

**THE APPROPRIATENESS OF THE EXISTING
PERMANENT ESTABLISHMENT CONCEPT IN THE
DIGITALISED ECONOMY**

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**Submitted in partial fulfilment of the requirements for
the degree
MASTER OF LAWS (LLM) IN TAX LAW**

**Prepared under the supervision of Dr Benjamin Kujinga
at
THE UNIVERSITY OF PRETORIA**

NOVEMBER 2015



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DECLARATION

I, **LEANI NORTJÉ**, hereby declare that this dissertation is the product of my own original and independent work. To the extent that ideas and words of others have been used the appropriate sources have been acknowledged accordingly. This dissertation is being submitted in partial fulfilment of the prerequisites to obtain a Master of Laws (LLM) in Tax Law at the University of Pretoria, and has not been submitted to any other academic institution for the purposes of any similar degree.

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30 November 2015

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TABLE OF DEFINITIONS

"BEPS"	:	Base Erosion and Profit Shifting;
"Commentary"	:	The Commentary to the OECD MTC;
"EU"	:	European Union;
"HMRC"	:	Her Majesty's Revenue and Customs;
"ICT"	:	Information and Communication Technology;
"OECD"	:	The Organisation for Economic Co-operation and Development;
"OECD MTC"	:	OECD Model Tax Convention;
"PE"	:	Permanent Establishment;
"SARS"	:	South African Revenue Service;
"UK"	:	United Kingdom;
"UN MTC"	:	United Nations Model Tax Convention; and
"US"	:	United States of America.

The terms defined in the Table of Definitions are the most common terms used throughout this dissertation. Not all defined terms used in this dissertation are, however, listed in the Table of Definitions and some terms have been defined in the text of the dissertation.

All references to Articles in this dissertation are to articles of the 2014 OECD MTC, unless specifically indicated otherwise.

CHAPTER 1

INTRODUCTION

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I INTRODUCTION AND BACKGROUND

Before a country can levy tax on income, a connection or nexus must be established between the country and that income. A connection can be established either because the person receiving the income is connected to the particular country (so-called residence basis of taxation) or because the activities that give rise to the income are connected to the country (so-called source basis of taxation).¹ In terms of the residence basis of taxation, a country taxes its residents on their worldwide income regardless of the source of such income. In terms of the source basis of taxation a country taxes income derived by a person from a source or deemed source within its territorial jurisdiction or geographical confines, regardless of the person's country of residence.²

The rationale for the residence basis of taxation is that a resident enjoys the protection of the country that he/ she resides in, and therefore, he/ she should contribute towards the cost of the government, regardless of where he/ she earns his/ her income.³ In contrast, the rationale for the source basis of taxation is that both residents and non-residents should contribute to the costs of the infrastructure and the running of a country to the extent that they earn income from that country's resources.⁴ Most jurisdictions have adopted a combination of the source and residence basis of taxation, including South Africa.⁵

In circumstances where a resident of one country derives income from a source in another country, the interaction of the source and residence principles generally give rise to double taxation as both the country of residence and the country of source will, in terms of their respective domestic taxing laws, seek to tax the income so derived.

As double taxation is likely to have a negative impact on economic activities and investment, countries often enter into bilateral tax treaties to eliminate such double taxation. In order to achieve this, tax treaties allocate taxing rights between the country of residence and the country of source, with the effect that one of the countries is

¹ Olivier & Honiball *International Tax: A South African Perspective* (2011) pp. 9-10.

² Oguttu & Van der Merwe *Electronic Commerce: Challenging the Income Tax Base* (2005) p. 306.

³ Olivier & Honiball *International Tax: A South African Perspective* (2011) p. 19.

⁴ *Id* p. 11.

⁵ *Id* p. 10; See also Oguttu & Van der Merwe *Electronic Commerce: Challenging the Income Tax Base* (2005) p. 306.

required to surrender its domestic taxing right in whole or in part in favour of the other country.

Whilst there are significant differences between bilateral tax treaties, the principles underlying the treaty provisions governing the taxation of business profits are relatively uniform.⁶ In this regard, the source country is required to surrender its taxing rights in respect of business profits unless a certain minimum jurisdictional nexus, known as a "**permanent establishment**" (PE), has been established by the non-resident enterprise within the source country's borders. Until a PE is established, the residence country enjoys exclusive taxing rights on the business profits derived by its resident in the source country, and only once the non-resident enterprise has established a PE in the source country is the source country permitted to tax the business profits attributable to that PE.⁷ The residence country and the source country then share the taxing rights on the business profits so derived, but this is likely to give rise to double taxation. Therefore, in order to eliminate such potential double taxation, the treaty generally requires the residence country to provide its resident with a credit or exemption for the taxes paid in the source country.⁸ In doing so, the residence country is surrendering its domestic taxing right in favour of the source country to the extent of the taxes paid by its resident in the source country.

It follows that the PE concept acts as a nexus rule in a tax treaty context to determine whether or not a country may exercise its taxing rights on business profits derived by a non-resident within its jurisdiction. The concept, therefore, acts as a mechanism to allocate taxing rights on business profits between the country of residence and the country of source, and ultimately assists with eliminating double taxation which could otherwise have an adverse impact on international trade and investment.

II PROBLEM STATEMENT

As illustrated above, in a treaty context, if the activities of a non-resident enterprise in a source country do not meet the PE threshold the source country has no taxing rights on business profits derived by that non-resident enterprise within its jurisdiction. This is so because the PE concept reflects the international consensus that, as a general rule,

⁶ OECD 2005, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce?*, Committee on Fiscal Affairs Final Report, p. 6.

⁷ See Article 5 read with Article 7, 2014 OECD MTC.

⁸ See Article 23A and Article 23B, 2014 OECD MTC.

until a non-resident enterprise establishes a PE in a source country it is not sufficiently participating in the economic life of the source country to justify the source country having taxing rights on the business profits derived by the non-resident enterprise within its jurisdiction.⁹ The PE concept is, therefore, aimed at aligning taxation rights with the country where the economic activities that give rise to business profits are performed and where value is created.

In terms of the existing PE concept, however, a non-resident enterprise will only meet the PE threshold if it establishes and maintains a relatively significant and regular physical presence in the source country.

The existing PE concept was formulated in the pre-digital era on the basis of traditional business models where a physical presence in a source country was essential for a non-resident in order to be heavily involved in the economic life of that country and to earn substantial profits from that country. In the modern economy, however, ICT developments are increasingly enabling entities to derive substantial profits from a foreign market without the need to have a physical presence in that market. In addition, ICT developments have resulted in the development of completely new business models that are wholly digital, and which did not exist when the PE concept was originally formulated.

Continuing sophisticated ICT developments are, therefore, increasingly enabling non-resident enterprises to significantly participate meaningfully in the economic environment of a source country without meeting the requisite levels of physical presence required under tax treaties to establish a PE in such source country. Consequently, by virtue of the existing PE concept the source country has no taxing rights on the business profits derived in its jurisdiction, despite the fact that the non-resident is participating in its economic base to such an extent that source taxation is arguably justified.

Accordingly, due to the increased digitalisation of the economy, concerns are arising that the existing PE concept no longer appropriately aligns taxing rights with the jurisdiction where economic activities are performed and where value is created.

⁹ See Commentary on Article 7, 2014 OECD MTC, paragraph 11, p. 134.

III RESEARCH QUESTIONS

On the basis of the problem statement set out above, the following research questions will be addressed in this dissertation:

- (a) whether the application of the existing PE concept in the digitalised economy is contributing to the erosion of source countries' income tax base;
- (b) whether the application of the existing PE concept in the digitalised economy is contributing to BEPS, which erodes the global income tax base;
- (c) whether the digitalisation of the economy is merely a natural evolution of business, or if it is revolutionary in the manner in which it enables enterprises to conduct their businesses;
- (d) whether the existing PE concept remains an appropriate nexus rule in the digitalised economy in that it still appropriately aligns taxing rights with economic activities and value creation; and
- (e) whether the existing PE concept needs to be modified in order to be realigned with economic realities or if it needs to be replaced with another taxing mechanism to ensure the appropriate taxation of business profits derived in the digitalised economy.

