one of multiple locations around the world. Software is not physical so its actual functions with respect to particular transactions are not readily identifiable. These factors make it inefficient to rely on measuring the functions performed by applications software as a basis for measuring compliance with, and administering the resulting tax consequences, with respect to a source country's right to tax the business profits earned by the enterprise.

Certainty and simplicity

170. As noted in the preceding paragraph, it was argued that the option would increase certainty and simplify the application of the existing rules because trying (under these rules) to determine an enterprise's level of activity based on functions performed by software involves considerable uncertainty and complexity.

171. Some members, however, had difficulties understanding the exact scope of the proposed exception. For them, a rule that would attempt to exclude some functions based on the way these are performed would not be consistent with the general framework of paragraph 4 of Article 5 as it might, for example, result in excluding from the permanent establishment definition places of business where core business functions are performed. It was also noted that a rule that attempted to exclude functions performed by software could be difficult to apply as this would require a determination of which functions performed at a particular location are attributable to software.

Effectiveness and fairness

172. The argument was made that because of the aforementioned difficulties in identifying the participation of a particular location's software in a particular transaction or business activity, analyzing the software at a particular location is unlikely to produce the right amount of tax at the right time. Therefore, excluding the functions performed by software from the analysis will not detract from the ability of the source jurisdiction to produce the right amount of tax at the right time. With respect to minimizing tax evasion and avoidance, excluding the functions performed by software from the analysis would prevent enterprises from making affirmative allocations of the tax base to tax havens by storing software onto servers located in the tax haven jurisdiction.

173. It was also stated, however, that such a rule creating a blanket exception could create loopholes. One example that was given was that of application hosting, where an enterprise carrying on the business of providing software to other enterprises could be found not to have a permanent establishment, under the proposed rule, where that core business function would be carried on.

Flexibility

174. It was argued that the proposed alternative would be an affirmative decision not to take into account certain technological advances in business because of the uncertainty, complexity, and inefficiency that would result from attempting to analyze the functions performed at a particular location by software present at that location.

Compatibility with international trade rules

175. It was agreed that the option would probably not raise concerns as regards its compatibility with international trade rules.

The need to have universally agreed rules

176. Whilst it was argued that the option would merely be a clarification which could be implemented without making a change to the Model Tax Convention, a majority of members believed that it would be a new rule requiring such a change.

177. It was suggested that because it is unlikely that countries would agree to share taxing rights with respect to the business profits earned by the enterprise on the basis of functions performed by software, excluding the functions performed by software should reduce disputes between countries. A number of government representatives, however, expressed the view that many countries would be unlikely to agree to this proposed rule.

d) Elimination of the existing exceptions in paragraph 4 of Article 5 or making these exceptions subject to the overall condition that they be preparatory or auxiliary

i) Description of the alternative

178. The TAG examined the option to eliminate all the exceptions included in paragraph 4 of the definition of permanent establishment (i.e. the preparatory or auxiliary exceptions). This would also involve the elimination of paragraph 5 of Article 7, according to which no profits may be attributed to a permanent establishment by reason of the mere purchase by the permanent establishment of goods or merchandise for the enterprise.

179. Since the TAG concluded that the option to eliminate all the exceptions in paragraph 4 of Article 5 would be impractical (some members considering that this would also be inappropriate as a policy matter), it also examined a less radical option to make all the activities referred to in the existing exceptions subject to the overall limitation that they be of a preparatory or auxiliary nature.

ii) Justification

180. The rationale for deleting the exceptions listed in paragraph 4 would be on the grounds that these exceptions refer to business activities which are carried on within a fixed place of business in a country and which, based on a functional analysis, are capable of having reasonably significant profits attributed to them.

181. A main concern, for many government representatives, is the possible fragmentation of functions to take advantage of the various exceptions in paragraph 4. Since paragraph 4 is drafted in relation to functions carried on at each particular place of business, it creates a distinction between the case of activities carried on at the same location which, when taken together, go beyond the preparatory or

auxiliary threshold and the case where the same activities are carried on at different places in the same country so as to take advantage of the various exceptions of paragraph 4.

182. The alternative option to subject the activities covered by the exception to the overall limitation that they be of a preparatory or auxiliary nature is based on the same rationale but is arguably better targeted as it implicitly restricts the exceptions to activities that contribute only marginally to the profits of the enterprise. It could also be argued that this alternative option is fully in line with the purpose of paragraph 4, which is described as follows in paragraph 21 of the Commentary:

“The common feature of these activities is that they are, in general, preparatory or auxiliary activities” [...] “Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.”

iii) *Assessment of this alternative in light of the evaluation criteria*

Consistency with the conceptual base for sharing the tax base

183. Arguably, under the conceptual base examined in the previous section, any business activity carried on in a country contributes to the overall profitability of an enterprise and should therefore be considered as giving right to the country to tax a share of the business profits of the enterprise. Thus, the option to eliminate all exceptions would ensure a greater conformity with the conceptual base.

184. A conceptual justification for maintaining the exceptions, however, could be made on the basis that very limited business profits originate from the performance of the activities listed in paragraph 4. Under the current rules, the starting point is that the mere selling of goods or services by an enterprise to customers into a country without a business presence there does not entitle that country to tax a share of the business profits. Where the presence in the country is only in terms of the activities covered by paragraph 4, as the Commentary states (see paragraph 3 of the Commentary on Article 5), whilst it may be axiomatic to assume that each part of an enterprise contributes to the productivity of the whole enterprise, it does not follow that there should be a right to tax such activities on this basis. It is in the interest of facilitating international trade and commerce that countries must exercise a reasonable level of tolerance in relation to physical presence by enterprises of another contracting state. An exclusion of auxiliary and preparatory activities has therefore been found to be a reasonable line to draw. That reasoning would not preclude, however, restricting the existing exceptions to the condition that they be of a preparatory or auxiliary nature.

Neutrality

185. If the options were aimed solely at e-commerce businesses, this would potentially breach the neutrality principle. As presented, however, both options would apply to all businesses and would arguably not offend that principle.

Efficiency

186. This would seem the main drawback of the option to eliminate all existing exceptions. It would clearly impose a significant additional compliance burden on enterprises. Tax administrations would be chasing additional permanent establishments, many of which would have very limited functions, and therefore profits, attributable to them.

187. The alternative option to make all the exceptions subject to the “preparatory or auxiliary” condition would not be as burdensome, although it would still impose the additional requirement of

establishing whether or not activities that are currently expressly covered by paragraph 4 meet that condition. Since it would result in more permanent establishments and, as noted below, in more disputes between taxpayers and tax authorities, it would also increase the compliance burden of enterprises.

Certainty and simplicity

188. The option to eliminate all existing exceptions would likely provide more certainty and simplicity in determining whether or not a permanent establishment exists as there would be fewer arguments as to whether a place of business is used only for the activities currently covered by paragraph 4 or for such activities and other non-preparatory or auxiliary functions. The option would also eliminate a number of technical uncertainties arising under the current wording of paragraph 4. For instance, it is not clear to what extent the reference to "goods or merchandise" in subparagraphs *a)*, *b)* and *c)* can apply to digital products or, more generally, data. It is also not clear to what extent the words "storage" and "delivery" can apply to digital products downloaded from servers through computer networks. The question was also discussed whether or not paragraph 4 would apply where various activities listed alternatively in subparagraph *a)* and *b)* are carried on at the same location and these activities go beyond the preparatory or auxiliary threshold so as to preclude the application of subparagraph *f)*. Regardless of the views expressed on the option to eliminate these exceptions, the TAG agreed that it would be useful if these questions were dealt with in the Commentary in order to provide greater certainty to taxpayers and tax administrations as to the exact scope of the current exceptions included in paragraph 4.

189. The option, however, could arguably have the effect of introducing greater uncertainty as regards the determination of the profits attributable to permanent establishment as there would be a need to attribute profits to permanent establishments that perform relatively minor functions.

190. The alternative option to make all the exceptions subject to the "preparatory or auxiliary" condition would reduce certainty by subjecting the existing exceptions that currently apply automatically and therefore provide a bright line test to a condition that is inherently more subjective. The change would therefore increase the potential for disputes between taxpayers and tax authorities. In light of paragraph 21 of the Commentary on Article 5, it could be argued, however, that there is already some uncertainty as to whether or not all the existing exceptions are implicitly subject to this condition.

Effectiveness and fairness

191. The elimination of all exceptions would not appear to be fair with respect to taxpayers such as the foreign seller of goods who needs to perform limited storage activities in a country in order to export to that country or to the foreign enterprise that merely displays its goods in a country. The alternative option to subject all paragraph 4 exceptions to an overriding condition that they be preparatory or auxiliary would seem to be preferable as regards such cases. The effect of both options, however, would extend far beyond e-commerce as those options would affect all types of business.

192. Arguably, a main advantage of both options is that it would curtail some forms of tax planning involving the disaggregation of functions in a country. Subjecting all paragraph 4 exceptions to an overriding condition that they be preparatory or auxiliary may, however, be a more targeted response to that problem. Also, it was noted that the issue of fragmentation is discussed in paragraph 27.1 of the Commentary on Article 5 of the Model Tax Convention.

Flexibility

193. It has been argued that developments in e-commerce require that a different and more flexible approach be taken in relation to what are preparatory or auxiliary activities. The elimination of all

exceptions listed in paragraph 4 would, however, have much wider impacts than merely dealing with perceived difficulties arising from the practical application of paragraph 4.

194. To the extent that it is considered efficient to exempt from source taxation places of business where only minor business activities are performed, the alternative option to apply the preparatory or auxiliary condition to all the exceptions that appear in the paragraph would seem to be a more flexible approach. Indeed, the option would allow greater flexibility by not ruling out that certain activities (e.g. delivery) could be more than a preparatory or auxiliary activity in certain cases.

Compatibility with international trade rules

195. The two options would not appear to raise particular concerns as regards their compatibility with international trade rules.

The need to have universally agreed rules

196. The implementation of either option would require modification of existing treaties. No particular transition issues would, however, arise as treaties with and without the modified wording could easily co-exist.

197. It is unlikely that all countries would agree with the option to eliminate all paragraph 4 exceptions. Some countries would likely be reluctant to accept the administrative burden of trying to tax places of business where minor activities take place; countries would also be concerned about exposing their taxpayers to source taxation where only a very small amount of profits should be taxed.

e) Elimination of the exceptions for storage, display or delivery in paragraph 4 of Article 5

i) Description of the alternative

198. In addition to the options discussed in the previous section, the TAG discussed the suggestion that paragraph 4 of Article 5 be amended so that the use of facilities solely for purpose of storage, display or delivery should no longer be considered not to constitute a permanent establishment. The main focus of the discussion was the reference to “delivery” (which does not appear in the U.N. Model).

ii) Justification

199. The rationale for the option would presumably be that the activities in question (i.e. storage, display and delivery³¹) are regarded as significant in the context of particular businesses and, based on a functional analysis, are capable of having reasonably significant profits attributed to them. In particular, removing the exception for “delivery”, in line with the position under the U.N. Model Tax Convention, is often advocated. The U.N. Commentary says that “delivery” was deleted “because the presence of a stock of goods for prompt delivery facilitates sales of the product and thereby the earning of profit in the host country by the enterprise having the facility. A continuous connection and hence the existence of such a supply of goods should be a permanent establishment, leaving as a separate matter the determination of the amount of income properly attributable to the permanent establishment.” It goes on to acknowledge that “Some members from developed countries disagree with this conclusion, believing that since only a small amount of income would normally be allocated to a permanent establishment whose only activity is

31 The question was raised whether the exception for “storage, display or delivery” applies if more than one of these activities is being carried on. The application of the exception would be more limited if the coexistence of storage and delivery activities, which would be normal, would have to meet the subjective aggregation test in subparagraph (f) of paragraph 4.

delivery, this variance from the OECD Model Convention serves no purpose.” The U.N. Commentary also notes that 75% of tax treaties entered into by developing countries reflect the U.N. Model position.

200. It was also argued in support of that option that an enterprise need only maintain a warehouse in the source country for delivery of goods and, especially in the case of e-commerce, the infrastructure for the delivery of goods may be a substantial part of business operations. If one accepts that paragraph 4 is aimed at activities that are essentially preparatory or auxiliary, it does not seem appropriate to apply the paragraph to an activity which forms an essential and significant part of the activity of the enterprise.

201. As indicated in the previous section, many government representatives also expressed concerns with the possible fragmentation of business functions to take advantage of this exception. It was suggested that an enterprise could maintain a place of business solely for display, storage and delivery in a country but sell the goods stored at, and delivered from, that place from another location in the same country. Since paragraph 4 is drafted in relation to functions carried on at each particular place of business, it creates a distinction between the case of activities carried on at the same location which, when taken together, go beyond the preparatory or auxiliary threshold and the case, illustrated in the above example, where the same activities are carried on at different places in the same country so as to take advantage of the various exceptions of paragraph 4.

iii) Assessment of this alternative in light of the evaluation criteria

Consistency with the conceptual base for sharing the tax base

202. As in the case of the previous alternative, it could be argued that any business activity carried on in a country contributes to the overall profitability of an enterprise and should therefore be considered as giving the right to the country to tax a share of the business profits of the enterprise. Thus, the option to eliminate storage, display and delivery activities from the list of exceptions would ensure a greater conformity with the conceptual base as regards these particular activities.

203. Again, however, one could justify maintaining these activities in the list of exceptions on the basis that very limited business profits originate from the performance of these activities. One could also argue that the advent of e-commerce should not be the precipitating event for any such changes, as one element of many e-commerce business models is to reduce delivery costs, thereby making delivery less of a “core” function. It could also be argued that the traditional view that merely selling goods to a country should not justify source taxation would be blurred by the option to the extent that the use of facilities or the presence of goods in that country for the mere purpose of storing or delivering goods that have been sold to that country could now create a permanent establishment.

