



Business and Industry Advisory Committee to the OECD

Comité Consultatif Economique et Industriel Auprès de l'OCDE

**Business and Industry Advisory Committee to the OECD (BIAC)
Comments on the November 26, 2003
OECD Business Profits TAG (BP TAG) Discussion Draft :
“Are the Current Treaty Rules for Taxing Business Profits Appropriate
for E-Commerce?”**

January 30, 2004

The Business Profits TAG Draft

BIAC commends the OECD for its thoroughness in setting forth the tax treaty policy issues involved in evaluating the appropriate international tax treatment of e-commerce and related business models.

BIAC welcomes the findings of the OECD BP TAG that initial fears of significant tax base erosion from e-commerce have not materialized; that the benefits of e-commerce (and new business models generally) are being enjoyed by a wide variety of countries, including developing countries; that a separate tax regime for e-commerce is not appropriate; and that applying traditional permanent establishment and profit attribution principles to new business models will produce fair and equitable results.

We commend the BP TAG drafters for not recommending adoption of the radical changes to the definition of permanent establishment, which are described in Section 4B of the Draft.

BIAC, however, notes that the Discussion Draft goes beyond the realm of e-commerce and new business models and enters into a number of fundamental permanent establishment issues that will impact traditional business practices. BIAC raises a strong caution that the Model Treaty has for many years served as an excellent foundation in the context of trade and investment among OECD countries. Although e-commerce has raised some questions that need to be addressed, we do not believe that the basic principles of the Model should be modified; and we are strongly opposed to efforts to lower the permanent establishment threshold or to bring the OECD Model Treaty into line with the UN Model Treaty.

If individual OECD countries want to expand source country taxing powers, they should seek do so in their bilateral treaty negotiations. Changes that would lower the permanent establishment threshold should not be incorporated into the OECD Model Treaty itself.

In accordance with the Draft's request, we will comment in particular on the following options for modifying the permanent establishment definition:

- Section 4A(d) – Making the exceptions contained in Article 5, paragraph 4, of the Model Treaty subject to an overriding requirement that they be “preparatory or auxiliary.”
- Section 4A(g) – Adding a provision that would allow taxation of services income where the foreign enterprise performs the services in the local country for a certain period of time.

Section 4A(d). Preparatory/Auxiliary Test

The exceptions contained in Article 5, paragraph 4 of the Model are:

- Use of facilities or maintenance of a stock of goods solely for the purpose of *storage, display, or delivery* of goods or merchandise belonging to the enterprise
- Maintenance of goods solely for *processing* by another enterprise
- Maintenance of a fixed place of business solely for *purchasing* goods or collecting information for the enterprise
- Maintenance of a fixed place of business solely for the purpose of carrying on any other activity of a preparatory or auxiliary nature

BIAC opposes the suggestion that these exceptions be subject to an overall test of preparatory or auxiliary, by which the Draft would seem to say that each enumerated activity must in addition satisfy a separate test of preparatory or auxiliary in order to be exempt. The current Model says that each activity be carried out “solely” for the designated purpose. Where more than one exempted activity is carried out at a particular place of business, subparagraph (f) requires that such activities in the aggregate must be preparatory or auxiliary in order for the exemptions to apply.

There is a statement in the current Commentary, Article 5, paragraph 21, that: “The common feature of these activities is that they are, in general, preparatory or auxiliary activities.” This language does not impose a requirement that each of these activities has to be evaluated to see whether it is preparatory or auxiliary, rather it observes that in general the enumerated activities *are* preparatory or auxiliary in nature. It is only in the case of *other* unspecified activities or a *combination* of enumerated activities that the activities must satisfy the test of preparatory or auxiliary.

Applying an additional preparatory or auxiliary test to the enumerated exceptions would be a significant departure from the plain wording of the current Model and would impose unwarranted complexities:

- If the currently excepted activities are now to be considered as giving rise to permanent establishment, transfer pricing analyses and attendant documentation will be required. This will increase the potential for transfer pricing disagreements with tax authorities, putting a heavy burden on businesses and tax authorities alike. This burden is hardly justified since only a small taxable profit will be attributable to such activities in any event.