IV OBJECTIVES

In light of the problem statement and research questions, the objectives of this dissertation are the following:

- (a) to consider the origin and development of the existing PE concept into an internationally accepted standard;
- (b) to consider the requirements that need to be satisfied in order to meet the existing PE threshold as contained in Article 5 of the OECD MTC;
- (c) to illustrate that the activities of a non-resident enterprise in a source country cannot meet the existing PE threshold unless the non-resident establishes and maintains a some form of regular physical presence in such source country;

- (d) to illustrate, with reference to case law, how technology advances have challenged tax laws based on physical nexus requirements, including but not limited to the PE concept;
- (e) to examine how ICT developments have influenced the way in which traditional business models operate in the digital economy, and to illustrate the challenges that arise when the existing PE concept is applied to tax business profits derived in the digitalised modern economy;
- (f) to consider the OECD's work, prior to the OECD/G20 BEPS Project, in relation to the digital economy and the guidelines established by the OECD in applying the existing PE concept in the digitalised economy;
- (g) to critically evaluate the effectiveness of the OECD's guidelines in applying the existing PE concept in the digitalised economy;
- (h) to consider the BEPS concept and the OECD's role in addressing BEPS;
- (i) to consider the impact of the digital economy on BEPS, particularly when the existing PE concept is applied in the digital economy;
- (j) to consider the OECD's report on *BEPS Action 1: Addressing the tax challenges of the digital economy* ("**Action 1**")¹⁰ and the OECD's proposals to address BEPS concerns in the digital economy;
- (k) to consider the tax policy concerns brought about by the digital economy as set out in Action 1, and the OECD's proposals to address these challenges;
- (l) to consider the proposed amendments to the existing PE concept as set out in Action 1;
- (m) to consider the proposed alternative taxing mechanisms in the place of the existing PE concept as set out in Action 1;
- (n) to consider the proposed amendments to the existing PE concept as set out in the revised discussion draft on *BEPS Action 7: Preventing the artificial avoidance*

¹⁰ OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project.

of PE status ("**Action 7**"),¹¹ and whether any of these amendments relate to the digital economy specifically;

- (o) to analyse unilateral legislative actions taken by countries in the midst of the BEPS project in relation to the artificial avoidance of a PE, and whether these actions may potentially undermine Action 7;
- (p) to consider whether the OECD expresses a view in the OECD/ G20 BEPS Project as to whether the existing PE concept remains an appropriate nexus rule to tax business profits derived in the digital economy;
- (q) to express a view as to whether the application of the existing PE concept in the digitalised economy is contributing to the erosion of source countries' income tax base;
- (r) to express a view as to whether the application of the existing PE concept in the digitalised economy is contributing to BEPS;
- (s) to express a view as to whether the digitalisation of the economy is merely a natural evolution of business, or if it is revolutionary in the manner in which it enables enterprises to conduct their businesses;
- (t) to express a view as to whether the existing PE concept remains an appropriate nexus rule in the digitalised economy, in that it still serves its intended purpose of aligning taxing rights on business profits with the jurisdiction where the activities that gave rise to those profits are performed and where value is created;
- (u) to express a view whether the existing PE concept requires modification so as to be aligned with economic realities or if other alternatives to the existing PE concept should be considered to tax business profits derived in the digital economy; and
- (v) to identify areas for proposed future research.

V RESEARCH METHODOLOGY

The research will be qualitative in nature as it will entail an extensive critical literature review of secondary data sources to address the objectives of this dissertation as set

¹¹ OECD 2015, *Preventing the artificial avoidance of PE Status, Revised Discussion Draft*.

out above. The study will also be descriptive and analytical in nature as it will describe various concepts, such as *inter alia* the existing PE concept and BEPS concept, and also critically analyse these concepts.

Following the above-mentioned approach is essential for the deductive research approach that will be followed, in that it provides the foundation for developing a comprehensive theoretical framework against which the research questions identified above will be tested.

VI LIMITATIONS

The ambit of the dissertation is limited as follows:

- (a) only the existing PE rules as set out in the OECD MTC and Commentary will be considered. The PE rules as set out in other model tax conventions or specific bilateral tax treaties will not be considered, nor will the PE concept as contained in domestic rules of specific jurisdictions be considered;
- (b) The case law considered in this dissertation has been limited due to the vastness of the PE concept and due to the fact that each jurisdiction's application of the PE concept differs based on their domestic tax laws as well as the relevant tax treaty involved in the dispute. Accordingly, case law has only been relied upon to illustrate that over the years, technology advances have been challenging tax laws based on physical nexus requirements, including but not limited to the PE concept. In addition, a few examples will be mentioned of cases that have taken into account the OECD's approach in addressing the challenges raised by the digital economy. It is noted that due to the fact that the available case law span across many jurisdictions the author was not necessarily able to obtain copies of all the judgements or copies of the judgements in English, and therefore, had to rely on secondary sources in certain instances. To the extent that secondary sources have been relied upon the author has ensured, as far as possible, that these sources are reputable (for example reputable journal articles or revenue authorities' websites);
- (c) only BEPS and tax policy concerns in relation to direct taxes with reference to the digital economy will be addressed, and indirect tax concerns in this regard will not be considered;

- (d) the proposed options to address BEPS and tax policy concerns in relation to the taxation of the digital economy will be limited to direct tax options proposed in Action 1, and will not take into account proposed indirect tax options or options proposed in other sources of literature;
- (e) importantly, as part of this dissertation the OECD/ G20 BEPS Project and the reports on Action 1 and Action 7 were examined in the form they took prior to **30 September 2015**. In this regard, the report on Action 1 considered in this dissertation is the report published during September 2014, and the report on Action 7 is the revised discussion draft which was published during May 2015 and which was in circulation at the time that this dissertation was drafted. Subsequent to the drafting of this dissertation and on 5 October 2015, the OECD released its finalised BEPS reports. Due to time constraints in relation to the submission of this dissertation, the author was not able to consider the finalised reports on Action 1 and Action 7 in detail and to incorporate the contents thereof in this dissertation. The author did, however, review the finalised reports on a high-level basis and the most salient observations that transpired from this review are discussed in the conclusion chapter (Chapter 7). The potential impact, if any, of the finalised reports on the findings of the dissertation is also noted in the conclusion chapter; and
- (f) the analysis of the unilateral legislative actions taken by countries in the course of the OECD/ G20 BEPS Project will be limited to the unilateral actions of the UK and Australia in relation to the artificial avoidance of a PE due to their relevance to Action 7.

VII CHAPTER OUTLINE

This section outlines, on a high-level basis, the most important considerations that will be discussed in each chapter of this dissertation (excluding Chapter 7 which sets out the final conclusion).

(a) Chapter 2: Meeting the PE threshold

The principal purpose of Chapter 2 is to examine the PE concept, and particularly, the requirements that need to be satisfied in order to meet the existing PE threshold as contained in Article 5 of the OECD MTC.

(b) Chapter 3: Application of the existing PE concept in the digitalised economy

The impact that ICT developments have had on the way that business models operate in the modern economy is considered in Chapter 3. Taking this into account it is considered whether the digital economy is merely a natural evolution of business with which the existing PE concept can cope, or if it is so revolutionary in the manner in which it enables enterprises to conduct their businesses that it warrants changes to the existing PE concept. The view that the OECD has maintained in this regard, prior to launching the BEPS Project, is also considered in this chapter and the OECD's guidelines in applying the existing PE concept in the digitalised economy is evaluated.

(c) Chapter 4: The impact of the digital economy and the existing PE concept on BEPS

In Chapter 4 the BEPS concept is considered in light of the OECD/ G20 BEPS Project. In particular, BEPS is considered in the context of the digital economy and it is examined whether the existing PE concept contributes to BEPS.

(d) Chapter 5: Appropriateness of the PE concept in the digitalised economy: OECD view

As part of the BEPS Project the OECD has acknowledged that the digital economy is challenging the existing PE concept, and in an attempt to address these challenges it has proposed possible solutions. These challenges and the proposed solutions are considered in Chapter 5. In particular, it is considered whether the OECD deems the existing PE concept adequate to effectively tax business profits derived in the digitalised economy.

(e) Chapter 6: Analysis of unilateral legislative actions taken in the midst of the BEPS Project in relation to the artificial avoidance of PEs

From the outset of the BEPS Project the OECD has called on governments to refrain from taking unilateral measures until the BEPS Project is finalised. Notwithstanding this, the UK and Australia has introduced unilateral BEPS measures specifically to address the artificial avoidance of a PE. These unilateral measures are considered in Chapter 6, and particularly whether they potentially contradict the work undertaken by the OECD in relation to the artificial avoidance of PEs.