Neutrality

204. If the option were aimed solely at e-commerce businesses, this would potentially breach the neutrality principle. As presented, however, the option would apply to all businesses and would arguably not offend that principle. It was argued, however, that e-commerce would not in itself provide a justification for making that change as storage, display and delivery activities are not more important for e-commerce than for other forms of carrying on business.

Efficiency

205. The option would impose an additional compliance burden on some enterprises. It would be particularly burdensome for exporters of products that currently store goods in destination countries pending final delivery. Tax administrations would be chasing additional permanent establishments, many of which would have limited profits attributable to them.

Certainty and simplicity

206. On the one hand, it could be argued that the option might provide more certainty as there would be fewer arguments as to whether a place of business is used only for storage, display or delivery or for these activities and other non-preparatory or auxiliary functions. On the other hand, however, there would be more uncertainty about the amount of profits attributable to the new type of permanent establishments created by the option. At a more technical level, the option would also raise the question of the extent to which facilities used, or goods or merchandise maintained, for storage, display or delivery could be covered by the general preparatory or auxiliary exception in subparagraph 4 *e*).

207. As already indicated, however, there are already a number of technical uncertainties related to the exceptions dealing with storage, display or delivery activities (see paragraph 188 above). For instance, it is not clear to what extent the reference to "goods or merchandise" in subparagraphs *a*), *b*) and *c*) can apply to digital products or, more generally, data (although similar issues were addressed in the report on Treaty Characterisation Issues arising from E-commerce, this particular point was not dealt with in that report).³² It is also not clear to what extent the words "storage" and "delivery" can apply to digital products downloaded from servers through computer networks. The question was also discussed whether or not paragraph 4 would apply where various activities listed alternatively in subparagraph *a*) and *b*) are carried on at the same location and these activities go beyond the preparatory or auxiliary threshold so as to preclude the application of subparagraph *f*).

208. The TAG agreed that it would be useful if these questions were dealt with in the Commentary in order to provide greater certainty to taxpayers and tax administrations as to the exact scope of the current exceptions included in paragraph 4.

Effectiveness and fairness

209. The delivery of some types of goods may well require some limited storage or delivery facilities (e.g. in a harbour) in the destination country. In such a case, it may not seem fair to subject the foreign seller of such goods to source taxation.

210. Arguably, a main advantage of the option is that it would curtail some forms of tax planning involving the disaggregation of functions in a country.

Flexibility

211. It has been argued that developments in e-commerce require that a different and more flexible approach be taken in relation to what are preparatory or auxiliary activities and that the option would allow such greater flexibility by not ruling out that delivery (or storage, display or delivery) could be more than a preparatory or auxiliary activity. On the other hand, a greater volume of deliveries of physical goods as a result of greater market penetration via the internet would not appear to justify a greater proportion of profits being attributed to the delivery function.

32 OECD, "2002 Reports related to the OECD Model Tax Convention", in *Issues in International Taxation no. 8*, Paris, 2003, page 33. The report was adopted by the Committee on Fiscal Affairs on 7 November 2002 and was based on the 2001 final report by the Technical Advisory Group on Treaty Characterisation Issues arising from E-Commerce.

Compatibility with international trade rules

212. The option would not appear to raise particular concerns as regards its compatibility with international trade rules.

The need to have universally agreed rules

213. Since the U.N. Model already removes delivery from the list of the preparatory or auxiliary exceptions to the permanent establishment definition, the option would likely be agreed to by a large number of developing countries. It is not clear, however, whether a majority of developed countries would agree to it.

214. The implementation of the option would require modification of existing treaties. No particular transition issues would, however, seem to arise as treaties with and without the reference to storage, display or delivery could easily co-exist.

f) Modification of the existing rules to add a force-of-attraction rule dealing with e-commerce

i) Description of the alternative

215. The suggestion was put forward that paragraph 1 of Article 7 of the OECD Model Tax Convention could be amended to include a so-called “force-of-attraction” rule which would deal with e-commerce operations. The following draft amendment was presented for discussion (the words to be added to the existing paragraph appear in bold italics):

“1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in 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. ***Profits deriving from sales or other business activities sold or carried on in that other state through the web site of the enterprise of goods or activities of the same or similar kind as those sold or carried on through that permanent establishment shall be deemed to be attributable to that permanent establishment.***”

216. The aim of the amendment is to ensure that a country may tax profits derived from selling in that country, through an enterprise’s web site, products similar to those sold through a permanent establishment that the enterprise has in the country. In effect, the rule would deem the functions performed through the web site to be performed through the permanent establishment.

217. Whilst the option could act as anti-avoidance rule intended to address arrangements such as those described in paragraph 7 of the Commentary on Article 7,³³ it would in fact have a broader scope as it would cover any situation in which a permanent establishment coexists with a web site of the head office accessible from the source country. The goal would be to attribute the profits from the electronic operations to the physical permanent establishment.

33 The relevant part of the paragraph reads as follows: [paragraph 1 as drafted] “might leave it open to an enterprise to set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade, perhaps of an extensive nature, that the enterprise carried on in that country through independent agents and the like.”

218. The principles of paragraphs 2 and 3 of Article 7 would be applied for purposes of determining such profits. The profits from the electronic operations would be determined on the assumption that products sold through the internet are sold through the permanent establishment. An arm's length internal transfer of property between the head office and the permanent establishment would therefore be considered to take place for purposes of determining such profits. Also, by virtue of paragraph 3 of Article 7, it would seem appropriate to allow the deduction of an adequate portion of the costs related to the development and updating of the web site and the product delivery systems used for selling the products through the net.

ii) Justification

219. The proponents of this option argued that the generalization of e-commerce will not lead to business models in which physical presence in the source country fully disappears but to the coexistence of both the physical and the electronic presence through the web site. There will therefore be an important interaction between both types of presence. The physical establishment will normally play an important role in order to improve the internet sales and, vice versa, the web site could contribute to a significant increase of the activity of the physical establishment. Given that clear interaction, it seems that the arguments against the force-of-attraction approach, which are currently put forward in paragraphs 8 to 10 of the Commentary on Article 7, would not be applicable. These arguments would still be relevant, however, for the situations where activities are carried on through independent agents, but those activities would not be covered by the option, which is a force-of-attraction rule specifically directed to the electronic channel.

iii) Assessment of this alternative in light of the evaluation criteria

Consistency with the conceptual base for sharing the tax base

220. The option raises the issue of whether it is appropriate to tax profits that are unrelated to a permanent establishment merely because of the existence of that permanent establishment.

221. The answer to that question, however, depends on the previously-discussed two approaches to the supply-based view of where profits originate as well as on the issue of whether the permanent establishment is considered to be a nexus/source rule or merely an administrative threshold. If one adopts the view that this remote sales activity constitutes a use by the enterprise of a country's legal and economic infrastructure and that such use should be considered to be one factor which, under the supply-based view, allows that country to claim source taxing rights on a share of these profits, the option is arguably consistent with the supply-based view of where profits originate. This is because the option would allow a country to tax profits which, under that approach, may be considered to originate from that country whilst, at the same time, making source taxation depend on the permanent establishment threshold to ensure that tax is only levied in circumstances where the enterprise has physical presence in the country and where a tax on net profits may effectively be enforced.

222. Under the alternative approach to the supply-based view, however, extending source taxing rights to business profits that are not related to a permanent establishment is inappropriate to the extent that only profits attributable to activities carried on in the country should be considered to originate from that country and the permanent establishment is the commonly-agreed threshold to determine whether sufficient activities are carried on in a country to justify source taxation. Some members who adopted that view also argued that to the extent that the proponents of the proposed rule seem to be concerned with getting tax revenues from e-commerce sales made through the web sites of foreign enterprises, a consumption tax would seem a conceptually more appropriate way of securing such revenues.

Neutrality

223. It was argued that the option would ensure greater neutrality since the current rules provide for a different tax treatment of similar business operations depending on whether or not these are performed through the internet or otherwise. Many members, however, disagreed with that view. They considered that the option would be non-neutral, for instance between remote selling on the internet and other forms of remote selling. It would also be non-neutral between operations carried on through branches, which would constitute permanent establishments and thereby allow the rule to apply, and subsidiaries, which would not.

224. Another aspect of the option that would raise neutrality concerns is that it would differentiate between the web site activities of an enterprise which has a permanent establishment in a country and the web site activities of an enterprise which has not. It would seem difficult to justify that result, especially in a case where the permanent establishment activities would be relatively minor when compared to the web site activities. Also, the proposed rule might have the effect of discouraging investment in a country where an enterprise makes internet sales or carry on other business activities through its web site.

Efficiency

225. It was argued that, from a compliance point of view, this rule should not create any problem for enterprises because it would only apply where they already have a permanent establishment in the source country. It was also argued that the rule would simplify the determination of profits since it would only require a determination of the price of the products transferred and the costs incurred for the purposes of the e-commerce sales attributed to a particular permanent establishment, which could be much easier than calculating the price of the services provided by the permanent establishment to the web site activity and vice-versa.

226. The option would, however, clearly impose an additional compliance burden on enterprises, which would need to track internet sales to any country where they have a permanent establishment. Tax administrations would also be put in the difficult situation of trying to verify e-commerce activities performed in their country by all enterprises that have a permanent establishment therein.

Certainty and simplicity

227. The practical application of the concept of “goods or activities of the same or similar kind as those sold through [a] permanent establishment” would likely give rise to a number of practical issues, particularly as regards the reference to “activities”. For instance, is the electronic version of a newspaper a good “of the same or similar kind” as the paper version? Also, is offering advertising through the internet a “same or similar” activity as offering advertising on billboards?

Effectiveness and fairness

228. A main problem with the proposed rule (and with the existing U.N. Model provision on which it is based) is that it would not apply to enterprises that have subsidiaries, as opposed to permanent establishments, in countries where they sell (or perform other business activities) through their web site. Thus, the profits derived from web site sales and other business activities of a parent company in a country would not be allocated to the subsidiary that performs sales or other activities of the same or similar kind in that country.

229. If that issue were not dealt with, the option would seem neither very effective nor fair as between different modes of carrying on business in a country. To extend the scope of the proposed rule to cover activities of related entities such as subsidiaries would, however, create a whole new set of problems (e.g.

rules would be required to determine which entities would be covered). It would also be an important departure from the separate entity principle that underlies the existing treaty rules. Whilst it was suggested that an alternative way of dealing with this issue would be to deem the subsidiary to be a permanent establishment of the parent company as regards the electronic activities of the parent company web site, that approach would give rise to the same concerns.

Flexibility

230. The option is based on the assumption that the development of e-commerce requires an adaptation of the existing permanent establishment definition. The proposed rule, however, could be seen as a change of principles rather than as an adaptation of the rules as it would allow source taxation in the case of sales or business activities performed from abroad.

Compatibility with international trade rules

231. Given that the proposed rule follows the approach of paragraph 1 of Article 7 of the U.N. Model, it would not appear to raise particular concerns as regards its compatibility with international trade rules.

The need to have universally agreed rules

232. Since the U.N. Model already includes a limited force-of-attraction rule in paragraph 1 of Article 7, the countries that already follow the U.N. Model may consider that the option is a narrower version of that rule and may consider the U.N. provision as a superior alternative. Clearly, however, the countries that currently oppose the U.N. provision (which is only found in a minority of bilateral treaties) because of the uncertainty of that provision and because it allows source taxation in cases where profits are clearly not connected to a permanent establishment, would be unlikely to agree to the option.

233. The implementation of the option would require modification of existing treaties. Whilst treaties with and without the proposed provision could easily co-exist, such co-existence would mean that a multinational's e-commerce activities would preferably be carried on from countries that generally oppose the inclusion of the provision in their treaties.

g) Adopting supplementary nexus rules for purposes of taxing profits arising from the provision of services

i) Description of the alternative

234. The option would be to modify the OECD Model to include a provision, similar to that already found in the U.N. Model, that would allow for the taxation of income from services if the enterprise that provides such services is present in the other country for that purpose during a certain period of time.

235. Under the current U.N. Model, enterprises that are in the business of providing services are subjected, like any other enterprise, to the permanent establishment rules. In addition, however, enterprises that provide services in a country without having a fixed place of business therein may also be taxed in that country if a physical presence test is met. For reasons that are not totally clear but are probably based on the historical treaty distinction between professional and other services (the OECD eliminated that distinction when it deleted Article 14 from its Model), the physical presence test of the U.N. Model is drafted differently in two different provisions:

(Article 5) 3. The term "permanent establishment" also encompasses:

- (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;
- (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period.

(Article 14) 1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:

- (a) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or
- (b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.

236. If a supplementary basis based on physical presence were adopted for independent services, it would be necessary to determine whether the relevant days should be any days of physical presence in the country (as is the current rule under subparagraph 15(2)(a)) or should be restricted to the days during which the taxpayer is performing services in the country. Whilst the TAG discussed that issue, it did not reach agreement on a preferred approach. The U.N. Model uses the first approach in Article 14 but the second approach in Article 5. One reason might be an implicit assumption that Article 14 applies only to individuals whilst Article 5 applies to business entities. Indeed, it seems inappropriate to apply a test based on days of physical presence to an enterprise which has a large number of employees or other personnel without excluding the days when these employees/personnel are not providing services for the enterprise. Subparagraph 5(3)(b) of the U.N. Model deals with that issue by referring to the period of activities ("only if activities of that nature continue (for the same or a connected project) [...] for a period or periods aggregating more than six months within any twelve-month"). The U.N. Model requirement that the services be related to a single project or to related projects means, however, that an enterprise could be furnishing services in a country throughout the year without triggering source taxation rights, provided that these are furnished under unrelated projects. Also, a reference to "connected projects" would require a clarification of the circumstances in which projects would be considered to be connected. Another issue that would need to be addressed is how the rule would apply to situations where employees of various enterprises that are part of a multinational group work on the same project.