- The terms “preparatory or auxiliary” are inherently subjective. The overlay of this type of terminology will make the availability of the paragraph 4 exceptions highly uncertain. Moreover, any departure from the clear tests that are currently in the Model will increase the costs of tax compliance for all affected parties. Controversies will arise and trade will be burdened, with minimal shift in tax revenues.
- In support of the suggested change, the Draft points out that some people have questioned whether “delivery” should even be considered to be preparatory or auxiliary in the context of e-commerce transactions, for example, in the case of remote delivery of digital products. We would say, to the contrary, that despite the enhanced speed and capacity afforded by electronic means, storage and delivery are still preparatory/auxiliary functions in the business of selling goods and services. In other words, technological advances have not changed the essential nature of these activities, and thus should not change their treatment under tax treaties.

In addition, we counsel against the outright elimination of the delivery exception. The Draft makes reference in this regard to the UN Model Treaty. We believe that treaty practices recommended in the case of non-OECD countries, which are strongly biased in favour of source-based taxation (often because of weak domestic tax collections), should not be held up as desirable guides for shaping treaties between OECD member countries. Trade and investment among OECD member countries is highly reciprocal. Efforts to favour the source country may increase its tax revenue for certain inbound transactions while decreasing its revenues on comparable outbound transactions.

As the history of the OECD Model Treaty shows, one of the purposes and great achievements of the Model and the bilateral treaties based on the Model has been to reduce the tax costs and administrative burdens of cross-border transactions and investment by means of the permanent establishment threshold, as well as the agreed reductions in or elimination of withholding taxes on dividends, interest and royalties.

Any effort to lower the longstanding permanent establishment threshold of the OECD Model, whatever the theoretical or political argument may be, will diminish its reliability and value. At a time when, as now, grave difficulties are being experienced in maintaining a global consensus in international trade matters, BIAAC urges the OECD to exercise great restraint in modifying any part of a tax document that has served for so long as an accepted set of rules for cross-border transactions and investment among OECD member countries.

We support the notion that the terms “goods or merchandise” should be deemed to include digital products and data.

Section 4A(f) – Force of attraction

The Draft has also considered a change to Article 7 (Business Profits) of the Model Treaty. According to this proposal (“Modification of the existing rules to add a force-of-attraction rule dealing with e-commerce”- Section 4A(f)) a force-of-attraction rule for e-commerce activities would be added to the first paragraph of the Business Profits Article to provide that the profits generated by e-commerce activities, provided that these activities are similar to activities currently carried out by an existing permanent

establishment, would be attributed to such present permanent establishment. BIAC urges the TAG to discard this notion as being contrary to fundamental OECD tax principles.

Section 4A(g) – Adding a provision that would allow taxation of services income where the foreign service provider is present in the local country for a specified number of months.

Under the current OECD Model Treaty and Commentary several factual questions must be answered in determining whether a permanent establishment has been created in the case of services.

The first question to be resolved is whether the service provider has a “fixed place of business” in the local country. Where a foreign enterprise performs services at the premises of a client, the question is whether these premises are “at the disposal” of the enterprise; if not, the enterprise would not have a fixed place of business within the meaning of Article 5, and consequently would not have a permanent establishment.

Even if the enterprise has a fixed place of business, there will be a permanent establishment only if the activities go beyond “preparatory or auxiliary,” and, provided further, that the activities are conducted for a sufficient length of time to achieve the requisite level of “permanency.”

Thus, there are three essential elements in testing for a permanent establishment in the case of services. The recent amendments to the Article 5 Commentary on these three points are unclear. BIAC commented on these changes in its letter of 15 September 2003 and suggests that the OECD should work to clarify existing principles before considering changes to them. In addition, the recent Italian cases on permanent establishment reveal some fundamental difficulties even in OECD-member countries with interpreting basic permanent establishment concepts. The OECD should seek to communicate and educate its members in the application of the existing Treaty and Commentary.