CHAPTER 2

MEETING THE PE THRESHOLD

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I INTRODUCTION

As illustrated in Chapter 1, in a tax treaty context, before a source country is permitted to tax business profits derived by a non-resident enterprise from a source or deemed source within its jurisdiction, the activities of that non-resident enterprise must first meet a certain minimum threshold, known as a PE.

The principal purpose of this chapter is to examine the PE concept. Particularly, the origin and subsequent development of the PE concept into an internationally accepted standard will be considered, as well as the requirements that need to be satisfied in order to meet the PE threshold as contained in Article 5 of the OECD MTC.

II HISTORY BEHIND THE ORIGIN AND DEVELOPMENT OF THE PE CONCEPT INTO AN INTERNATIONALLY ACCEPTED STANDARD

In the words of *Skaar*, "[t]he history of the PE clause in tax treaties is as long as the history of double taxation conventions itself".¹ Therefore, the entire history behind the PE concept will not be repeated in this section as it has been set out in great detail by many scholars.² Accordingly, this section only sets out the most important historical events leading up to the development of the PE concept into an internationally accepted standard.

The PE concept originated in Prussia (a former state of Germany) in 1845, albeit initially not as a tax concept.³ The concept only made its way into the Prussian tax framework towards the middle of the 19th century when the need to prevent double taxation arose among the Prussian municipalities.⁴ In this regard, the concept was used to tax a trade in a municipality, even if the owner lived in another municipality.⁵ *Skaar* notes⁶ that although sources on the meaning of a PE at this point in history are

¹ *Skaar Permanent Establishment: Erosion of a tax treaty principle* (1991) p.71.

² For a detailed discussion see *Skaar Permanent Establishment: Erosion of a tax treaty principle* (1991) Chapter 7; *Kobetsky International Taxation of Permanent Establishments: Principles and Policy* (2011) Chapter 4.

³ See *Skaar Permanent Establishment: Erosion of a tax treaty principle* (1991) p. 72, the concept was initially adopted in the Industrial Code of Prussia and later into the business legislation of the German Empire to express the total space used for the conduct of a business activity.

⁴ *Ibid.* Therefore, the original purpose of introducing the PE concept into the taxation system was to act as a mechanism to prevent double taxation. This has remained the ultimate purpose of the PE concept through its evolution into its current form.

⁵ *Ibid.*

⁶ *Skaar Permanent Establishment: Erosion of a tax treaty principle* (1991) p. 73.

limited, it seems reasonable to assume that the term connoted permanence and location within an area, such as a town, rather than a physical location in one specific place. The Prussian judiciary subsequently developed the PE concept to entail a fixed location and an intention to perform business activities at that location.⁷ In 1885 the term was introduced in German tax statutes and in 1891 it was codified in Prussia.⁸

In 1899 Prussia entered into its and the first international tax treaty with Austria-Hungary.⁹ Under this treaty, business profits derived by a PE located in the other country were to be taxed in that country. The definition of a PE in terms of the treaty conformed to the meaning of the term as developed by the Prussian judiciary,¹⁰ and specifically included business operations carried on through an agent as well as a place of business maintained for purchasing as a PE.¹¹ Following this, many Central European countries entered into bilateral tax treaties which contained similar PE definitions.¹²

Subsequently, the PE concept was enacted in the German Double Taxation Act of 1909 which was aimed at eliminating double taxation among the German states.¹³ According to *Skaar*¹⁴ the definition of a PE in German law at this point in history included some of the core elements of the PE rule as it is known today, namely, the existence of a place of business, the location of the business at a specific geographical spot and the permanence of the business.

After World War I, there was a significant increase in international commerce, and businesses were required to create branches of the main entity (or a similar physical presence) in other countries where it conducted business.¹⁵ Accordingly, industrialisation and the expansion of international trade called for uniform international

⁷ *Ibid.*

⁸ *Skaar Permanent Establishment: Erosion of a tax treaty principle* (1991) p. 74.

⁹ *Id* p. 75, *Skaar* notes that conventions with provisions on tax issues were concluded since ancient Greek-Roman times and thereafter general tax treaties were concluded within federations of states, but that the treaty between Prussia and Austria-Hungary is recognised as the first general international tax treaty concluded.

¹⁰ *Ibid.*

¹¹ Kobetsky *International Taxation of Permanent Establishments: Principles and Policy* (2011) p. 110.

¹² *Skaar Permanent Establishment: Erosion of a tax treaty principle* (1991) p. 76.

¹³ *Id* p. 74.

¹⁴ *Ibid.*

¹⁵ Oguttu & Tladi *E-commerce: A critique on the determination of a "permanent establishment" for income tax purposes from a South African perspective* (2009) p. 75.

provisions for the elimination of double taxation, especially in light of the high post-war tax rates.¹⁶ In response to this, the League of Nations, who played a leadership role in promoting international co-operation on direct taxes at the time, published the first draft MTC on the double taxation of income in 1927, which introduced the PE concept into the international tax framework.¹⁷

The purpose of the PE concept was to act as a mechanism to determine to what extent economic activities carried on in a source country could be taxed, with reference to identified subjective and objective elements that made taxation applicable to material or physical transactions.¹⁸ Within the traditional economic context of the PE concept, a material or physical transaction took place if a person developed tangible economic activities in a certain territory for a minimum period of time. If the economic activities met the conditions of a PE, taxing rights would be allocated to the state where the activities were so carried on.¹⁹

The PE concept, therefore, represented a form of international equity in that it provided a reasonable compromise between the interests of nett-exporting nations and nett-importing nations.²⁰ The exporting nations derived revenues from taxing value added at the productions stage and the importing nations derived revenues from taxing the income generated by the activities.²¹

Unlike the earlier Prussian treaties, the PE concept introduced by the League of Nations did not include a general definition of the basic PE rule, but rather defined a PE with reference to examples of what would and would not constitute a PE.²² Examples of what constituted a PE included branches, factories, offices and dependent agents. Dealings through a *bona fide* agent of independent status did, however, not constitute a PE.

¹⁶ Skaar *Permanent Establishment: Erosion of a tax treaty principle* (1991) p. 77.

¹⁷ *Id* p. 82. The 1927 draft MTC was based on principles included in two reports compiled by expert groups on double taxation, which reports were submitted to the League of Nations in 1923 and 1925, respectively.

¹⁸ Gárate *The "fixed place of business" in the Context of Electronic Commerce* p 2.

¹⁹ *Ibid.*

²⁰ Oguttu & Tladi *E-commerce: A critique on the determination of a "permanent establishment" for income tax purposes from a South African perspective* (2009) p. 76

²¹ *Ibid.*

²² See Skaar *Permanent Establishment: Erosion of a tax treaty principle* (1991) p. 83 for the definition of a PE included in the 1927 draft MTC.

Comments on the 1927 draft MTC, however, revealed significant disagreement and two additional drafts as well as a revised draft of the 1927 MTC followed in 1928²³, which in turn, was followed by three multilateral tax conventions in 1931 as well as further draft MTCs in 1933 and 1935.²⁴ All of these drafts modified the PE concept slightly, but it was the so-called Mexico MTC in 1943 and the so-called London MTC in 1946 which signified the importance of the PE concept in the international tax framework.²⁵

The Mexico MTC introduced a system of source-based taxation of business profits in which the PE concept was merely an example and not a decisive criterion. However, the succeeding London MTC overturned the Mexico MTC's approach to the PE concept and reinstated it as a pre-condition for source state taxation of business profits.²⁶ In addition, the Mexico and London MTCs developed the PE concept to include a building site as a PE if it was "destined" to last for at least 12 months, as well as the principle that the presence of a subsidiary in a country does not automatically create a PE for the parent in that country.²⁷

After World War II, the UN replaced the League of Nations and although it continued the work of the League of Nations until the mid-1950s, the Organisation for European Economic Cooperation ("**OEEC**"), now known as the OECD, took the lead in establishing tax treaty provisions for the purpose of eliminating double taxation.²⁸ The OEEC Fiscal Committee submitted its first report in 1958 which included the definition of a PE.²⁹ The definition drew heavily from the London MTC, but included additional features that favoured capital-exporting countries over capital-importing countries.³⁰ This definition was included in the OECD's draft MTC in 1963, and subsequently in the finalised OECD MTC in 1977, with the definition having been maintained in successive

²³ See *Id* pp. 84-85 for a discussion on the minor amendments that were effected to the definition of a PE in the revised draft MTC in 1928.