237. It could also seem inappropriate to take into account the presence of employees/personnel engaged in activities that are merely preparatory or auxiliary or activities (such as marketing or preparing options for potential clients) that are not directly compensated by the person to whom the services will be provided. Such a modification of a physical presence test could, however, present practical difficulties.

238. Another question is which principle should guide the determination of the relevant period of time. On the one hand, there would clearly be an advantage to adopt a period of time that would be consistent with that under Article 5 (see paragraph 6 of the Commentary on Article 5) and under Article 15. On the other hand, the six-month period should be contrasted with current paragraph 3 of Article 5 of the OECD Model, which provides that a building site or construction project constitutes a permanent establishment only if it lasts more than twelve months (the equivalent rule of the U.N. Model, however,

refers to a period of six months). Arguably, there would not be any reason to establish a shorter period for technical or professional service providers than for building and construction service providers.

239. One member suggested that the option should be restricted to cases where services are rendered in a country without any support from abroad so as to exclude situations where resources located outside the source country (e.g. a database or personnel) are used in providing the services. Other members, however, questioned the practicability of that alternative option, noting that it would be very easy to avoid the application of the rule by making sure that at least some resources located abroad are used in providing any services in a country. That alternative was therefore not further examined.

ii) Justification

240. It has been argued that the current permanent establishment rule does not provide appropriate results in the case of services. The rules regarding permanent establishments were created with a view towards manufacturing and sales. Accordingly, an enterprise that does not have an office or other facility in the host jurisdiction will generally be treated as having a permanent establishment only in cases where its agents in that jurisdiction have the authority to conclude contracts. In the manufacturing and sales case, these rules generally work well to allocate taxing jurisdiction on the basis of function. Obviously, if a business does not have a facility in the host jurisdiction, it is not engaged in manufacturing there. The other major profit-generating activity is sales, and that is covered by the fixed base and dependent agent rules.

241. The rules do not provide similar results in the case of services. Many service providers are entirely mobile. Lawyers and accountants can meet with clients, do research, consult with colleagues, and draft memos and opinion letters without leaving their hotel room or coffee shop. All they need is laptop and a telephone. Engineers and computer programmers seem to be similarly mobile. Accordingly, the line that is drawn in Article 5 of the OECD Model allows significant income-producing functions to take place in a jurisdiction without allowing that jurisdiction to tax. To be clear, the argument for change is not, as it is stated in the Commentary to the U.N. Model, that the activity produces large amounts of income. Instead, it is the fact that the income-producing functions take place in the host jurisdiction that justifies a change to allow the country to tax that income.

iii) Assessment of this alternative in light of the evaluation criteria

Consistency with the conceptual base for sharing the tax base

242. Since the option seeks to allow a country to tax profits derived from services performed in that country, the option would be consistent with the conceptual base described in the previous section regardless of any difference of views on the supply-based approach.

Neutrality

243. It could be argued that the option would be neutral because it would treat service providers who do not need a fixed base to conduct their business in the same way as those who do. Accordingly, the professional service provider would no longer receive an advantage vis-à-vis other providers. A counter-argument, however, would be that a departure from the fixed place of business standard that would be restricted to services would create a non-neutral situation between businesses that provide services and those that provide goods. Some members felt that the option would be equivalent to extending the geographical scope of the current permanent establishment definition to the entire territory of a country in the case of services.

Efficiency

244. The option would likely increase the administrative burden of enterprises and tax administrations as both tax administrators and businesses would have to keep track of the length of time spent in a country by personnel of service enterprises. Whilst it could be argued that this is similar to the burden imposed by the current rules of Article 15 and should therefore not be overly difficult, one could object that it is easier to detect the presence of a foreign employee (through the records of the employer) than that of an independent contractor.

245. Also, apart from the compliance burden associated with the increase of the number of permanent establishments that would result from the rule, enterprises would face the risk of having unexpected permanent establishments where they cannot determine in advance how long their employees will be present in a particular country (e.g. situations where that presence is extended because of unforeseen difficulties or at the request of a client). Such unexpected permanent establishments create particular compliance difficulties as they require the enterprise to retroactively comply with a number of administrative requirements associated with a permanent establishment. These concern the need to maintain books and records, the taxation of the employees (e.g. the need to make source deductions in another country) as well as other non-income tax requirements. It was suggested that one way to deal with these difficulties would be for the rule to only apply prospectively, i.e. a permanent establishment would only be deemed to exist from the date that the required period of presence has been satisfied.

246. Arguably, a physical presence test for services might also create difficulties for the determination of the profits subjected to source taxation and the collection of tax. The rules of Article 7 were drafted with a fixed place of business in mind. For instance, reliance on separate accounts (see paragraph 12 of the Commentary on Article 7) is logical when one thinks of a permanent establishment as a real place of business where accounting records are kept but becomes more difficult in the context of a deemed permanent establishment. Whilst Article 7 already applies to one type of deemed permanent establishment (i.e. the one resulting from the activities of a dependent agent), this normally involves activities carried on at the place of business of the agent. The option, however would have the effect of creating a permanent establishment in cases where no individual place of business (with access to accounting records) might be identified. Similarly, the collection of tax could present difficulties in the absence of physical assets in the country.³⁴

Certainty and simplicity

247. Most countries probably already have a number of treaties that include this provision, so there is a great deal of experience in applying it. The rule would arguably provide more certainty with respect to services than the existing rules. Under the existing rules, there are constant disagreements over when a client's premises will constitute a "fixed base" for a consultant and other matters of interpretation. Adopting a special rule for services, however, would require a distinction between the provision of services and other business activities; since that distinction has shown to be problematic in some situations, the rule would add uncertainty in this regard. Also, to the extent that the rule adopted the concept of "activities ... for the same or a connected project", there would be the additional uncertainty of determining whether or not particular projects are "connected".

248. Article 15 currently uses the test of a taxpayer's physical presence in a country for purpose of determining source taxation rights on employment income in the absence of a permanent establishment (or residence) of the employer. One advantage of adopting a similar test for independent services would be to

³⁴ As already noted, however, recent developments in the area of exchange of information and assistance in the collection of taxes may gradually reduce the importance of these issues.

avoid the difficult interpretation issue of whether one deals with employment or independent services and to eliminate planning intended to convert employment services into independent services. A counter-argument, however, would be that the threshold for the taxation of an individual deriving employment income might be considered as not particularly relevant for the taxation of a type of business profits.

Effectiveness and fairness

249. As discussed above, the option would allow the country where profit-generating activities take place to tax those activities. Of course, the host country would still have to apply the arm's length principle to ensure that it is not taxing the part of the profits that relate to activities performed in the home jurisdiction, which has been a source of disagreement in the past. Also, the rule would need to ensure that only host country profits, as opposed to gross payments for the relevant services, are subjected to tax.

Flexibility

250. The proposed rule would appear to be quite flexible and would deal with a number of different types of services.

Compatibility with international trade rules

251. Given that the option would follow an approach put forward in Article 7 of the U.N. Model and already adopted in a number of treaties, it would not appear to raise particular concerns as regards its compatibility with international trade rules.

The need to have universally agreed rules

252. According to a research project carried on by the IBFD, out of 811 tax treaties concluded between 1980 and 1997, 221 treaties (around 27%) included a provision based on that found in subparagraph 5(3)(b) of the U.N. Model and 284 (around 35%) included a provision similar to that found in 14(1)(b) of that Model. Therefore, as already noted, most countries probably already have treaties that include a time presence threshold for the taxation of services.

253. The provision would probably be quickly accepted by most developing countries. Developed countries might be more reluctant to accept it, however, although some of these countries (for example, Norway, Australia, New Zealand) routinely include it in their treaties.

254. The implementation of the option would require modification of existing treaties. Treaties with and without the proposed provision currently co-exist and that situation does not seem to create particular difficulties.

B. Changes that would require a fundamental modification of the existing rules

a) Adopting rules similar to those concerning taxation of passive income to allow source taxation of payments related to some forms of e-commerce (so as to subject them to source withholding tax)

i) Description of the alternative

255. The TAG examined various approaches under which a withholding tax would be applied on all or certain cross-border payments related to e-commerce. Some of these approaches were variations of other options discussed in this note (e.g. the "base erosion approach" and the "virtual permanent establishment"),

or were too narrowly focused (e.g. an option dealing with the taxation of satellite operations) to be discussed in the context of this note. The TAG therefore discussed a general option under which a final withholding tax would be applied to e-commerce payments made from a country, whether or not the recipient has personnel or electronic equipment in that country.

ii) *Justification*

256. It was argued that the development of electronic devices and e-commerce makes it in some areas possible to effectively penetrate a foreign market with little or no physical presence in that market whereas only a few years ago the same degree of market penetration necessitated a physical presence giving rise to a permanent establishment and, therefore, allowing the source country to tax. Some countries may consider that they lose tax revenues because of this development, both with regard to existing sales level and future increased market penetration. On this basis, these countries could argue that the market country should be given the right to tax this activity.

iii) *Assessment of this alternative in light of the evaluation criteria*

Consistency with the conceptual base for sharing the tax base

257. Since the option was articulated in terms of giving taxing rights solely by reason of a country providing the market for goods or services supplied through e-commerce, it was found to be based on the supply-demand approach to the determination of the origin of business profits, an approach which the TAG had rejected. Indeed, many members considered that the arguments in favour of the option described above would be more appropriate to justify a consumption tax approach than an income tax approach to tax the relevant operations. It was noted, however, that a consumption tax could not be applied to e-commerce imports only, as this would violate the WTO rules. Also, a general consumption tax on e-commerce only would put e-commerce at a disadvantage compared with traditional commerce.

258. One could argue, however, that the option seeks to allow source taxation in cases where an enterprise makes use of a country's infrastructure to generate profits. From that angle, the option could be considered to be in line with one approach to the supply-based view as to where profits originate. It could also be argued that the option simply follows the approach already applicable, under the OECD Model, to interest earned by financial enterprises like banks, which may be taxed in the country of source regardless of whether or not the enterprise has a permanent establishment in that country. A counter-argument, however, is that the current rules allowing source taxation of interest paid to banks already create difficulties and this has led many countries to include in their treaty a specific exemption for that category of interest. Also, it is not normally the case that revenues derived from companies engaged in e-commerce transactions are economically similar to passive forms of income such as dividends, interest and royalties. Furthermore, the example of interest would not seem to justify source taxation of all types of business profits any more than the example of the current rules which do not allow source taxation of income from international transport would justify not having any source taxation of all business profits.

259. Finally, the option to have income taxation of e-commerce through a final withholding tax would be inconsistent with the concept of an income tax since it would be a tax on gross payments. Whilst it may be argued that the application of a low rate of tax could act as a proxy to a full-rate tax on net profits, this would, at best, only be a rough approximation (the alternative of allowing foreign enterprises the option to file on a net basis is dealt with in the section on base erosion). A withholding tax on cross-border e-commerce payments would essentially be a tariff on e-commerce transactions. This form of taxation is, by nature, inefficient, as it does not take into account the different cost structures of individual taxpayers and often over-taxes some revenues and under-taxes others.

Neutrality

260. It would be difficult to justify applying a withholding tax only on cross-border e-commerce and not on traditional cross-border trade. Such a tax would violate the tax neutrality principle as presented in the Ottawa framework conditions. The alternative of applying the tax to all forms of cross-border trade would mean, however, the introduction of tariff-like taxation, which might well be against WTO rules and principles.

261. Also, as will be seen below, a withholding tax system would only seem practical as regards business-to-business e-commerce, which would mean that e-commerce directed at private consumers would escape the application of the tax. This would introduce another non-neutrality.

Efficiency

262. Experience with consumption taxes has shown that private consumers are not a practical collection point. Thus, the option must, for practical reasons, be restricted to payments made between enterprises. This would mean that business-to-consumers e-commerce would not be affected by the proposed rule, which would constitute a serious disadvantage.

263. The option would clearly impose an additional compliance burden on enterprises, which would need to keep track of internet payments and ensure that the relevant tax is withheld. Tax administrations would also be put in the difficult situation of trying to verify e-commerce payments made by enterprises in their country.

Certainty and simplicity

264. Arguably, withholding taxation of payments going to non-residents is a well-established method of taxation that is relatively easy to apply. There is no need for the tax authority to identify the foreign receiver of the payment, as long as it is clear that the payment is made to a non-resident. The lack of physical presence is therefore not an obstacle to the collection of tax.

265. Clearly, however, the imposition of a withholding tax on e-commerce operations would require a definition of e-commerce. This would likely be a difficult task. As the various business models described in section 1 illustrate, modern information technologies permit a number of business operations and it is far from clear which of those would be covered by the definition. Also, as mentioned above, the option would require enterprises to keep track of e-commerce payments and tax administrations would have the difficult task of verifying e-commerce payments made by enterprises in their country.

Effectiveness and fairness

266. The imposition of a withholding tax is generally an effective tax collection mechanism but one that cannot be relied on in the case of business-to-consumers electronic commerce. If the main justification for applying withholding tax to e-commerce transactions is the concern that a country may be unable to levy source tax in cases where foreign enterprises carry on substantial e-commerce operations in that country, the need to exempt business-to-consumers transactions would appear to be a serious limitation.

267. Since the withholding tax would apply exclusively to payments to non-resident enterprises and would be levied regardless of profitability, it would appear unfair, particularly with respect to start-up enterprises which may not realize profits for some years.