The Draft has put forward for discussion a possible amendment to the Model, providing that a permanent establishment would be created by the performance of services for some specified period of time (to be agreed), despite the absence of a fixed place of business.

The notion of a pure time test for services is explicitly derived from the UN Model Treaty, which incidentally has a six-month threshold. As stated above, BIAC believes that treaty practices recommended in the case of non-OECD countries, which are strongly biased in favor of source-country taxation, should not be held up as desirable guides for shaping treaties between OECD member countries. The OECD Model Treaty, which reflects the general economic balance in trade and investment among its member countries, has served an invaluable purpose in reducing the tax costs and administrative burdens of cross-border transactions and investment. The permanent establishment threshold has been a key element in achieving this result.

The application of the current OECD Model facts and circumstances approach to services has, to our knowledge worked effectively, and we see no need to introduce a test that would discard the longstanding requirement of a fixed place of business. The new test for

services might, at first glance, seem to promise greater certainty in determining whether or not a permanent establishment exists. BIAC does not believe that this is the case, as many questions of interpretation and judgment will still exist.

Some OECD countries may want to follow the example of non-OECD countries in taxing cross-border services. If so, they can, of course, seek to negotiate such provisions in their bilateral treaties. This approach should not, however, be adopted in the OECD Model.

Nevertheless, should the TAG decide to recommend a bright line test, BIAC would strongly urge that:

- The time period should be at least eighteen months. We recognize that the construction project exemption is twelve months in the OECD Model, but services projects are inherently more fluid, less reliant on the local economy, and thus warranting a longer exemption period.
- The permanent establishment should not be deemed to come into existence until after the eighteen-month period has been satisfied. In other words, the first eighteen months would not be taxable. Having the permanent establishment relate back to the beginning of the service activity, in cases where the time threshold is exceeded, would be very burdensome.
- If the services are performed for less than the specified time period, there would be no permanent establishment even where the enterprise has a local place of business.
- There would need to be reasonable and specific rules as to how the time period would be measured.
- Unrelated projects should be separately measured.
- The preparatory/auxiliary exceptions would continue.

Further Points in the TAG Draft

The Draft discusses three other possible permanent establishment modifications that are of interest to BIAC.

1. Exclusion for activities that do not involve onsite human intervention.
2. Provision that a computer server cannot, standing alone, constitute a permanent establishment.
3. Exclusion for functions attributable to software when applying the preparatory or auxiliary exception.

The proposal to exclude activities lacking onsite human involvement

BIAC welcomes the fact that the TAG is considering this point. The Internet seems to have sparked confusion about what it takes to conduct a business. It is people, not equipment, that carry on a business. If individual countries want to insist that certain equipment standing alone will constitute a permanent establishment, they can do so in bilateral negotiations, but the Model should not permit such an approach.

Computer servers

When the issue was first raised a few years ago, many in the business community were in favour of excluding computer servers, standing alone, from the definition of permanent establishment. The OECD, however, took the approach set forth in the revised Commentary, basing the determination on the functions of the server. This approach is unfortunate. It requires the application of subjective concepts to intricate fact patterns; it increases uncertainty for taxpayers; yet the revenues at issue in this approach are clearly minimal. BIAC hopes that the OECD will take this opportunity to revisit the question and provide that servers by themselves cannot be a permanent establishment.

Software functions

The third suggestion (eliminate software functions from the determination of preparatory and auxiliary) is reminiscent of an earlier argument, in the debate over whether a server could constitute a permanent establishment, that a software program could be an “agent.” After some discussion, software was found not to be a “person,” therefore, not an agent. That conclusion supports the proposed clarification in the Draft, since a software program itself should never be regarded as “performing” the activities that are automated through computer systems, for purposes either of determining whether a permanent establishment exists or for purposes of profit attribution. Accordingly, BIAC supports this proposal, insofar as it would remove speculation about what software is “doing,” from permanent establishment determinations.

BIAC appreciates the opportunity to provide these comments. We are ready to answer any questions you may have concerning this response.