²⁴ See *Id* pp. 85-86 for a discussion on the amendments to the PE definition in these draft MTCs.

²⁵ See *Id* pp. 88-95 for a discussion on the Mexico MTC and the London MTC.

²⁶ *Id* pp. 88-89.

²⁷ *Id* pp. 94-95. The introduction of a building site as a PE if it will last for a period of at least 12 months was substantially similar to rules adopted in German domestic laws decades earlier.

²⁸ *Id* p. 96; See also Lennard *The purpose and current status of the United Nations Tax Work* (2008) p. 23.

²⁹ Skaar *Permanent Establishment: Erosion of a tax treaty principle* (1991) p. 96.

³⁰ See McIntyre *Developing Countries and International Cooperation on Income Tax Matters: An Historical Review* (2005) p. 5. A capital-exporting country encourages outflows of capital, whereas capital-importing countries encourage inflows of capital.

OECD MTCs.³¹ During 1967 the UN re-entered the field of international tax and commenced with work based on the OECD MTC to produce a finalised UN MTC, which was finally adopted in 1980.³²

Although the rationale behind the UN MTC and OECD MTC are the same, in that they were both designed to encourage investment by preventing double taxation, their provisions are not uniform.³³ The difference between the models can be ascribed to the varying extent by which the source country surrenders its taxing rights.³⁴ Traditionally, the OECD MTC has been regarded as favouring residence country taxation as it generally reduces the source country's taxing rights whilst preserving the residence country's taxing rights.³⁵ In contrast, the UN MTC has been viewed as favouring source country taxation as it provides for the converse.³⁶ In this regard, it has been said that the UN MTC is more the successor to the source country-predominant Mexico MTC, whilst the OECD MTC is more the successor to the London MTC.³⁷ Accordingly, the OECD MTC is generally favoured by capital-exporting countries (usually developed countries), whereas the UN MTC is generally favoured by capital-importing countries (usually developing countries).³⁸ This is, however, not an unwavering rule, as South Africa, being a developing country, generally follows the OECD MTC in negotiating its bilateral tax treaties, although it is not a member of the OECD.³⁹

Specifically in relation to the PE concept, the UN MTC and the OECD MTC differs slightly, but the core elements are similar. These differences will, however, not be

³¹ Oguttu & Tladi *E-commerce: A critique on the determination of a "permanent establishment" for income tax purposes from a South African perspective* (2009) p. 76.

³² See Lennard *The purpose and current status of the United Nations Tax Work* (2008) pp. 23-24 for a complete discussion of the development of the 1980 and 2001 UN MTC.

³³ See *Id* pp. 25-29 for a discussion on the main differences between the provisions of the UN and OECD MTC.

³⁴ *Id* p. 25.

³⁵ *Ibid*.

³⁶ *Ibid*.

³⁷ *Id* p. 23.

³⁸ *Id* p. 25.

³⁹ Although South Africa is not a member of the OECD, it has observer status which means that it can participate in certain OECD committees and working parties.

discussed as this dissertation relies on the PE concept as contained in the OECD MTC.⁴⁰

III THE PE CONCEPT AS IT CURRENTLY APPEARS IN ARTICLE 5 OF THE OECD MTC

Currently, Article 5 of the OECD MTC provides for two types of PEs, namely, a so-called Fixed Place PE and an Agency PE.⁴¹ The requirements to establish a Fixed Place PE and an Agency PE are discussed in detail below.⁴² It must be noted that neither the Fixed Place PE nor the Dependent Agent PE can be met unless a non-resident enterprise maintains a sufficient level of physical presence in the source state, in the form of a place of business or an agent, as set out below.

(a) Fixed Place PE (Article 5(1) read with Articles 5(2) to 5(4))

Article 5(1) defines a PE as "...a fixed place of business through which the business of an enterprise is wholly or partly carried on." From this definition the essential requirements to establish a Fixed Place PE can be summarised as follows:⁴³

- (i) the existence of a "place of business";
- (ii) the place of business must be "fixed"; and
- (iii) the business of the enterprise must be carried on "through" this fixed place of business.

(i) Place of business

The Commentary notes that the term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise in the source state,

⁴⁰ Refer to Article 5 of the UN MTC and Article 5 of the 2014 OECD MTC; See also Lennard *The purpose and current status of the United Nations Tax Work* (2008) pp. 26-27 for a discussion on the differences between the PE definition in the UN MTC and the OECD MTC.

⁴¹ Castro *Problems Involving Permanent Establishments: Overview of Relevant Issues in Today's International Economy* (2012) p. 130.

⁴² Although not included in the text of the OECD MTC, the Commentary provides for a third type of PE, namely, a so-called Services PE. In this regard, profits derived from regular services performed in a source country by a non-resident enterprise through individuals are taxable in the source country even if there is no PE as defined in Article 5 of the OECD MTC to which such profits are attributable. A deemed PE is therefore established if the individuals that render services are present in the source country for a certain amount of time. Therefore, similarly to the Fixed Place PE and the Agency PE it requires a regular level of physical presence in the source state. For a detailed discussion on a Services PE refer to the Commentary on Article 5, 2014 OECD MTC, pp. 115-125.

⁴³ Commentary on Article 5, 2014 OECD MTC, paragraph 2, p. 94.

whether or not it is used exclusively for that purpose.⁴⁴ On the other hand, a place of business may also exist where no premises are required for the carrying on of the business, and the enterprise simply has an amount of space at its disposal in the source state which it uses for its business activities.⁴⁵ In both situations, however, some form of physical presence is required in the source state.

In order to complement the general definition, Article 5(2) sets out the following list of examples that would *prima facie* constitute a PE:⁴⁶

- a. a place of management;
- b. a branch;
- c. an office;
- d. a factory;
- e. a workshop; and
- f. a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Article 5(3) also includes a construction or installation project as a PE, but only if it lasts more than 12 months.⁴⁷

The above examples would still, however, need to meet the remaining requirements for a PE, namely, the place of business must be "fixed", and the business of the enterprise must be carried on "through" that fixed place of business.

Article 5(4) includes a list of examples of scenarios which would not constitute a PE. The purpose of this list is to exclude any activity which has a mere preparatory or auxiliary character to the main business activity of the enterprise, and includes:

- a. the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

⁴⁴ *Ibid* paragraph 4, p. 95. It is immaterial whether the premises, facilities or installations are owned or rented by the enterprise.

⁴⁵ *Ibid*; See also *Id* pp. 95-96 for examples of when an enterprise will have a location at its "disposal". It is also noted that a PE could even exist where an enterprise illegally occupies a certain location for purposes of carrying on its business as no legal right to use the place is required in order to establish a PE.

⁴⁶ See pp. 100-101 for the Commentary on Article 5(2), 2014 OECD MTC.

⁴⁷ See pp. 101-103 for the Commentary on Article 5(3), 2014 OECD MTC.

- c. the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- d. the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- e. the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- f. the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

To determine whether an activity will be of a preparatory or auxiliary character, the Commentary notes that the decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.⁴⁸

(ii) Fixed place of business

Once it has been established that a place of business exists in the source country, it must be determined whether the place of business is "fixed". The Commentary notes that, for a place of business to be "fixed", it must be established at a distinct place with a certain degree of permanence.⁴⁹ Accordingly, the place of business must be at a specific geographical spot (the location test) and there must be a certain degree of permanence at each geographical spot (the duration test).⁵⁰ In determining whether both tests are satisfied, the nature of the enterprise's business must be taken into account.

In relation to the location test, it may be difficult to determine if a single place of business exists in circumstances where the nature of an enterprise's business is such that its activities are moved between neighbouring locations.⁵¹ The general rule in this regard is that a single place of business will exist where a particular location within

⁴⁸ Commentary on Article 5, 2014 OECD MTC, paragraph 24, p. 104.

⁴⁹ *Id* paragraph 2, p. 94.

⁵⁰ Oguttu & Tladi *The Challenges E-Commerce Poses to the Determination of a Taxable Presence: The "Permanent Establishment" Concept Analysed from a South African Perspective* (2009) p. 214.