Flexibility

268. On the one hand, the option would have some flexibility since a state could always adjust the withholding rate to be applied to different products and services or even exempt some of them. Such adjustments, however, would make the system less certain and increase tax planning opportunities. On the other hand, however, it could be argued that the option's inability to address business-to-consumers transactions shows that it is not an appropriate answer to technological and commercial developments.

Compatibility with international trade rules

269. As already mentioned, there is a risk that a withholding tax on e-commerce payments to foreign enterprises might be considered to be discriminatory against offshore vendors and subject to challenge under WTO rules (e.g. Article III of the GATT). It would clearly impose a more burdensome taxation on e-commerce goods and services from abroad.

The need to have universally agreed rules

270. To the extent that the option would allow source taxation where no business activities take place in a country and could result in taxation where no or little profits arise, it would strongly be resisted by a number of countries and by enterprises. The potential violation of the international trade rules (see above) would also seriously undermine the chance that the option could quickly gain universal acceptance.

271. The implementation of the option would require modification of existing treaties. Whilst treaties with and without the proposed provision could easily co-exist, such co-existence would mean that a multinational e-commerce activities would preferably be carried on from countries that generally oppose the adoption of the option in their treaties.

b) A new nexus: base eroding payments arising in a country

i) Description of the alternative

272. An alternative to the preceding option has been put forward by commentators who have suggested a nexus rule that focuses only on whether the foreign enterprise is receiving a payment from an in-country payor that the payor may deduct for domestic tax purposes rather than on where the activities giving rise to the product or service are located.³⁵ Under this nexus rule, the source state would be entitled to impose a withholding tax on all such cross-border payments.

273. This regime (generally referred to as the "base erosion approach") would supplement, rather than replace, the traditional permanent establishment nexus rules. Countries would retain the right to tax all non-resident enterprises with a permanent establishment in the jurisdiction. In addition, however, a country of consumption ("country C") would also be given the right to levy a withholding tax on payments from its territory to a non-resident vendor (a "country R vendor"). Under this approach, the country R vendor could file a tax return in country C as if the income were attributable to a country C permanent establishment in lieu of suffering the withholding tax. Cross-border payments from country C private consumers to country R vendors would not be subject to withholding because private consumers would not deduct or add the payments to cost of goods sold.

35 See, for instance, Richard Doernberg, "Electronic Commerce and International Tax Sharing," 16 *Tax Notes Int'l* 1013, March 30, 1998; High-Powered Committee on "Electronic Commerce and Taxation" (as constituted by the Central Board of Direct Taxes, India), *Report of the High-Powered Committee on Electronic Commerce and Taxation*, issued July, 2001.

274. A variation of the option that has been put forward would be to use the system *in place of* the permanent establishment approach.³⁶ Proponents of that variation acknowledge that theoretically, a base erosion approach could be implemented whilst the existing permanent establishment concept is preserved. However, they consider that

“... simultaneous application of the ‘base erosion approach’ and the existing [permanent establishment] principles would not be possible. As discussed earlier, the allocation of profits to permanent establishments in e-commerce situation will be negligible. The ‘base erosion approach’ will be easily avoided by the enterprises, if the PE concept survives ...”³⁷

275. For that reason, they have proposed an alternative that would apply in lieu of, rather than as a supplement to, the permanent establishment concept and that would consist in a low withholding tax on base eroding payments which would preferably be final (i.e. without the option of being taxed on net income).

ii) Justification

276. The main objective of these options is to ensure that e-commerce does not unduly shift the tax base of a source state (i.e., the state of consumption) to the state of residence. Its proponents suggest that the increasing application of technology to modern businesses could allow non-resident entities to make significant sales into the market jurisdiction without having sufficient physical presence in the market jurisdiction to constitute a permanent establishment (and without establishing a local affiliate), thus arguably causing an erosion of the market jurisdiction’s tax base.

iii) Assessment of this alternative in light of the evaluation criteria

Consistency with the conceptual bases

277. To the extent that the base erosion approach would result in a final withholding tax on business payments as opposed to a tax on profits, its consistency with the conceptual base for allocating taxing rights would be subject to the same comments as the previous option (see above section “Adopting rules similar to those concerning taxation of passive income to allow source taxation of payments related to some forms of e-commerce”). Thus, the option would seem to be based on a supply-demand view of where business profits originate, an approach that was rejected by the TAG, but could arguably be justified under one approach to the supply-based view (i.e. by considering that business profits partly arise from an enterprise’s use of a country’s infrastructure.)

278. The main difference between the two variants of this option is the option of filing a tax return as if the income were attributable to a permanent establishment. That option would partly address the important concern that a final withholding tax on a gross payment is conceptually inconsistent with the principles of an income tax. Indeed, a final withholding tax on gross payments applicable to all cross-border transactions could constitute a serious impediment to international trade. Whilst in some cases the additional tax could result merely in a shifting of the tax collection from the country of residence to the country of source, assuming the country of residence grants a full foreign tax credit, in other cases the imposition of the tax may become a cost which is passed onto consumers in the market jurisdiction (assuming that the foreign supplier could remain competitive when doing so).

³⁶ Indian High-Powered Committee on Electronic Commerce and Taxation (note 29).

³⁷ Id, at 76.

Neutrality

279. Under the Ottawa framework conditions, taxation should be neutral and equitable between different forms of commerce (*e.g.*, between conventional and electronic; between different types of electronic, etc.). The base erosion approach would be neutral with respect to the type of product and form of commerce if it were applied to all cross-border transactions, as recommended by some of its proponents. It would violate the neutrality principle if the option were applied only to a certain defined subset of international transactions, such as “e-commerce” transactions.

280. The option, however, would not be neutral with respect to the type of transaction since it would apply to business-to-business transactions and not to sales or other transactions made directly with private consumers. To the extent that foreign suppliers of goods and services to a domestic business would be subject to a withholding tax which could be final, the option would also appear non-neutral between foreign and domestic business suppliers.

Efficiency

281. Under the base erosion approach, only those cross-border payments that are deductible by the payor are subject to withholding. Assuming that local deductions are contingent on withholding, this approach would likely offer a degree of self-enforcement because the local withholding agent would have a built-in incentive to withhold.

282. The requirement to withhold would, however, impose a significant compliance burden on the local business consumer. Collection of tax and information reporting would now be required on a vast number of individual transactions. Also, withholding would only be required with respect to payments for goods and services supplied from abroad but it could be difficult, if not impossible, for the customer to determine the source of a particular purchase from online vendors. The advantage of self-enforceability would need to be weighed against the actual enforcement costs and challenges to both local enforcement officials and companies.

283. The option of filing a tax return as if the income were attributable to a permanent establishment would also have significant compliance and administrative consequences. A large number of enterprises that simply export to a country would now have tax filing obligations under that option. Also, in most cases where the option would be chosen, all the relevant expenses would be incurred outside the country and the local authorities would not have access to accounting records or employees at a physical location in the country. The administrative burden of determining and verifying the tax would therefore be substantially increased.

284. Also, to the extent that enterprises would have to pay a withholding tax on business payments made to them from a particular country before having the possibility to recover that tax following the filing of a return, the base erosion option would impose a significant compliance burden on foreign enterprises. Such a system could have significant effects on enterprises' cash flows, especially in the case of businesses that deal with high-value but low profit margin goods or services.

Certainty and simplicity

285. One significant advantage offered by the base erosion approach is the simplification (through elimination) of current income characterization and sourcing rules. Income characterization has long been a complicated issue, and tax authorities have struggled for decades to distinguish sales from royalties, sales from services and services from royalties. Similar questions have arisen recently in the context of software and e-commerce transactions. Although the characterization questions have been difficult at times, historically it has been possible to develop tests to reach reasonable results, including with respect to recent

issues involving software and e-commerce.³⁸ The base erosion approach would eliminate this issue altogether to the extent that all base eroding payments would be treated in the same way.

286. By replacing the current permanent establishment standard as the nexus for taxation, the base erosion approach also would largely eliminate the need for sourcing rules that currently apply to allocate income to a jurisdiction. Again, as with the income characterization issue discussed above, whilst tax authorities typically have been able to reach reasonable conclusions on sourcing questions, the base erosion approach would eliminate this issue altogether (except presumably to the extent that a real permanent establishment exists).

287. Whilst the base erosion approach would eliminate the need for traditional characterization and source rules, it could also raise new classification issues. For instance, if different withholding rates were to be imposed on different products and services to reflect different profit margins or political decisions,³⁹ there would still be characterization issues at the margins, similar to those faced under customs law today. Also, since the option would apply to business-to-business transactions and not to transactions made directly with private consumers, rules would be required to distinguish the two categories of transactions.

288. Thus, the base erosion approach could be consistent with the principles of certainty and simplicity if it was applied in its purest form, i.e. a single withholding tax imposed on all deductible cross-border transactions. The principles of certainty and simplicity would not be met to the same extent if distinctions began to be drawn among transactions, such as by imposing different levels of withholding tax on transactions in agricultural products versus computer equipment. To determine whether a base erosion approach would be certain and simple, the mechanics of how such a system would operate would therefore need to be identified. For instance, the following types of questions would have to be answered: (i) will withholding certificates be issued on a transaction-by-transaction basis? (ii) when, where, and to whom should the taxpayer turn over the withheld amounts? (iii) is it realistic to expect that a uniform withholding rate could be applied across-the-board?

Effectiveness and fairness

289. As mentioned under the preceding option, the imposition of a withholding tax is an effective tax collection mechanism but the fact that this mechanism cannot be relied upon in the case of business-to-consumers transactions is a serious drawback. Also, the option of filing a tax return as if the income were attributable to a permanent establishment would substantially reduce that effectiveness to the extent that such a return, which would be produced by a non-resident enterprise with no physical presence in a country, would be difficult to verify. Finally, the fact that the option would only apply to business-to-business payments could give rise to arbitrage opportunities (e.g. it would encourage structures where sales are made directly to consumers rather than to local distributors).

290. Since a final withholding tax would apply exclusively to payments to non-resident enterprises and would be levied regardless of profitability, it would appear unfair, particularly with respect to start-up enterprises which may not realize profits for some years. The option of filing a tax return as if the income were attributable to a permanent establishment could address that concern but this would be subject to the number of taxation years during which such an option would require an enterprise to file on a net basis.

38 See, for example, OECD Model Treaty Commentary, Article 12, Pars. 12-17 (software) and the Final Report of the OECD Technical Advisory Group on Treaty Characterization Issues arising from E-commerce, released on 1 February 2001.

39 The Report of the Indian High-Powered Committee (note 29, at 78) notes, for example, that given the sensitivity of oil and fertilizer imports to the Indian economy, it may be impossible to tax such goods.

Flexibility

291. To the extent that the option would result in a final withholding tax, it would be subject to the comments concerning flexibility which were made with respect to the previous option. The option of filing a tax return as if the income were attributable to a permanent establishment would, however, add an element of flexibility to this option.

Compatibility with international trade rules

292. There is a risk that the base erosion approach might be considered to be discriminatory against offshore vendors and subject to challenge under of Article III of the GATT since it would impose a more burdensome taxation on imported goods as compared to goods of domestic origin. This is not the case under current tax rules for two reasons: (i) permanent establishments and domestic enterprises are taxed on a consistent basis; and (ii) income taxes are not product-specific taxes. Whilst, under the tax rules of most countries, withholding taxes on certain payments are creditable to the same extent as income taxes, they are fundamentally not income taxes. When imposed on payments made for the cross-border purchase of goods, the withholding tax, a tax that is clearly product-specific, would appear to be *de jure* discriminatory, as the purchase of an identical product domestically would not trigger the tax (notwithstanding the fact that the profits of the domestic vendor would be subject to an income tax). The tax could not be compared to a value added tax (VAT), because unlike the withholding tax, VAT applies to sales made by domestic and offshore suppliers alike. Thus, a VAT does not discriminate based on the origin of the good.

The need to have universally agreed rules

293. Clearly, the option is inconsistent with the existing international tax rules and would require radical change to all existing double taxation treaties. Even proponents of the base erosion approach warn that double taxation could only be avoided if this approach were adopted through international consensus. There is little prospect that this consensus would be reached in the near future. The transition period, with its accompanying problems, could be extremely long. Any unilateral imposition of the base erosion approach would almost certainly result in double taxation in those jurisdictions where relief from double taxation is by the credit method. Double tax relief is allowed under most treaties only for taxes that are imposed in accordance with the treaty. Risks of double taxation could arise if the residence jurisdiction took the view that this flat rate tax is not the same as or similar to existing taxes covered by the convention.

294. Advocates of the base erosion approach argue that it is necessary to adopt that approach to ensure an equitable distribution of tax revenues. Maintenance of an existing equilibrium between residence and source state taxation, however, is not an internationally accepted or recognized principle of taxation. If a substantial number of countries continued to believe that the existing rules ensure the most acceptable division of revenues, these countries would probably reject the base erosion approach.

295. Moreover, if “undue tax base shifting” is a main justification for changing to a base erosion approach, it would not be reasonable to implement the change until clear evidence of the shifting has, in fact, emerged. It would not be appropriate to proceed with such a fundamental change without ensuring that the main reason justifying the change is actually material, i.e. is something other than a mere expectation or concern.⁴⁰

40 Id., at 78.

c) ***Replacing separate entity accounting and arm's length by formulary apportionment of profits of a common group***

i) *Description of the alternative*

296. Because of difficulties encountered in the implementation of the separate entity and arm's length principles which underlie the existing rules, some have suggested that these rules should be replaced by a system based on formulary apportionment as the international method of allocating and measuring business profits that countries may tax.

297. Under a formulary apportionment system, a formula would be used to divide the net profits of a company, or a group of related companies, doing business in more than one country among the countries where the corporation (or group) operates. Suppose, for example, that it were decided to use payroll and sales (at destination), weighted equally, to apportion income. Suppose also that a corporation (or group) had 50 percent of its payroll in each of two countries but made 70 percent of its sales in country A and 30 percent in country B. The corporation would pay tax on 60 percent of its profits to country A and tax on 40 percent of its profits to country B (60 percent is the average of 50 percent and 70 percent; 40 percent is the average of 50 percent and 30 percent.)

298. It is important to note, however, that there is no single system of formulary apportionment. It is possible to design a large variety of different methods that share the common feature of using a formula to apportion income. The following are some of the main issues that would enter into the design of a formulary apportionment system:

- *Relationship between source and residence-based taxation.* Formulary apportionment could conceptually replace both the existing source and residence-based systems, although most options assume that the existing residence-based system would remain largely unchanged, with formulary apportionment being used to distinguish between foreign-source and domestic-source income.
- *Uniformity of the various countries' tax system.* In a logically consistent system of taxation based on formulary apportionment, all key elements of the system, other than the choice of tax rates, would be uniform across countries. Achieving this degree of international uniformity would, however, be a daunting task, and perhaps impossible. The question, then, is whether the degree of uniformity described above as desirable is truly essential. An analysis of the existing rules based on the separate entity and arm's length principles shows that lack of uniformity is not a complete barrier to the adoption of formulary apportionment.
- *Nexus / threshold for taxation of business profits by source countries.* In a formulary apportionment system, it would be possible for source countries to continue using the presence of a permanent establishment as the test of jurisdiction to tax. The logic of formulary apportionment suggests, however, that sufficient nexus would exist in a country if the formula factors are present in that country, subject to the following two provisos a) whether enough revenue could be at stake to justify the cost of compliance and b) whether the rule is administrable. But what is practicable depends crucially on the degree and nature of international cooperation.
- *Application to all industries or only to electronic commerce.* To the extent that problems of implementing source-based taxation are associated with electronic commerce, it might seem appropriate to replace separate entity accounting and the arm's length standard only for electronic commerce. This approach, however, seems impractical as it would require a

definition of electronic commerce. Assuming that this could be done, discrimination would result in direct contradiction to the Ottawa framework conditions, which require neutrality with regard to the techniques of commerce. Moreover, if a taxpayer were involved in both electronic commerce (however defined) and non-electronic commerce, it would be necessary to distinguish income from the two types of commerce.

- *Application to individual companies or group of companies.* It seems, both in principle and as a practical matter, that application of formulary apportionment should not be limited to individual companies. Since most corporations use separate entities to conduct foreign operations, not much would be gained from applying formulary apportionment only to individual companies. The need to use separate entity accounting and the arm's length standard to determine the income of separate entities would remain if formulary apportionment were limited to individual companies.
- *Criteria to be used to determine application to groups.* If the method is applied to a group of companies, criteria would be needed for that purpose. These could be based solely on common ownership or on the existence of a "unitary" business. Including in the group only commonly owned entities that are engaged in a unitary business seems to make more sense from an economic point of view but it may imply the need to segregate the income of distinct unitary businesses that occur within a commonly-owned group, presumably by using separate entity accounting and arm's length standard. Moreover, what constitutes a unitary business is far from straightforward in practice.
- *Factors to be used to apportion income and weight to be given to each.* Assuming that the objective of formulary apportionment is to tax income where it originates, the apportionment factors should be chosen to reflect where income originates. The formula should be stable, so as to provide certainty, and it should not be capable of manipulation, by either taxpayers or taxing bodies. It is far from clear, however, which factors or combination of factors would best meet these principles and any choice would clearly be motivated by political considerations.
- *Whether the apportionment factors should be company-(or group) specific or industry-specific.* Whilst most options (and the current systems in Canada and the United States) use apportionment factors that depend on the activities of the particular taxpayer (or corporate group), it would be possible to employ apportionment factors based on industry averages.
- *Measurement of the individual factors.* Experience in the United States indicates that how to define and measure apportionment factors can be difficult. Most practical problems of measurement involve the sales factor (for example, whether sales are defined on a net or gross basis). Although the property factor creates fewer practical problems, its definition is deeply flawed (e.g. the treatment of intangible assets in the property factor and of sales of intangibles in the sales factor pose important problems). The payroll factor is the simplest, but problems arise in the case of independent contractors and work done in various jurisdictions.
- *Income to be apportioned.* Whether all income should be apportioned depends crucially on a) the type of income and b) whether apportionment is applied to the income of corporate groups or limited to the income of individual corporations. If a distinction is made between business and non-business income, additional issues may arise, such as the allocation of expenses (e.g., for interest expense) between business and non-business income.

- *Countries that would not accept formulary apportionment.* If not all countries decided to adopt formulary apportionment, two approaches would be possible. Under the first, countries employing the formulary apportionment system would apportion the world-wide income of corporate groups subject to that system, including income earned in countries that did not use that system, as determined under the current system. Under the second approach, the formulary apportionment system would be used only to apportion income attributed to those countries that use the system. For this purpose separate entity accounting and the arm’s length principle would be used to determine apportionable income. That co-existence approach, however, would likely create practical difficulties as the same revenues and expenses of individual companies would need to be allocated on a different basis between various countries.

299. The following paragraphs describe some examples of formulary apportionment methods.

300. In 2001, the European Commission issued a report that presented for discussion two possible formulary apportionment methods that could be adopted in order to address obstacles to the single market as regards the taxation of business profits within the European Union (the report also examined two other alternatives that would require adoption of a uniform system, but did not consider these as politically viable in the near future). Both methods would allow corporations to use a consolidated corporate tax base for their EU-wide activities and then use formulary apportionment to distribute that consolidated income among the Member States.

301. The first method is that of “Home State Taxation” (HST). The HST would be optional for both EU Member States and corporations. Under HST, each corporate group operating in the EU could, at its option, be taxed by participating Member States under the rules for computing taxable income of the EU Member State where the parent has its headquarters. Each participating Member State would mutually recognize the tax laws of the others. The tax systems of the various Member States would continue to be effective for corporate members of groups that do not opt for HST, as well as for all corporations operating in Member States that do not participate in HST. Whilst there would still be different national tax systems, a given corporate group that opted for the HST would need to comply with only one, plus those of Member States that choose not to participate in the HST. Separate entity accounting and the arm’s length standard would still be used to isolate the income of companies choosing not to participate in the HST and the income of companies operating in Member States that do not participate in the HST, as well as the non-EU-source income of the group. Income of a group opting for HST would be apportioned among participating Member States; the apportionment formula has not been determined, but the value-added tax base (adjusted to place it on an income/origin basis) has been suggested. The share of the overall income that would be allocated to a particular country on that basis would then be taxed at the applicable rate in that country. It is assumed that the discipline of “mutual recognition” of each other’s tax systems would prevent Member States from getting too far out of line, i.e. Member States would not try to use excessively favorable tax treatment to lure away corporations now resident in others, for fear that mutual recognition would be denied or rescinded.

302. The second method, “Common Base Taxation” (CBT),⁴¹ would also be optional for corporate groups, but all Member States would presumably participate in it if the EU adopted it. Under CBT, corporate groups operating in the EU could choose to be subject to taxation based on a common tax base that would be determined at the EU level. Members of corporate groups that did not choose this option would continue to be taxed under the tax laws of the various Member States. Groups opting for CBT would

41 Subsequent work from the Commission refers to this method as “Common Consolidated Base Taxation” (CCBT) in order to better distinguish it from Home State Taxation.

use a formula, yet to be specified, to apportion their income among the Member States. Thus for such groups there would be only one set of tax rules for all of the EU.

303. The states of the United States have a long experience of formulary apportionment. Forty-five states (plus the District of Columbia) tax corporate income. All administer their own taxes and all use formulary apportionment to determine the portion of the total business income of a corporation (or group of affiliated corporations) they will tax. State tax rates range from zero (in states that have no tax) to almost 10 percent, but effective tax rates are actually only 65 percent that high (that is, ranging from zero to 6.5 percent), because state tax is deductible in calculating liability for federal income tax. Calculation of apportionable income begins with income for federal tax purposes, but each state may make adjustments. The ratios of in-state to total payroll, property, and sales (generally attributed to the state of destination of sales) are used to apportion income. Whereas these apportionment factors have traditionally been weighted equally, over the past two decades there has been a move to place greater (or sole) weight on sales and less on payroll and property; more than half the states now accord at least half the weight to sales. Many states “combine” the activities of corporations deemed to be engaged in a “unitary business,” netting out transactions occurring within the unitary group and using the factors of the entire group to apportion the group’s total income, but roughly half apply their taxes to the income of individual legal entities.

304. Canada also has formulary apportionment experience, although the application of formulary apportionment at the provincial level in Canada is more limited since the method applies separately for each company (i.e. there is no consolidation or combination of profits of related companies). The Canadian system exhibits substantial uniformity. All the Canadian provinces levy corporate income taxes and the federal government administers the taxes of all but three of the provinces. A common two-factor apportionment formula that accords equal weight to payroll and sales is used to apportion income, which, with a few minor variations, is defined uniformly in all provinces.

ii) Justification

305. For its proponents, formulary apportionment would address a number of perceived problems arising from the separate entity and the arm’s length principles. Among these interrelated problems are a) economic interdependence between related entities, i.e. an MNE group is more than the sum of its parts, thereby realising economies of scale, efficiency gains from integrating some functions and centralising others, etc, which can be difficult to reconcile with the basic assumptions underlying separate entity accounting and the arm’s length principles; b) the lack of arm’s length prices for many transactions between related entities (because there are no comparable transactions with unrelated parties, for example vertical integration in some industry sectors means there are no independent parties and there are particular comparability problems with unique and highly valuable intangible assets, which are of paramount importance in many modern corporations); c) the possibility of arranging transfer prices on transactions between related entities, including finance charges and payments for the use of intangible assets, and d) the difficulty of applying to electronic commerce the traditional transaction-based transfer pricing methodologies favoured by the OECD Transfer Pricing Guidelines and the approach in the Guidelines of using profit methods only as a last resort (this argument being the only one that specifically relates to e-commerce). These problems may be exacerbated by the fact that the separate accounting and arm’s length principles make it possible to shift income to low-tax jurisdictions.

iii) Assessment of this alternative in light of the evaluation criteria

Consistency with the conceptual base for sharing the tax base

306. Formulary apportionment deals primarily with the measurement of profits to be taxed by each jurisdiction rather than with the issue of when should a jurisdiction have a right to tax a share of profits

(although it would be possible, as previously discussed, to envisage a system of formulary apportionment where a country's right to tax would depend on the existence of apportionment factors in that country). Thus, different apportionment factors could be chosen to reflect different approaches as to where profits originate. For instance, the use of a sales factor would seem appropriate under the supply-demand view, or under the supply-based approach that takes account of what some view as the use of a country's infrastructure, but would be difficult to justify under the supply-based approach which considers that profits should only be considered to originate from a country to the extent that an enterprise carries on business activities in that country beyond the use of that country's infrastructure.

307. One difficulty, however, is that (unlike the profit split method) the factors of formulary apportionment methods would not be chosen on a case-by-case basis and so would likely be inappropriate at least for some of the companies or groups to which they would be applied. Formulary apportionment would produce arbitrary results in many cases and there is no way of knowing how far the results that it would produce would differ from what would be viewed as the "right" share of the overall business profits of an enterprise under the various conceptual approaches as to where profits originate. In the extreme case, formulary apportionment will result in a company or a group that realizes an overall loss not being taxable in a country even though its operations in that country, taken in isolation, are clearly profitable (and, vice-versa, a share of profits could be allocated to a country even if the operations in that country are not profitable).

Neutrality

308. At a general level, the non-neutralities created by formulary apportionment would be different from those arising under the existing rules. Taxation based on formulary apportionment would discourage undertaking the activities that enter the apportionment formula (e.g., payroll, property or sales) in the taxing jurisdiction.

309. Clearly, a formulary apportionment method that would be restricted to electronic commerce (assuming that such a method could be effectively designed) would not be neutral between e-commerce operations and other business activities.

Efficiency

310. If formulary apportionment were implemented uniformly across countries, costs of compliance and administration could be reduced dramatically (although one should not underestimate the practical difficulties, such as currency adjustments, that would arise in the application of a worldwide formulary apportionment system). Of course, the same would be true to a large extent if separate entity accounting and the arm's length standard were implemented uniformly across countries. It is unclear whether a non-uniform system of formulary apportionment would be more efficient than the present system; that depends in part on the nature and extent of non-uniformity.

Certainty and simplicity

311. Again, if formulary apportionment were implemented uniformly and properly across countries, it would be more certain and simpler than now, as would separate entity accounting and the arm's length standard if they were implemented uniformly across countries. The changes that would be required to do so would, however, be considerable (e.g. the determination of a common base and common formula and some form of multinational dispute resolution mechanism). It is unclear whether a non-uniform system of formulary apportionment would be more certain and simpler than the present system; that depends in part on the nature and extent of non-uniformity. What is clear, however, is that having formulary apportionment run in parallel with the existing rules at the international level would add substantial complexity.

Effectiveness and fairness

312. Formulary apportionment would in some cases produce arbitrary results that would be unfair. The present system also sometimes produces results that are unfair. However, the distortions produced by formulary apportionment are likely to be greater and indeed may be perverse (e.g. the impact of currency depreciation) and so such a system is likely to be less fair. For instance, in a case where all the distribution activities are carried on from one country whilst all the production is done in another one, a formulary apportionment based primarily on sales would allocate too much profit to the first country. The case-by-case approach of the separate entity and arm's length principles is likely to be fairer as it takes into account the individual circumstances of taxpayers.