⁵¹ Commentary on Article 5, 2014 OECD MTC, paragraph 5.1, p. 96.

which the activities are moved constitute "a coherent whole commercially and geographically" with respect to that enterprise's business.⁵² The Commentary uses the business operations of a mine as an example in this regard.⁵³ If a single place of business cannot be identified on the basis of a coherent whole commercially and geographically and the other requirements of Article 5 are met at more than one location, an enterprise may well have multiple PEs.⁵⁴ Furthermore, it is not a requirement of the location test that the place of business be physically connected to the ground.⁵⁵

Under the duration test, the place of business must have a certain degree of permanence, in other words it must not be purely of a temporary nature.⁵⁶ The period of time required to satisfy this test depends on the nature of the business concerned. The Commentary notes that practices followed by OECD member countries in relation to time requirements have not been consistent, but experience has shown that PEs have normally been considered to exist where a business had been carried on in a country through a place of business that was maintained in excess of six months.⁵⁷ Furthermore, where a particular place of business is used for very short periods of time, but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.⁵⁸ In addition, temporary interruptions of activities will not cause the existence of a PE to terminate, but the activities must continue to be carried out on a regular basis.⁵⁹

(iii) Through which the business of the enterprise is carried on

For a place of business to constitute a PE the enterprise must carry on its business wholly or partly through that place of business.⁶⁰ In terms of the Commentary, this usually means that persons who, in one way or another, are dependent on the

⁵² *Ibid.*

⁵³ See Commentary on Article 5, 2014 OECD MTC, pp. 96-97, which provides further examples of businesses that constitute a coherent whole commercially and geographically.

⁵⁴ Commentary on Article 5, 2014 OECD MTC, paragraph 5.1, p. 96.

⁵⁵ *Id* paragraph 5, p. 96.

⁵⁶ *Id* paragraph 6, p. 97.

⁵⁷ *Ibid.*

⁵⁸ Commentary on Article 5, 2014 OECD MTC, paragraph 6.1, p. 98.

⁵⁹ *Id* paragraph 7, p. 98.

⁶⁰ *Ibid.*

enterprise (such as personnel) conduct the business of the enterprise in the country in which the fixed place is situated.⁶¹

Where the personnel of an enterprise merely set up automated equipment in a source country, but the business of the enterprise is not carried on through that equipment, no PE will arise for the enterprise.⁶² This will also be the case where the automated equipment is set-up by the personnel of an enterprise and then leased to other enterprises.⁶³ A PE may exist, however, if the enterprise which sets-up the equipment also operates and maintains it for its own account.

(b) Agency PE (Article 5(5) read with Article 5(6))

If an enterprise does not have a Fixed Place PE in a source country (within the meaning set out above), it may still have a PE if it has a so-called "dependent agent" acting for it in a source country.⁶⁴

A dependent agent is a person, whether or not an employee of the enterprise, who is not an independent agent within the meaning of Article 5(6), and who has the authority to conclude contracts in the name of the enterprise, and habitually exercises such authority in the source country.⁶⁵ Dependent agents may be individuals or companies and need not be residents of, nor have a place of business in, the country in which they act for the enterprise.⁶⁶

Furthermore, the dependent agent needs to make use of his or its authority to conclude contracts repeatedly and not only in isolated cases.⁶⁷ The agent need not conclude contracts literally in the name of the enterprise, but is required to conclude contracts that are binding on the enterprise even if those contracts are not actually in the name of the enterprise.⁶⁸ The agent is also not required to sign the contract, and it is sufficient if

⁶¹ Commentary on Article 5, 2014 OECD MTC, paragraph 2, p. 94.

⁶² *Id* paragraph 10, pp. 99-100.

⁶³ *Ibid.*

⁶⁴ Commentary on Article 5, 2014 OECD MTC, paragraph 32, p. 107.

⁶⁵ *Ibid*; *Id* paragraph 33, p. 108.

⁶⁶ Commentary on Article 5, 2014 OECD MTC, paragraph 32, p. 107.

⁶⁷ *Ibid.*

⁶⁸ Commentary on Article 5, 2014 OECD MTC, paragraph 32.1, p. 107.

he or it negotiates all elements and details of the contract in a way binding on the enterprise.⁶⁹

Where an enterprise, however, carries on business in a source state through a broker, general commission agent or any other agent of an independent status it cannot be taxed on business profits derived in such source state. An agent will only be considered "independent" if he or it is independent from the enterprise both legally and economically, and if the agent acts in the ordinary course of his or its business when acting on behalf of the enterprise.⁷⁰

IV ATTRIBUTION OF PROFITS TO A PE

It is important to note that Article 5 only determines whether an enterprise has a PE in a source country, but does not in itself allocate taxing rights to the source country. This is achieved by Article 7 which provides that only profits attributable to the PE may be taxed in the source country.⁷¹ Therefore, once a PE is established in the source country, the source country's taxing rights do not extend to profits derived by the non-resident enterprise in its jurisdiction that are not attributable to the PE, unless those profits fall into other categories of income dealt with under other Articles of the treaty which provide taxing rights to the source state (such as dividend or royalty income).⁷²

The rule to determine which business profits are attributable to a PE is set out in Article 7(2). In this regard, the profits attributable to the PE are those profits that the PE might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risk assumed through the PE and through the other parts of the enterprise.⁷³

⁶⁹ *Id* paragraph 33, p. 108.

⁷⁰ *Id* paragraph 37, p. 109; See also *Id* pp. 109-111 for a further discussion in relation to an independent agent.

⁷¹ See Article 7, 2014 OECD MTC.

⁷² Commentary on Article 7, 2014 OECD MTC, p. 132.

⁷³ Refer to the Commentary on Article 7 for a detailed discussion in this regard as it does not form part of the scope of this dissertation, see *Id* pp. 132-154.

V CONCLUSION

The PE concept was formulated during the 19th and 20th century when business models were relatively immobile, and where tangible economic activities had to be carried on in a state via a regular physical presence in order to engage in significant business activities in that state.⁷⁴ Due to the immobile and tangible environment in which businesses operated when the PE concept was formulated, the decisive criterion to meet the PE threshold was set at whether a non-resident maintained a sufficient level of physical presence in a source state. This criterion is still at the core of the existing PE concept today, as can be seen from the requirements to meet the Fixed Place PE and Agency PE thresholds set out above.

⁷⁴ See OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project p. 125.

CHAPTER 3

APPLICATION OF THE EXISTING PE CONCEPT IN THE DIGITALISED ECONOMY

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I INTRODUCTION

ICT developments in recent years have significantly influenced the manner in which traditional business models operate in the modern digital economy. Most notably, non-resident enterprises no longer necessarily require the level of physical presence in a source state that was traditionally required in order to conduct significant business there. ICT developments are, therefore, increasingly challenging the PE concept's reliance on a physical presence in order to establish a tax nexus. Technological advances have, however, been challenging tax laws based on physical nexus requirements even before the advent of the digital era. Accordingly, the question arises whether the digital economy is merely a natural evolution of business with which the existing PE concept can cope, or if it is so revolutionary in the manner in which it enables enterprises to conduct their businesses that changes to the existing PE concept are warranted. This question is considered in this chapter as well as the view that the OECD has maintained in this regard (prior to its work in relation to the BEPS Project).

II HOW TECHNOLOGY ADVANCES HAVE CHALLENGED TAX NEXUS RULES THAT RELY ON A PHYSICAL PRESENCE: CASE LAW

Over the years the courts have been called upon to interpret the application of tax nexus rules that rely on a physical presence in the evolving business environment, and particularly, in respect of technology and infrastructure advancements. A few examples of prominent court cases in this regard are briefly discussed below.

(a) Telegrams: *Erichsen v Last*¹

Advances in technology have been challenging tax laws since as early as 1881, as is evident in the case of *Erichsen v Last*,² a Court of Appeal decision concerning whether a trade was exercised in the UK.

In this case a Copenhagen company had three cables running across the North Sea to a base in Scotland for the purpose of delivering telegrams. The company had an

¹ *Erichsen v Last*, 4 TC 422 (1881).

² On the basis of the sources available to the author, the author was not able to obtain a copy of the judgement, however, the judgement has been summarised as it appears on HMRC's website, accessible at: <http://www.hmrc.gov.uk/manuals/intmanual/intm263030.htm> (last accessed 24 November 2015).

agreement with the UK Post Office in terms of which the Post Office would collect messages for transmission and the related monies from UK residents. After deducting its agreed remuneration, the Post Office would hand the message and monies over to the company's operators in the UK who would then transmit the message via the cables across the North Sea. Depending on their destination, the messages would pass through cables owned by the Danish and Russian governments.