313. It could be argued, however, that formulary apportionment would deal more effectively with the allocation of group benefits, such as economies of scale, than traditional transaction-based transfer pricing methods. Even if that argument were accepted, it could be replied that profit-based transfer pricing methods that follow the arm's length principle do so more fairly and effectively given their case-by-case approach.

314. If formulary apportionment were applied to groups of related firms, it would likely reduce the potential for evasion and avoidance of tax, although support may still be needed from the separate entity and the arm's length principles to deal with transactions with non-consolidated but controlled entities and to prevent manipulation of factors. Otherwise, it would leave open many of the same avenues of abuse as under the present system.

315. Finally, since intra-group payments would be eliminated for purposes of allocating the income subject to source taxation, a potential advantage of formulary apportionment is that it could have the effect of replacing withholding taxes imposed on intra-group payments by a tax on net profits. That substitution effect, however, would depend on the definition of the income subject to the formulary apportionment.

Flexibility

316. As long as the chosen formula remains acceptable, formulary apportionment (with unitary combination) would not be much affected by technological and other developments that change the way business is conducted. There is, however, the possibility that, over time, the choice of apportionment factors would become inappropriate, as happened in the United States in the case of the origin-based treatment of sales of intangible products in the sales factor and omission of intangible assets from the property factor. One could argue that the separate entity accounting and arm's length principles have also proven not to be able to handle technological and other business developments very well. A contrary view, however, is that the arm's length principle has been able to adapt itself to changing circumstances, most recently through the development of profit-based methods, and that the case-by-case approach underlying the existing principles is likely to prove less rigid than a formulary approach.

Compatibility with international trade rules

317. Formulary apportionment seems to be generally compatible with international trade rules, at least to the extent that origin-based factors such as payroll, property, and value added (or sales) at origin are used to apportion income. It has been argued, however, that using only sales at destination to apportion income could be inconsistent with international trade rules that allow border tax adjustments (compensating import taxes and rebate of taxes on exports) only for indirect taxes. Whether using sales at destination in conjunction with origin-based factors is consistent with international trade rules could then depend on the weight assigned the various factors.

The need to have universally agreed rules

318. During the 1980s, much of the developed world opposed the use of worldwide unitary combination by some of the American states, and in 1992 the Ruding Committee summarily dismissed global formulary apportionment. It could be argued that, in the interim, globalization has increased the pressure on the use of separate entity and arm's length principles to the point where many countries (especially those that lack the highly trained personnel required to implement the current rules) might be willing to consider an alternative such as formulary apportionment. It seems clear that, at a minimum, the increased economic integration of Europe has caused the European Commission and some EU Member States to rethink their stand against formulary apportionment within the EU.

319. Clearly, however, the worldwide adoption of formulary apportionment would involve a massive shift in thinking and practice. It is difficult to know whether it would be possible to achieve substantial uniformity. Achieving a sufficient degree of international uniformity would be very difficult and perhaps impossible. There is no internationally accepted measure of income, there has never been any serious discussion of the other elements of a standard system of apportioning income, and virtually all of the issues on which international agreement would be desirable are controversial. Moreover, in the absence of a universally agreed and economically rational conceptual basis for apportioning income and deciding which countries should have the right to tax, the international political consensus necessary to adopt formulary apportionment would be very difficult to achieve. Each country would likely be tempted to argue for the factors or weightings that give them the greatest share of tax revenues.

320. The transition from the current rules to some method of formulary apportionment would raise very difficult issues. It would be difficult for bilateral treaties based on existing rules to co-exist with bilateral treaties adopting a formulary apportionment approach based on unitary combination (not to mention the fact that bilateral treaties based on different formulary apportionment methods would create huge additional difficulties). There would be substantial transition costs in moving to a new system and in changing double taxation rules and re-negotiating treaties based on the existing system etc. There would also be a high risk of over-taxation in any transition period where both sets of rules would apply simultaneously.

321. Whilst the alternative of a multilateral agreement could ensure a more efficient transition, it seems politically unrealistic, at this point in time, to think that this could be done (except in the context of a regional organization where there is economic convergence). It also seems clear that the move to formulary apportionment is a fundamental change that could not be justified only, or even primarily, by the new business models resulting from new communication technologies.

d) Adding a new nexus of "electronic (virtual) permanent establishment"

i) Description of the alternative

322. The concept of 'virtual PE' is a suggestion of an alternative nexus that would apply to e-commerce operations. This could be done in various ways, which would all require a modification of the permanent establishment definition (or the addition of a new nexus rule in treaties), such as:

- extending the definition to cover a so-called "virtual fixed place of business" through which the enterprise carries on business (i.e. an electronic equivalent of the traditional permanent establishment);
- extending the definition to cover a so-called "virtual agency" (i.e. an electronic equivalent of the dependent agent permanent establishment);

- extending the definition to cover a so-called “on-site business presence”, which would be defined to include "virtual" presence.

323. The “Virtual Fixed Place of Business PE” would create a permanent establishment when the enterprise maintains a web site on a server of another enterprise located in a jurisdiction and carries on business through that web site. The place of business is the web site, which is virtual. This alternative would effectively remove the need for the enterprise to have at its disposal tangible property or premises within the jurisdiction. It would nevertheless retain some or all of the other characteristics of a traditional PE, i.e. the need for a “place” (whether physical or electronic) within a jurisdiction having the necessary degree of permanence through which the enterprise carries on business. Thus, for example, a commercial web site, through which the enterprise conducts its business and which exists at a fixed location within a jurisdiction (i.e. on a server located within that jurisdiction) is regarded as a fixed place of business.

324. The second alternative, “the Virtual Agency PE”, would seek to extend the existing dependent agent permanent establishment concept to electronic equivalents of a dependent agent. This alternative would extend the dependent agent permanent establishment concept to other circumstances where contracts are habitually concluded on behalf of the enterprise with persons located in the jurisdiction through technological means rather than through a person. Thus, for example, a web site through which contracts binding on the foreign enterprise are habitually completed might be treated as a dependent agent permanent establishment of that enterprise regardless of the location of the server on which that web site is stored.

325. The third alternative, “On-site Business Presence PE” proposes a new threshold for source taxation which does not depend on the existence of a fixed place of business at the disposal of the enterprise or on the traditional view of a business activity taking place within a jurisdiction. Rather, it looks at the economic presence of an enterprise within a jurisdiction in circumstances where the foreign enterprise provides what the proponents of that approach view as on-site services or other business interface (which could be a computer or phone interaction) at the customer’s location. Under this alternative, it would be necessary to specify a minimum threshold to ensure that source country taxation only applied where there is a significant level of economic activity. Possible thresholds might include a minimum time during which the enterprise regularly operates within the jurisdiction, or monetary thresholds, or limitations on the types of activities covered (e.g. exclusions for preparatory or auxiliary activities, or intermittent and occasional activities).

326. The question of the attribution of profits under these three alternatives would give rise to some difficulties under the existing rules. Fundamentally, the arm’s length principle sets out that taxable profit is attributed on the basis of functions performed in a country, having regard to the assets used and risks assumed for that purpose. This raises the issue of whether the arm’s length principle is capable of application where profits must be attributed not by reference to functions performed by people and assets used by the enterprise at a fixed geographical point in the country, but by reference to economic activity generated by the interaction between customers of that country and a web site of that enterprise. Under a conventional functional analysis, it is likely that no substantial profit (if at all) could be attributed to a "virtual PE" or "on-site business presence" under the first and third approaches.⁴² This means that alternatives to the arm’s length principle would need to be considered to attribute significant amounts of

42 A significant reinterpretation of the arm’s length principle would be required in order to introduce the notion of virtual functions, use of virtual assets and virtual risk assumption, beyond the possible recasting suggested for the virtual agent alternative. This would likely mean the end of the concept, as it would be very difficult to reconcile rules that would reward functions performed, assets used and risks assumed at a specific geographic point and, as the same time, reward the corresponding virtual notions.

profit under these two approaches.⁴³ As for the second approach (the "virtual agency PE"), the functional analysis would centre on the functions of the virtual agent in the country. Whilst it could be argued that this must already be done in the case of the dependent agent permanent establishment under paragraph 5 of Article 5, the difference is that, in the case of the Virtual Agent PE, the "agent" does not perform functions at any geographical point in the country and has no tangible assets in the country. Clearly, therefore, the broadening of Article 5 to encompass Virtual Agent PEs would need to be accompanied by consequential changes to Article 7 in order to entertain the notion that profits could be attributable to virtual agents.

ii) *Justification*

327. Since the modern business environment arguably allows many enterprises to conduct their business operations in other jurisdictions without the need for a fixed physical presence, some commentators have suggested that a more appropriate indicator of sufficient participation in the economy of a jurisdiction may be a "virtual PE". The concept of "virtual PE" seeks an alternative threshold for determining when an enterprise has a significant and ongoing economic presence such that it could be said that it has a sufficient level of participation in the economy of a jurisdiction to justify source taxation, notwithstanding that the enterprise may have little or no physical presence in that jurisdiction.

328. The broadest of the three approaches, the On-site Business Presence PE, is said to address the potential for changes in international business operations from a physical presence in foreign jurisdictions to temporary, mobile and virtual presences. For its proponents, it also acknowledges the shift in trade from tangible goods to services and intangibles and the ability for businesses to interact with customers at their premises without the need for a fixed place of business using modern technology. It seeks to tax at source the trade of highly specialised services such as professional, management, and technical expertise, which its proponents consider as being performed at the customer's location even though it is performed by personnel located abroad. It also seeks to tax services associated with equipment that may be mobile, such as off-shore hydro-carbon equipment or automatic equipment that requires little or no supervision by the enterprise to which it belongs such as unattended telecommunications facilities. In many of these cases, a permanent establishment may not exist under the current definition notwithstanding that the foreign enterprise may have substantial economic activities in the jurisdiction from which it derives considerable profits.

iii) *Assessment of this alternative in light of the evaluation criteria*

Consistency with the conceptual base for sharing the tax base

329. To the extent that the three options would seek to allow source taxation in cases where some consider that an enterprise makes use of a country's infrastructure to generate profits, they would be in line with one approach to the supply-based view as to where profits originate. The options are more difficult to reconcile with the supply-based approach according to which a country is only justified to consider that profits originate from its territory if the enterprise carries on activities thereon. Whilst it could be argued that the options address situations where business functions are performed in a country without any physical presence of the business in that country, it could also be said that the options (and primarily the "Virtual Agency PE" and "On-site Business Presence PE") would clearly cover cases where no business functions are performed by the enterprise itself in the jurisdiction.

⁴³ One such alternative would be for a country to levy a tax at a flat rate on the total value of the sales made through virtual means (that approach has been discussed in section 4-B a). Another one would be to introduce a sharing of tax revenues between both countries, presumably through bilateral or multilateral negotiations (but this unprecedented approach would likely give rise to important practical and political difficulties).

330. Other conceptual difficulties could arise to the extent that the options would require alternatives to the current rules for measuring profits taxable by the source country. For instance, as already mentioned, the application of a final withholding tax would be inconsistent with the concept of an income tax since it would be a tax on gross payments.

Neutrality

331. It was argued that by relying on the existence of a fixed place of business (albeit a virtual and not a physical place), the options rely on essentially the same rules as traditional permanent establishments and therefore should not raise any significantly new or different neutrality issues from the current regime. It was also argued that the mobility of servers and the ability to split functions performed by software lead to the possibility that an enterprise could structure its affairs to ensure that business profits from electronic commerce are attributed to a PE situated in a low tax or no tax jurisdiction, which would itself lead to a non-neutral outcome between conventional business in a jurisdiction and e-commerce business conducting similar levels of commerce in the same jurisdiction.

332. The counter-argument, however, is that virtual is not real and that there is, in fact, no place of business in the cases in which the options seek to deem a permanent establishment to exist. The neutrality principle would be violated to the extent that the options would result in different tax outcomes for conventional and electronic forms of commerce in the application of the test of physical presence.

Efficiency

333. It was argued that the compliance and administrative requirements for a Virtual Fixed Place of Business PE are essentially the same as for e-commerce businesses under the current regime. A counter-argument, however, is that extending the permanent establishment concept to cover situations where web sites are being hosted in a country would create serious compliance difficulties for businesses (e.g. an enterprise may not even know that an ISP hosts its web site in a particular country) and for tax administrations, which would have to deal with permanent establishments involving no physical assets or personnel within the country.

334. Whilst it could also be argued that the compliance and administrative challenges and costs already associated with the traditional PE rules, including the dependent agent permanent establishment, would also exist under the Virtual Agency PE and On-site Business Presence PE, it seems clear that, because both options would deem a permanent establishment to exist in a country where the enterprise would have no physical assets, personnel or even a web site, enterprises would be faced with the increased compliance burden of satisfying tax obligations in all the countries where customers access their web sites to conclude contracts. Under both options, for instance, an enterprise would need to properly identify the ultimate jurisdiction of the e-commerce transaction. In the case of downloaded goods or services, where independent evidence such as shipping documents are absent, there may not currently be any reliable means of establishing this jurisdiction.

335. The reporting obligations in the resulting increased number of jurisdictions would affect the compliance costs. The determination of profits of each virtual PE could also present compliance difficulties for enterprises, since it is unlikely that enterprises conducting business electronically would maintain separate accounts for activities in each country where customers access their web sites.

336. Since the On-site Business Presence PE would probably require some minimum taxation threshold (e.g. based on duration of operations, turnover or other monetary threshold), an additional compliance and administrative difficulty would be the administration of that threshold in an environment where there might not be a reliable domestic information source. Whilst it was suggested that a possible

solution to these compliance and administrative problems may be to consider combining the On-site Business Presence model with a tax collection model that provides for a non-final withholding tax, this would raise the difficulties described in the analysis of the base erosion approach (see section 4-B b) above).