The company contended that the UK did not have taxing rights on all the profits arising from the relaying of the messages, as some of the profits arose from the transmission of the messages along cables in other countries. The court dismissed this argument and held that notwithstanding the fact that the service is provided through electric cables that are partly abroad, the company derived all its profits from contracting with clients in the UK for the transmission of the messages. Accordingly, all the profits derived in this regard were taxable in the UK.

(b) Wireless broadcasting: *Commissioner of Internal Revenue v. Piedras Negras Broadcasting Co.*³

In this case a US Court needed to decide whether a Mexican radio broadcasting station derived any taxable income from sources within the US by virtue of having a physical presence in the US.

The taxpayer, a Mexican radio station, derived *inter alia* its income from selling advertising over the radio. In this regard, all the income producing contracts were executed in Mexico and all services under the contracts were rendered in Mexico. Contracts with advertisers in the US were handled through an advertising agent which was an independent contractor of the taxpayer. The majority of the taxpayer's listeners were in the US, and ninety-five per cent of its income arose from advertisers within the US.⁴

The Court ruled that advertising over wireless broadcasting via a transmitter situated in Mexico to listeners in the US was not sufficient to create a physical presence for the taxpayer in the US, as the productive activity occurred at the place where the capital and labour inputs that directly contributed to the production of income were located and

³ *Commissioner of Internal Revenue v. Piedras Negras Broadcasting Co.* 127 F.2d 260 (1942). accessible at: http://scholar.google.co.za/scholar_case?case=16411492107854334337&q=piedras+negras+broadcasting&hl=en&as_sdt=2006&as_vis=1 (last accessed 25 November 2015).

⁴ *Id* p. 260.

not at the location of the US payer. Therefore, notwithstanding the fact that the majority of the taxpayer's income arose from the US, the Court ruled that the source of income was the place where the income producing service had been performed, which was clearly Mexico.⁵

(c) Mail orders: *National Bellas Hess Inc. v Department of Revenue of the State of Illinois*⁶ and *Quill Corporation v. North Dakota*⁷

In the US Supreme Court case of *National Bellas Hess v Department of Revenue of the State of Illinois* the Court had to consider whether the state of Illinois could require a company that conducted a mail order business to collect Illinois sales tax.

The company in question did not maintain any place of business in Illinois nor did it have any type of representative in Illinois. Twice a year the company mailed catalogues, which were occasionally supplemented by advertising flyers, to active or recent customers in Illinois. Orders for merchandise were mailed by the customers to the company and were accepted at its Missouri office. The ordered goods were then sent to the customers in Illinois either by mail or by common carrier.⁸

The Court ruled that the state of Illinois could only require the company to collect sales tax if it had a nexus in that state, and a nexus is created by physical presence. Due to the fact that the company's only connection to Illinois was with customers by common carrier or the United States mail service, the state of Illinois could not impose the collection obligation on the company as it did not have a sufficient nexus in Illinois.⁹

More than two decades later the US Supreme Court in the case of *Quill Corporation v. North Dakota* again examined whether a state could require a mail order company to collect tax where the company had no physical presence in that state. In this regard, the Court confirmed its decision in *National Bellas Hess v Department of Revenue of the State of Illinois*.

⁵ *Id* p. 261.

⁶ *National Bellas Hess Inc. v. Department of Revenue of the State of Illinois*, 386 U.S. 753 (1976), accessible at: [http://scholar.google.co.za/scholar_case?case=17097364606318958331&q=Quill+Corporation+v.+North+Dakota,+504+U.S.+298+\(1992\)&hl=en&as_sdt=2006&as_vis=1](http://scholar.google.co.za/scholar_case?case=17097364606318958331&q=Quill+Corporation+v.+North+Dakota,+504+U.S.+298+(1992)&hl=en&as_sdt=2006&as_vis=1) (last accessed 24 November 2015).

⁷ *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), accessible at: [http://scholar.google.co.za/scholar_case?case=3434104472675031870&q=Quill+Corporation+v.+North+Dakota,+504+U.S.+298+\(1992\)&hl=en&as_sdt=2006&as_vis=1](http://scholar.google.co.za/scholar_case?case=3434104472675031870&q=Quill+Corporation+v.+North+Dakota,+504+U.S.+298+(1992)&hl=en&as_sdt=2006&as_vis=1) (last accessed 24 November 2015).

⁸ *National Bellas Hess Inc. v. Department of Revenue of the State of Illinois* pp. 754-755.

⁹ See *Id* p. 758 and 765.

(d) Pipelines: *German Pipeline Case*¹⁰

In the so-called *German Pipeline Case*¹¹ a Dutch company supplied crude oil to German companies through its underground pipelines that ran through Germany. The Dutch company owned the pipeline but had no personnel or place of business in Germany. The supply of oil was regulated remotely through a computer in the Netherlands and all technical personnel were located in the Netherlands. Accordingly, the transportation of the oil was fully automated and the maintenance and repair of the pipelines was carried out by independent third parties. On the basis of these facts, the Court ruled that the pipeline established a PE for the Dutch company in Germany as it constituted a fixed place of business that served the business purpose of the enterprise. The Court noted that it is not a requirement for a place of business to be attached to the service of the earth or that it is visible above the ground.

With the rise of the digital economy, the *German Pipeline Case* caused quite an uproar at the time as the reasoning underlying the case could mean that almost any tangible component of electronic commerce could constitute a PE. As a result, the German authorities issued guidance principles¹² stating that computer servers are fixed places of business, but generally do not create PEs because their installation represents an activity of a preparatory or auxiliary character.¹³ On reconciling the *German Pipeline Case* with this guidance it seems that Germany came to the conclusion that a server can constitute a PE, but only if the activities carried out through the server are essential to the core activities of the business concerned.¹⁴ This was also the position taken in a subsequent case decided by the German Tax Court¹⁵ which involved a German corporation with a server in Switzerland. In this regard, the court found that the server constituted a PE as transmitting information from the server was the taxpayer's sole

¹⁰ German Pipeline Case, II R 12/ 192, 30 Oct 1996, Bundesfinanzhof, Germany.

¹¹ On the basis of the sources available to the author, the author was only able to obtain the judgement in German and not in English. The author is, however, illiterate in German, and therefore, the case has been summarised as it appears in an article by Eiker, *OECD PE guidance consistent with German case law and decree* (2001) p. 1 and Oguttu & Tladi *The Challenges E-Commerce Poses to the Determination of a Taxable Presence: The "Permanent Establishment" Concept Analysed from a South African Perspective* (2009) p. 214.

¹² Regional Finance Office of Karlsruhe, Decree 11 November 998, IStR 1999.

¹³ See article published by KPMG Germany, accessible at: <http://www.mondaq.com/x/16168/Corporate+Tax/251+Lower+Court+Sees+Server+as+Permanent+Establishment> (last accessed 24 November 2015).

¹⁴ *Ibid.*

¹⁵ Schleswig-Holstein Tax Court judgement of 6 September 2001, II 1224/97 – EFG 2001, 1535 = SWI 2002, 17.

business activity and there was no other activity to which such transmission could be preparatory or auxiliary.¹⁶

(e) Computer equipment: *Galileo International Inc. v Deputy Commissioner of Income Tax*¹⁷

In the case of *Galileo International Inc v Deputy Commissioner of Income Tax* a US entity, the appellant, engaged in the provision of electronic global distribution services to hotels, airlines, tour and cab operators by connecting to travel agents using a computerised reservation system ("CRS").¹⁸ For this purpose it maintained a master computer system with its main server located in the US. The main computer was directly connected to the airline/ hotel and travel agent servers to and from which data was continually sent and obtained. All the input processing and output was managed, processed and stored by the appellant through the master computer system in the US.¹⁹

In India, the appellant appointed an unrelated company to market and sell the CRS services to travel agents in India.²⁰ The Indian revenue authorities argued that as the activities in respect of bookings made by the travel agents in India were completed in India through the computers installed in and from travel agents in India the appellant had a fixed place of business, and hence a PE, in India.²¹ The Income Tax Appellate Tribunal agreed²² with the revenue authorities in this regard for the following reasons:²³

(i) the CRS system was the appellant's main source of revenue which was partially existent in the various computers installed at the premises of the travel agents as these computers formed an integral part of the entire CRS;

¹⁶ See article published by KPMG Germany, accessible at: <http://www.mondaq.com/x/16168/Corporate+Tax/251+Lower+Court+Sees+Server+as+Permanent+Establishment> (last accessed 24 November 2015).