Certainty and Simplicity

337. Since the options seek to extend the concept of permanent establishment rather than add a supplementary nexus, it could be argued that they would rely on a time-tested and well-understood set of rules. The fact is, however, that the options would be fundamentally different from the permanent establishment concept as it now exists since no physical presence in a country would be required.

338. The deemed permanent establishment that would be created under each of the alternatives would clearly add some uncertainty to existing rules. For instance, under the Virtual Fixed Place of Business PE, enterprises using ISP providers to host their web sites may be unaware of the exact servers being used by the provider to host these web sites. Hence, an enterprise may not know whether the requirements for temporal and geographic fixedness have been met. Under the Virtual Agency PE, an enterprise may have difficulties in identifying where the contracts are concluded. Under the On-site Business Presence PE, if source country taxation is conditional on exceeding a threshold, enterprises may not know at the outset whether, for example, their sales (if it is a sales threshold) will exceed the required minimum in each jurisdiction where they have economic presence.

Effectiveness and fairness

339. Each of the three options raises different concerns in relation to the principles of effectiveness and fairness.

340. Some members consider that the current rules are open to tax planning in that an enterprise carrying on electronic commerce in a jurisdiction can avoid having a permanent establishment simply by having its web site hosted on a server operated by a third party (e.g. an ISP) rather than on its own equipment. Whilst the Virtual Fixed Place of Business PE would seek to address this problem by removing the requirement for physical presence, it could itself be easily circumvented by relocating the web site to another server within the jurisdiction at regular intervals (whilst that problem could be addressed by modifying the “fixedness” requirement of the current definition of the permanent establishment, that would mean a significant departure from the existing rules), or by locating the web site on a server located in a low or no tax jurisdiction. Businesses could also minimise their tax liabilities by ensuring that core functions are performed wholly or primarily through software on servers located in low or no tax jurisdictions. The effectiveness of the Virtual Fixed Place of Business option would therefore be quite limited since it would only address situations where there would be business advantages in having a web site located on a server in the jurisdiction of the customer (these would include situations where faster response times or downloading speed of software is an important consideration in choosing between on-line competitors or choosing to buy through traditional channels).

341. Some members argued that the Virtual Agency PE option would improve fairness since it would ensure that what they view as the same functions being performed in a jurisdiction, i.e. the habitual conclusion of binding contracts, would attract the same tax treatment regardless of the mode of performance (i.e. whether by a person, machine or software). They added, however, that additional fairness may not be achieved under the conventional transfer pricing analysis if little or no profit would be attributable to the Virtual Agency PE and, therefore, consequential changes to Article 7 would be required in order to give effect to a Virtual Agency PE. Other members, however, considered that, unlike the current dependent agent rule, the option would cover the function of concluding contracts even when it is

performed outside a country. Also, the risk of non-compliance under the Virtual Agency PE option would be higher than under the existing dependent agent rules as the option would result in a permanent establishment in situations where there is a lack of physical or human contact points in the source country such as office staff, human agents or other intermediaries.

342. Finally, proponents of the On-site Business Presence PE option considered that the focus on activities conducted in a jurisdiction rather than on the existence of a fixed place makes the option more effective and harder to take advantage of than the current rules. A permanent establishment can currently be avoided in many situations by simply not setting up physical premises in a jurisdiction and accessing a market through a web site or through frequent but short-term presences. These proponents also indicate, however, that the requirement of some domestic threshold under the On-site Business Presence option may facilitate avoidance of a tax liability in the source country. Enterprises might, for example, split their operations between a number of tax entities to ensure that the specified thresholds are not met by any one entity. They also consider that to the extent that services can be “performed” in one jurisdiction, and delivered to the customer in another jurisdiction without creating an on-site presence e.g. sales made by mail order, the potential for avoiding a tax liability arising in the source country remains. For other members, however, the alleged advantages of the option and the risks of manipulation that it seeks to address relate to business activities that are not carried on within a country and should not, therefore, be taxed there.

Flexibility

343. Whilst the Virtual Fixed Place of Business PE may arguably improve the permanent establishment concept by removing a distinction based on whether a web site is hosted by an ISP or on a server at a disposal of an enterprise, it only makes sense as long as technology requires a server to be maintained in a jurisdiction (e.g. in order to provide quicker response times to customers). However, as technological barriers reduce, this is unlikely to be an important consideration in the future.

344. The proponents of the Virtual Agency PE argue that it would make the permanent establishment concept more robust and appropriate in the modern business environment, which does not require traditional human presence in order to perform what they see as the same functions that deem a dependent agent permanent establishment to exist (i.e. habitually concluding contracts on behalf of the principal). Similarly, it is argued that the On-site Business Presence PE option depends on economic activity, whether performed by people, machinery or electronic means, and therefore should be sufficiently flexible to deal with different business models and emerging technologies. The critical factor in this option is an economic presence through what the proponents view as the performance of significant business activities at the customer’s location. The technological or commercial method of performance may evolve without affecting the economic presence. Provided that amendments to the PE definition are drafted in terms of concept rather than specific examples (e.g. web site), they should remain relevant and flexible.

345. A serious drawback of the options, however, is that it is unclear how profits would be measured and tax collected under each of them. To the extent that alternatives such as withholding taxes may need to be considered for that purpose, the options might be seen as inappropriate answers to technological and commercial developments.

Compatibility with international trade rules

346. All three options should not raise any new issues regarding discrimination and non-neutrality unless they are associated with an alternative basis for measuring profits and collecting tax which would raise such concerns.

The need to have universally agreed rules

347. All three options seek to address concerns that source countries may lose to residence countries their share of profits generated by significant commercial activities within their jurisdiction. By focusing on economic presence rather than fixed physical presence, the broadest of these options (the On-site Business Presence PE) tries to ensure that mobile businesses (such as e-commerce and mobile service providers) receive equivalent treatment to traditional businesses that need to have a fixed place of business in a jurisdiction. Even if it is accepted that both source and residence countries contribute to the earning of income from cross border transactions and thus are entitled to share the tax revenue, all three options would therefore trigger a debate as to whether they result in an equitable division of tax revenues. Clearly, countries would take different approaches as to whether the options achieve such a result and it seems unlikely that a general consensus would quickly (if ever) emerge.

348. The implementation of any of the three options would require modification of existing treaties. Whilst treaties with and without the relevant provisions could easily co-exist, such co-existence would mean that a multinational enterprise's e-commerce activities would preferably be carried on from countries that generally oppose the adoption of the options in their treaties.

5. CONCLUSION

349. Based on the preceding analysis of the various advantages and disadvantages of the current treaty rules for taxing business profits and of a number of possible alternatives, and after having considered the comments received on its first draft, the TAG reached the following conclusions.

350. As regards the various alternatives for fundamental changes that are discussed in section 4-B above, the TAG concluded that it would not be appropriate to embark on such changes at this time. Indeed, at this stage, e-commerce and other business models resulting from new communication technologies would not, by themselves, justify a dramatic departure from the current rules. Contrary to early predictions, there does not seem to be actual evidence that the communications efficiencies of the internet have caused any significant decrease to the tax revenues of capital importing countries.

351. Also, for the TAG, fundamental changes should only be undertaken if there was a broad agreement that a particular alternative was clearly superior to the existing rules and none of the alternatives that have been suggested so far appears to meet that condition. The need to refrain from fundamental changes unless clearly superior alternatives are found is especially important since any attempt to change the fundamental aspects of the current international rules for taxing business profits would create difficult transition rules given the fact that many countries would likely disagree with such changes and that a long period of time would be required for the gradual adaptation of the existing network of tax treaties.

352. The comments received supported the overall analysis of the TAG and endorsed the conclusion reached on the various alternatives for fundamental changes discussed in section 4-B: none of the comments received supported any of these alternatives.

353. The TAG recognized, however, that there is a need to continue to monitor how direct tax revenues are affected by changes to business models resulting from new communication technologies. It also recognized that some aspects of the existing international rules for taxing business profits raise concerns. Some of these could be addressed through changes to tax treaties⁴⁴ based on some of the more restricted alternatives identified in section 4-A above. After having examined these alternatives in light of the comments received, the TAG reached the following conclusions:

- As regards the option to modify the permanent establishment definition to exclude activities that do not involve human intervention by personnel, including dependent agents (subsection 4-A a) above), the TAG concluded that this option would be unlikely to be adopted and that it did not need further consideration.
- As regards the options to modify the permanent establishment definition to provide that a server cannot, in itself, constitute a permanent establishment (subsection 4-A b) above) or to exclude functions attributable to software when applying the preparatory or auxiliary exception (subsection 4-A c) above), the Group concluded that while these options should not be pursued at this time, the application of the current rules to functions performed with the use of servers and software should be monitored to determine whether it raises practical difficulties or concerns, which could lead to further study of these alternatives or combinations or variants thereof.

⁴⁴ To the extent that treaty changes would result in increased source taxation rights, consequential changes to domestic law could also be required to allow countries to implement these taxing rights (and thereby to eliminate double non-taxation risks in cases where the residence country relieves double taxation through the exemption method).

- As regards the option to eliminate all the existing exceptions in paragraph 4 of Article 5 (the first of the two options in subsection 4-A d) above), the Group concluded that this option should not be pursued.
- As regards the options to make all the existing exceptions in paragraph 4 of Article 5 subject to the overall condition that they be preparatory or auxiliary (the second of the two options in subsection 4-A d) above) and to eliminate the exceptions for storage, display or delivery in paragraph 4 of Article 5 (subsection 4-A e) above), the Group concluded the application of these exceptions should continue to be monitored to determine whether practical difficulties or concerns warrant any such changes, which could lead to further study of these alternatives or of combinations or variants thereof. Regardless of these options, the Group also agreed that it would be useful if the issues raised in paragraph 188 were dealt with in the Commentary in order to provide greater certainty to taxpayers and tax administrations as to the exact scope of the current exceptions included in paragraph 4.
- As regards the option to modify the existing rules to add a force-of-attraction rule dealing with e-commerce (subsection 4-A f) above), the Group concluded that it should not be pursued.
- As regards the option to adopt supplementary nexus rules for purposes of taxing profits arising from the provision of services (subsection 4-A g) above), the Group noted that this option would be examined in the context of the work that the OECD will undertake on the application of tax treaties to services. The conclusions from that work could lead to further study of the option or variants thereof.

354. The TAG also observed that the effect of many of these alternatives would extend far beyond e-commerce. In considering any such alternatives, it would therefore be important to take account of their impact on all types of business activities.

ANNEX 1

MANDATE AND COMPOSITION OF THE TAG

General mandate

355. The general mandate of the TAG on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits is as follows:

“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.”

Specific mandate

356. In its work, the TAG on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits will be invited to consider fundamental and practical tax policy considerations related to the existing treaty norms for the taxation of business profits. The work of the TAG will involve looking at how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examining the feasibility and desirability of proposals for alternative rules. Thus it is envisaged that a large part of that work will be to monitor developments. For that reason, the Group might be in existence for some time and may produce a number of reports.

357. In the course of its work, the TAG will be particularly invited to consider and comment on the following questions:

- a) whether the concept of permanent establishment provides an appropriate threshold for allocating tax revenues between source and residence countries and with respect to the use of tax havens in the context of electronic commerce;
- b) whether there is a need for special rules relating to electronic commerce and whether such rules would be a viable alternative to existing international norms;
- c) whether the process of disintermediation that is often associated with electronic commerce is likely to result in a shift in the taxation of business profits, through the current permanent establishment concept, towards locations where physical production (e.g. where the enterprise maintains facilities through which its employees exercise their activities) takes place; and if so, whether the allocation of income that would result is consistent with the economics of the activity.

358. In addition, there are a number of issues related to the attribution of profit to a permanent establishment in an electronic commerce environment on which the TAG could provide input. For example, whether specific guidance might be needed in order to take into account the special factual nature of businesses engaged in electronic commerce. More fundamentally, the Steering Group on the OECD Transfer Pricing Guidelines is considering whether the existing guidance on how to attribute profits to a permanent establishments given by Article 7 of the OECD Model Convention, and its Commentary, needs to be updated to take into account modern business practices, including electronic commerce. One possible solution might be that the principles underlying the application of the arm's length principle contained in

the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations could be applied, by analogy, in making the attribution of profit under Article 7.

List of participants

359. The following persons participated in one or more meetings of the TAG:

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ANNEX 2

EXAMPLES OF NEW BUSINESS MODELS AND FUNCTIONS

The following are a number of examples of new business models and functions that have arisen from new communication technologies.

1) *Manufacturing*

Category 1: General manufacturing concerns

360. Manufacturers require various components, materials or services in order to produce their products. Through the use of Internet-based catalogues and auction sites, manufacturers can reduce the costs of procuring goods and services and need not rely on suppliers within proximity of their operations. In turn, suppliers, whether local or remote, can access new customers or markets and through web-based ordering systems reduce transaction costs, response times, and ordering errors.

Category 2: Manufacturing concerns with direct sales (made to order business model)

361. Manufacturers of durable goods with direct sales to consumers through various communication systems: phone, fax, e-mail, interactive web sites, or kiosks. A major advantage of this business model is that through web-based configuration assistance, consumers can custom order their desired products. Target markets may also include resellers and preferred business customers.

- Software and networking capabilities allow product configuration, product ordering, pricing, cataloging, and inventory availability to be handled effectively over the Internet.
- Order information can be accessed by consumers through interactive web sites, resellers through network applications providing real time access, and preferred business customers through customized web sites tailored specifically for them.