¹⁷ *Galileo International Inc. v Deputy Commissioner of Income Tax* (2008) 19-SOT-257 (Del).

¹⁸ The case is accessible at: <http://indiankanoon.org/doc/56225/> (last accessed 24 November 2015). Refer to p. 1, clause 2 of the pdf version.

¹⁹ *Id* p. 6, clause 1.

²⁰ *Ibid.*

²¹ *Id* p. 17, clause 3.

²² The Tribunal came to the same conclusion on similar facts in the case of *Amadeus Global Travel v Deputy Commissioner of Income Tax* (2008) 113TTJ (Delhi) 767 which was decided earlier the same year, accessible at: <http://indiankanoon.org/doc/1448169/> (last accessed 24 November 2015).

²³ *Id* pp. 77-78, clauses 17.1 and 17.2.

- (ii) the computers installed could not be shifted from one place to another even within the premises of the travel agent, therefore, the appellant exercised complete control over the computers so installed;
- (iii) in some cases the appellant itself had placed those computers at the travel agent's premises and in all the cases the appellant through its agent installed the telecommunication network; and
- (iv) the activity of the appellant was developing and maintaining a fully automatic reservation and distribution system with the ability to perform comprehensive information, reservation, communication, ticketing, distribution and related functions on a worldwide basis. The activities performed via the CRS on the computers were, therefore, not preparatory or auxiliary in nature as it formed an essential and significant part of the enterprise and contributed directly to the earning of revenue.

III THE IMPACT OF ICT DEVELOPMENTS ON TRADITIONAL BUSINESS MODELS

ICT developments are increasingly enabling businesses across all sectors to design and build their operating models around technological capabilities in order to improve flexibility and efficiency, bolster innovation, reduce operational costs and extend their reach into global markets.²⁴ As information and communication technology continues to advance and the costs in this regard continue to decline, it has become embedded and central to the business models of firms operating across the globe. Accordingly, although advances in technology have not changed the fundamental nature of the core activities of traditional business models (such as sourcing and acquiring inputs, creating and adding value, selling to customers, conducting market research, marketing and advertising and customer support) it has had, and continues to have, a significant impact on the manner in which these activities are carried out.²⁵

In particular, ICT developments have increased businesses' flexibility in relation to the location of their business functions and have enabled businesses to spread functions

²⁴ See OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, p. 71.

²⁵ *Id* p. 127.

and assets across multiple countries.²⁶ This flexibility, coupled with the liberalisation of trade policy and reduction in transportation costs, has enabled businesses to extend their reach into global markets and to take advantage of global value chains in terms of which various stages of production can be spread across multiple countries in order to benefit from the advantages afforded by various markets.²⁷ Accordingly, businesses are increasingly able to choose optimal locations for productive assets and activities even if that location is distant from the location of its customers or other related business functions.²⁸

ICT developments have also enabled businesses to manage their global operations on an integrated basis from a central location that may similarly be removed geographically from both the location in which the operations are carried out and the locations in which their suppliers and customers are located.²⁹ For example, it is now possible for multinational enterprises with existing PEs to shift part of their business operations from the PE in the source country to the Internet in order to consolidate their operations and outsource non-essential functions to foreign affiliates which has the effect of reducing the amount of income attributable to the PE in the source country.³⁰

The flexibility and efficiency brought about by evolving ICT developments have also reduced the need for personnel and many of the functions that traditionally required employees or fixed bases within source countries such as marketing, customer support and administrative functions can now be conducted via websites on the Internet, or via related or unrelated parties.³¹ In addition, increasingly sophisticated software and algorithms have resulted in decision-making being carried out automatically without human intervention.³² This has provided businesses with the opportunity to remove dependent agents from foreign markets as these advances, for example, can fully

²⁶ *Id* p. 87.

²⁷ *Id* p. 71.

²⁸ *Id* p. 88.

²⁹ *Id* p. 87.

³⁰ Cockfield *Transforming the internet into a taxable forum: A case study on E-Commerce Taxation* (2001) p. 1184.

³¹ *Id* p. 1183; OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, p. 127.

³² OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, p. 127.

automate the order filling, contract negotiation and payment processes which were traditionally performed by dependent agents in source countries.³³

Accordingly, it is clear that ICT developments are increasingly enabling traditional businesses to increase substantially in size and market reach without the need for the level of infrastructure and personnel that would ordinarily have been required in the pre-digital era.³⁴

IV CHALLENGES THAT ARISE WHEN APPLYING THE EXISTING PE CONCEPT IN THE DIGITALISED ECONOMY

As illustrated in the previous chapter, a non-resident enterprise will only meet the PE threshold in a source country to the extent that it establishes and maintains a sufficient level of physical presence in such source country, either in the form of a fixed place of business or a dependent agent. Also, as mentioned, the reliance of the existing PE concept on a significant physical presence is due to the fact that the concept was formulated in the pre-digital era where traditional business models were relatively immobile and required a local physical presence in a source country in order to conduct sales of goods and services in that source country.³⁵

As demonstrated in the previous section, however, the mobility and flexibility of business models brought about by ICT developments, the liberalisation of trade policy and the reduction in transportation costs is increasingly reducing the need for a non-resident to maintain a physical presence in a source country in order to derive business profits from that country.

Therefore, business models which would ordinarily have given rise to a PE in the absence of technology advances no longer give rise to a PE, or where they still give rise to a PE the amount of profits attributable to the PE can be minimised significantly. In addition, ICT developments have also given rise to new business models that are

³³ Cockfield *Transforming the internet into a taxable forum: A case study on E-Commerce Taxation* (2001) p. 1186.

³⁴ OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, p. 127.

³⁵ *Id* p. 125.

wholly digital, such as cloud computing, app stores, online payment services etc. which did not exist when the existing PE rules were designed.³⁶

The digital economy is also placing increased pressure on identifying value creation in a particular jurisdiction as data gathered from various sources as well as contributions of users and/ or customers in various jurisdictions are often a primary input into the process of value creation in the digital economy.³⁷ As it is difficult to identify the jurisdictions in which such value creation occurs, profits may not be appropriately allocated to the jurisdictions where they are generated.

In addition, the development of new digital products or means to deliver services create uncertainties in relation to the proper characterisation of payments made in the context of new business models, such as whether the payments constitute business profits that are attributable to a PE or rather other types of income such as royalties which are subject to withholding taxes in the source country.³⁸

Concerns are also being raised that the digital economy is causing activities which were traditionally preparatory or auxiliary in nature to become significant components of businesses in the digital economy, and as a result, enterprises participating in the digital economy are unfairly benefiting from the exemptions to the PE concept.³⁹

V THE CURRENT OECD APPROACH IN APPLYING THE EXISTING PE CONCEPT TO THE DIGITAL ECONOMY

The OECD has been considering the impact of the digital economy on the existing international tax framework since 1996 in various forums,⁴⁰ and up until the BEPS Project, the OECD has been of the view that the existing PE concept is equipped to deal with emerging issues relating to the taxation of business profits derived via

³⁶ See *Id* pp. 77-83 which discusses prominent examples of new business models.

³⁷ See *Id* pp. 128-132.

³⁸ See *Id* pp. 132-133; See also OECD 2001, *Tax Treaty Characterization Issues Arising from E-commerce*, Technical Advisory Group on Treaty Characterization of Electronic Commerce Payments, where the OECD clarified the characterisation of certain types of electronic commerce transactions for purposes of the OECD MTC.

³⁹ See *Id* p. 129 for a discussion in this regard.

⁴⁰ See Annexe A to OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, which sets out the prior work of the OECD on the digital economy.

electronic commerce transactions.⁴¹ As a result, the OECD simply extended the Commentary of Article 5 to components of the digital economy that could meet its requirements, such as a server and a website. This has also been the approach taken by the OECD in relation to other technology advances, and the OECD has previously expanded the Commentary on Article 5 to deal with satellites in orbit,⁴² telecommunications networks,⁴³ automatic equipment such as gaming and vending machines⁴⁴, and cables and pipelines that cross the territory of countries.⁴⁵ Accordingly, similarly to these technology advances, the OECD has deemed the impact of the digital economy on the business environment evolutionary rather than revolutionary as it made no changes to Article 5 itself, but merely tweaked the Commentary.