Category 3: Outsourced manufacturing activities

362. Many product suppliers outsource non-core competencies, such as manufacturing, in order to concentrate on research and development and sales activities. Traditional manufacturing concerns also may outsource manufacturing of components to lower cost locations.

- Web-based configuration systems aid the customer in selecting highly customer specific products. The detailed product information is transmitted electronically to the provider's "manufacturer". As part of its outsourcing strategy, the provider maintains quality control and provides product innovation data through web-based monitoring systems and data delivery systems.
- Because ordering information is electronically delivered and the production process can be monitored from remote places, outsourced manufacturing activities can be located in low-cost areas or near customer locations so as to reduce shipping time and costs for the customer.

Aside from the benefits received by customers, local industries and labor benefit from such arrangements.

2) *Distribution Systems*

Category 4: Traditional shipping services

363. Through online parcel order and tracking systems, shipping companies can make quicker and more accurate deliveries whilst customers utilize real-time information about their shipments.

Category 5: Logistics and fulfillment

364. Because shipping companies have developed extensive logistics technologies and experiences, businesses have begun outsourcing their order fulfillment functions (such as inventory control, assembly, warehousing, packaging, shipping, customer service, and returns) in order to concentrate on developing new product ideas and production. Such order fulfillment operations can be centered near the manufacturing location or the principal markets, or in locations with ample supply of inputs and labor.

3) *Marketing, Customer Relationship Management, and Decentralized Business Functions*

Category 6: Web-based marketing

365. Whether engaged in traditional sales or services, information technology, or the high-tech sector, any enterprise with a well-designed web site can present relevant product or service information to a larger audience in a more efficient and cost-effective manner. As the cost of conveying information to customers has been reduced through communication technologies, small and remote businesses who previously faced cost and geographical barriers to entry in certain markets may now more easily promote and sell their products and services in such markets.

Category 7: Call centers

366. A significant function of many businesses is to provide customer support. As a result of web-based networking and improved communication technologies, businesses can now place call centers and related operations in most jurisdictions. A jurisdiction which offers an educated and highly skilled employment base or presents cost-effective opportunities, however, will have a competitive advantage in attempting to serve as a preferred location for call centers.

- Customer support can be provided via trouble-shooting online databases, online communication with human technicians (e-mail or interactive transmission), or direct telephone communication.
- In addition, technical support that requires on-site services can be provided directly by company employees located in the relevant jurisdiction or outsourced to independent third parties.

Category 8: Shared service centers/regional management centers

367. Through communication efficiencies, both national and international businesses can decentralize many of their business functions to cost favored locations or locations closer to customers. These functions can include regional headquarters, regional marketing units, technical support or repair centers, and similar functions.

4) *Information Technology*

Category 9: Information delivery systems

368. Through content distribution networks, content providers can deliver information to individuals and businesses in remote places. This may include transmissions of newspaper stories to subscribers, internal reports from a CEO to regional offices and staff, or public announcements from companies or individuals to the mass media. As a result, media businesses increase their revenues from subscriptions, and other businesses and individuals reduce printing and shipping costs associated with the distribution of reports or announcements.

Category 10: Remote technical services

369. Using Internet-based networking systems, businesses can maintain and improve their operations with labor intensive technical services derived from remote jurisdictions.

- For example, the software industry's need for individuals with information technology talent is immense. With the advent of Internet-based networking systems, remote coding, software testing, system integrations, diagnostics, and monitoring can be performed from locations that offer such talent.
- Therefore, as businesses benefit from an increased geographic availability of labor, labor providers are able to access new markets in which to offer their services.

Category 11: E-learning/interactive training

370. Through Internet-based networking systems, businesses can train their employees in a more cost-effective, decentralized manner. Instructors can be located anywhere in the world including low cost jurisdictions offering labor pools with technical skills.

Category 12: Web-based information storage systems

371. Web-based information storage systems allow customers to access, upload, retrieve, and manipulate data remotely. Further, these systems protect information from fire, theft, and other casualties.

- Costs associated with storing and securing vast amounts of documents are reduced.
- Business operations can be decentralized as authorized users can be located anywhere in the world and be able to review, edit, or add to stored information (e.g., banks, insurance companies, etc. -- personnel located in different countries can access and change stored documents without the need to mail or fax documents to other offices).

Category 13: Application service providers (ASPs)

372. ASPs obtain licenses from software providers to host software applications for the benefit of end-users. As a result, end users have access to software applications that are hosted on computer servers owned and operated by ASPs. Through the use of these software applications, end users may automate their various business functions, such as procurement, or outsource significant portions of their information technology function, at a lower overall cost.

Category 14: Electronic bill presentment and payment

373. Companies with a vast number of customers (such as telephone companies, utility companies, financial institutions, and large health care providers) achieve significant savings by posting bills on their web sites or sending bills via e-mail and receiving electronic payments.

Category 15: Data Processing

374. As accounting, payroll, and other company information is processed and stored electronically, the task of processing transactions with regard to such information becomes centralized. As a result, processing activities can be located in any jurisdiction offering a suitable employment base and cost-effective opportunities.

5) *Financial Services*

Category 16: Financial services companies not representative of traditional brick and mortar infrastructures

375. Web-based providers of financial services such as banking, brokerage, and life insurance operate without extensive branch networks. Because web-based financial services companies are subject to lower costs as a result of automation and elimination of branch infrastructure, smaller companies can enter the marketplace and offer financial services.

- Success is still derived from the effective management of interest, financial, and operating risks.
- Web-based systems, however, reduce the various processing costs associated with traditional banks, brokerage firms, or life insurance companies.
- Products and services provided via telephone, web, ATMs, or kiosks located near particular groups of customers (e.g. groups of employees at particular companies).
- Through interactive web sites and using statistical models, financial services companies can evaluate, deny, or extend credit and provide other services at lower costs.
- Customer support provided via telephone, e-mail, or web interface.

Category 17: Traditional financial institutions with online presence

376. Traditional financial institutions use an online presence to provide information about their products and services, make available real time customer information, automate certain information gathering tasks, allow customers to transact business (i.e. internet banking), and provide customer support. The online presence, however, only supports the financial institution's main business function of generating business from corporate and individual clients. Further, financial institutions take on new functions such as authenticating digital certificates of participants in business to business electronic commerce.

Category 18: Targeted financial businesses

377. Specialty vendors/brokers provide particular financial services such as consumer loans and mortgage lending. Vendors/brokers reduce time consuming tasks (such as information gathering) through

the use of an interactive web site, and customers receive quotes from a variety of competing financial institutions allowing them to secure the most favorable pricing and terms.

- Because of low barriers to entry, vendors/brokers in any country may enter this market.
- Loan processing centers can be located in most cost-effective environments.

6) *General Service Providers*

Category 19: Online travel and tourism services

378. Various travel related providers benefit from web based networks that are extended to the end user. By enabling the end user to access travel-related information directly from a travel provider's system, transaction costs attributable to customer service and operations are reduced.

- Transportation operators (e.g. airlines, railroads, etc.) save money from reduced operating costs for customer service, ticket issuance, and affinity programs. Sales are increased from targeted Internet-based marketing campaigns based on specific customer information.
- Independent online travel web sites provide customers access to price quotes and availability from various service providers (e.g. airlines, hotels, etc.). Revenues are generated from commissions paid by service providers or service charges imposed on customers. Online travel web sites also allow airlines and other travel related entities to dispose of excess inventory (such as unsold airline seats and hotel rooms).
- Traditional travel agents also benefit from web-based interface systems as previously required networking systems are not a barrier to entry.

Category 20: Professional services (e.g., health care networks)

379. Individual health practitioners can participate in nationwide communities on which they have their own individual web sites. For instance, if a customer is searching for products from a local pharmacist, the customer can access the web site of a participating pharmacist that is part of the health care community.

- At the pharmacist's web site, the customer can obtain general information about medical products sold by the pharmacist or search for health related information. Through intelligent portals, the customer can provide personal, medical, insurance, and other payment information to the pharmacist and receive personalized information about specific medical conditions or medical prescriptions.
- Further, the customer will also have access to online health consultants. As a result, the pharmacist will be able to automate the ordering process and still provide quality health guidance.
- Finally, through interactive health care networks, billing information can also be transmitted between medical providers and health insurance companies; therefore, reducing the cost of processing insurance claims and transmitting patient information.

Category 21: Independent content providers (e.g., authors, musicians, or film directors)

380. Using digital media and web-based delivery systems, individual content providers residing in remote areas can present their works or talents directly to major publishing and entertainment companies in order to secure funding, distribution, and marketing of such works or talents.

7) *Commodity Suppliers*

Category 22: Raw material suppliers and purchasers

381. Through web-based bid/ask systems, commodity suppliers can offer raw materials on line, review bids, award sales, and process orders, thereby streamlining the sales process. As a result of a centralized exchange, both small and large purchasers have greater access to available products and competitive pricing.

8) *Retailers*

Category 23: Online retailer of tangible goods

382. Enterprises offering a web-based storefront may provide low cost products with a high degree of convenience and customization for its customers. Many business functions such as procurement, inventory management, warehousing, shipping, accounting, payment processing, customer service, and targeted marketing are automated through web-based systems. Certain business functions may be outsourced to service providers with a cost advantage. Along with access to new markets, the automation of the previously described business functions reduces costs and allows the enterprise to concentrate on revenue raising activities.

- In order to compete in target markets, online retailers still normally maintain marketing and sales personnel in such markets.
- Warehouses may be located in locations near target markets so as to offer quick response times or in locations that present cost-effective opportunities.

Category 24: Traditional retailer with online presence

383. A traditional retailer consisting of a chain of stores offering products or services may offer Internet access to supplement its traditional sales channels. Stores are located in various target markets, and a web-based storefront is available to purchase products and services over the Internet. Web-based presence, however, is primarily for price and inventory information, advertising of goods and services offered by the retail system, and customer service.

Category 25: Online retailer of digital products

384. Digital products can be marketed via direct purchase, rental, or pay-per-use (e.g., music, video, games, e-books, etc.). Sales, order processing, payment verification, and customer service functions are provided via web site. In order to attract customers, online retailer also provides related content specifically tailored to the tastes of targeted consumers (e.g., current events in a particular segment of the music industry).

- Content is generated through various means, such as the use of local organizations and reporters that gather information about current trends in the target market.

- Through sales tracking software, companies can establish and execute targeted marketing programs via e-mail or traditional avenues such as targeted mailings or print advertising.
- Through sophisticated ordering and database systems, the product can be delivered and packaged according to customer tastes and ordering requirements (e.g., a particular musical track with a limited life of 30 days).

9) *Electronic Marketplaces*

Category 26: Online consumer auctions

385. An online provider of auction services hosts various auctions for consumer goods. The seller transacts with the purchaser directly, and the enterprise hosting the auction is compensated through a commission or a flat fee. The online provider may facilitate the transaction by offering information by, or links to, shipping companies. Further, the online provider may associate itself with a financial institution to facilitate the payment and product exchange. The shipping companies and financial intermediary also generate fees based on the transaction.

Category 27: Electronic marketplaces operated by content aggregators

386. Electronic marketplaces can be operated by vertical or horizontal content aggregators. A content aggregator provides information for a particular industry (vertical aggregator) or for a particular function applicable across industry lines (horizontal aggregator). Revenues are generated from transaction fees, commissions, referral fees, advertising, or sponsorship.

- Sales or service transactions occur directly between the customer and the vendor or service provider associated with the marketplace.
- By associating themselves with content aggregators, small or remote vendors have a greater access to new markets.

Category 28: Online shopping portals

387. An online shopping portal hosts electronic catalogues of multiple vendors on its computer servers. Through this electronic medium, purchasers are exposed to a variety of vendors and their products.

- Purchasers are provided with the convenience of having to input shipping and payment information only once and the ability to select merchandise from a variety of vendors. Software directs purchasers to vendors with desired products.
- Through order-processing software, a vendor and a purchaser enter into and complete the sales transaction. The web site operator, however, has no contractual relationship with the purchaser but collects a commission from the vendor on the sale.
- Vendors without previous Internet experience or significant technology budgets or located in any country can tap new markets through online shopping portals.

10) *Comprehensive Business Model Example*

388. This example shows in more detail how a particular business model normally allocates its functions between head office and customer locations.

Category 29: Information technology service provider

389. An IT service provider designs, implements, and/or maintains the IT systems of its customers allowing them to concentrate on their core business functions and to reduce information technology costs. Information technology services encompass data center management, enterprise systems management, global network management, and/or help desk support. The IT service provider may also provide relevant hardware and software applications.

- The IT service provider may outsource part or much of the development of its general or custom made IT management products to remote jurisdictions offering lower labor costs.
- The IT service provider frequently contracts with third parties to provide the necessary hardware and software applications. If the IT service provider also produces hardware or software applications, it supplies the products to the end customer. Warranty services are conducted locally by employees of the third party or the service provider; the services may also be outsourced to local service providers.
- The IT service provider offers IT maintenance services remotely or onsite depending on customer specific needs. If a large customer outsources much or all of its IT needs, the IT service provider places its own personnel on the customer's site to operate and maintain the IT systems. On the other hand, if the scope of the engagement is smaller, the IT service provider only delivers remote help desk services, which can be located in any jurisdiction offering talented, low-cost labor.
- With regard to data management (processing and warehousing), the IT service provider operates its data centers within close proximity of its customer (even on customer sites) because of customer preference and current technology limitations. Although data centers may be located in remote locations, customers for comfort reasons desire their data to be processed and stored in locations near their operations. Further, with regard to bandwidth limitations, data centers need to be located on or near communication networks which enable information to be delivered as quickly as possible to the end customer.