In applying the components of the digital economy to establish a PE, the following guidelines are set out in the Commentary:⁴⁶

- (a) An internet website in itself cannot constitute a Fixed Place PE as it is not tangible property and therefore it does not have a location that can constitute a "place of business", and there is no facility such as premises, or in certain instances machinery or equipment.⁴⁷ A website can also not result in an Agency PE for the enterprise that carries on business through it, as it is not a "person", and therefore, cannot be seen to be acting as a dependent agent on behalf of the enterprise.⁴⁸
- (b) A server can constitute a PE in the following circumstances:⁴⁹
 - (i) if it is tangible property which has a physical location (a physical presence),⁵⁰

⁴¹ Oguttu & Tladi *E-commerce: A critique on the determination of a "permanent establishment" for income tax purposes from a South African perspective* (2009) p. 86.

⁴² Commentary to Article 5, 2014 OECD MTC, paragraph 5.5, p. 97.

⁴³ *Id* paragraph 9.1, p. 99.

⁴⁴ *Id* paragraph 10, p. 100.

⁴⁵ *Id* paragraph 26.1, p. 105.

⁴⁶ *Id* paragraph 42.1-42.10, p. 112.

⁴⁷ *Ibid.*

⁴⁸ Commentary to Article 5, 2014 OECD MTC, paragraph 42.10, p.115.

⁴⁹ See Gutuza *Tax and e-commerce: Where is the source* (2010) p. 337.

- (ii) this location is fixed in that it is established at a distinct place with a certain degree of permanence;⁵¹
 - (iii) the enterprise has the server at its disposal in that it, for example, owns or leases the server and operates it;⁵²
 - (iv) the business of the enterprise is being carried on, wholly or partly, through the server (taking into account the nature and the level of activity required).⁵³ The presence of personnel is not necessarily indicative of whether an enterprise is carrying on business at a location if no personnel are in fact required to carry on the business;⁵⁴ and
 - (v) the business activities carried on through the server are not preparatory or auxiliary in nature.⁵⁵ In this regard the Commentary to Article 5 notes that the following are examples of activities that would generally be regarded as preparatory or auxiliary in nature, unless they form an essential and significant part of the business activity of the enterprise as a whole:⁵⁶
 - a. providing a communications link, such as a telephone line, between customers and suppliers;
 - b. advertising of goods and services;
 - c. relaying information through mirror servers for security and efficiency purposes;
 - d. gathering market data for the enterprise; and
 - e. supplying information.
- (c) Website hosting arrangements with internet service providers that host websites of other enterprises on their own servers typically do not result in a Fixed Place PE for the enterprise that carries on business through the hosted website, as the

⁵⁰ Commentary to Article 5, 2014 OECD MTC, paragraph 42.2, p. 112.

⁵¹ *Id* paragraph 42.4, p. 113.

⁵² *Id* paragraph 42.3, p.113.

⁵³ *Id* paragraph 42.5, p. 113.

⁵⁴ *Id* paragraph 42.6, p. 113.

⁵⁵ *Id* paragraph 42.7, p. 113.

⁵⁶ *Id* paragraph 42.7-42.9, p. 114.

server that hosts the website is generally not at the "disposal" of that enterprise.⁵⁷ Similarly, such an arrangement should generally not create an Agency PE for such enterprises as the internet service providers will not have the authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts, or because they will constitute independent agents acting in the ordinary course of their business as evidenced by the fact that they host the websites of many different enterprises.⁵⁸

In summary, according to the OECD a server will only establish a PE for an enterprise in a country (where it has no Fixed Place PE or Agency PE in the traditional sense) if the enterprise concerned is carrying on business that is not of a preparatory or auxiliary nature though a website that runs on a server which is at the disposal of that enterprise at a fixed location.⁵⁹

It must be noted that many OECD member and non-member countries have expressed reservations to the OECD's guidelines summarised above (such as the UK, Chile, Italy and Portugal), and many countries have also issued local guidance in this regard. For example, the UK has taken the express position that a server which conducts electronic commerce through a website will not constitute a PE.⁶⁰ This is the UK's position regardless of whether the server is owned, rented, or otherwise at the disposal of the business.⁶¹ As a result, the OECD's guidelines in applying the existing PE concept to the digital economy have not been applied consistently internationally, and there have been various rulings by revenue authorities⁶² and judiciary on whether websites and servers constitute PEs in their jurisdictions.

⁵⁷ *Id* paragraph 42.3, p. 113.

⁵⁸ *Id* paragraph 42.10, pp. 114-115.

⁵⁹ Refer to *Id* pp. 125-127 for the reservations on the Commentary to Article 5.

⁶⁰ Gianni *The OECD's Flawed and Dated Approach to Computer Servers Creating Permanent Establishments* (2014) p. 27.

⁶¹ *Ibid.*

⁶² See for example Resolution 119 of 28 May 2007, issued by the Italian tax authorities, where a French company used servers located in Italy (which it owned) to offer video game subscriptions to Italian customers, but the configuration and operation of the servers were carried out in France. In this regard, the Italian tax authorities confirmed that the OECD's analysis should be used to determine if the server created a PE for the French company in Italy, and on this basis, due to the fact that the servers formed an integral part of the French company's core business of selling video games, the servers constituted a PE.

Two court cases that have been decided specifically with reference to the OECD's guidelines are that of *ITO v Right Florists Limited*⁶³ and *Dell Spain v Agencia Estatal de la Administración Tributaria*.⁶⁴

In *ITO v Right Florists Limited*⁶⁵ the Kolkata Tax Tribunal was faced with the taxability of payments made by an Indian resident entity to Google (situated in Ireland) and Yahoo (situated in the US) to place advertisements on their respective search engines.⁶⁶ In examining whether Google and Yahoo had a PE in India under the relevant tax treaties, the Tribunal considered *inter alia* the OECD's commentary that a website by itself could not constitute a PE due to the absence of a "fixed place", but that the server from where the website functions could constitute a "fixed place", and hence a PE.⁶⁷

Taking the OECD's commentary into account, the Tribunal decided that since a search engine is operated through a website, a website would only constitute a PE if the server through which the website is hosted was situated in India. Accordingly, as Google and Yahoo did not have servers in India, the PE threshold was not met, and therefore, neither Google nor Yahoo had a PE in India.⁶⁸

In contrast, in the case of *Dell Spain v Agencia Estatal de la Administración Tributaria*⁶⁹ the Court did not accept the OECD's commentary that a website does not generate a PE in a country unless the server that hosts the website is physically located in that country.

⁶³ *ITO v Right Florists Limited*, I.T.A. No. 1336/ Kol. / 2011.

⁶⁴ *Dell Spain v. Agencia Estatal de la Administración Tributaria*, 5 March 2012, case number 00/2107/2007.

⁶⁵ *ITO v Right Florists Limited*, I.T.A. No. 1336/ Kol. / 2011. The case is accessible at: http://itatonline.org/archives/wp-content/files/Right_Florist_Google_Yahoo_Advt_charges.pdf (last accessed 24 November 2015).

⁶⁶ *Id* paragraph 2, pp. 1-2.

⁶⁷ *Id* paragraph 14 and 15, pp. 14-17.

⁶⁸ *Id* paragraph 28, pp. 28-29.

⁶⁹ On the basis of the sources available to the author, the author was only able to obtain the judgement of this case. The case has, therefore, been summarised as it appears in an international tax alert of Ernst and Young, accessible at: <http://www.slideshare.net/antoniopg/dell-alert>, and a newsletter of the Spanish firm Comez-Acebo & Pombo, accessible at: http://www.gomezacebo-pombo.com/media/k2/attachments/the_spanish_substantialist_approach_to_fragmented_structures_of_business_the_dell_case_a_subsidary_as_permanent_establishment.pdf (last accessed 24 November 2015).

The facts of the case were briefly that Dell Ireland entered into a commissionaire arrangement with Dell Spain for the sale of Dell products in Spain. Dell Ireland had no employees or facilities in Spain and operated a model where purchase orders were placed in a web or call centre. The server which hosted the website was situated outside of Spain. Dell Spain was directly and actively involved in the logistics, marketing, post-sell and administration of Dell Ireland's online store. On the basis of these facts, the Court decided that the OECD commentary that a website will only establish a PE if the server on which it is hosted is situated in Spain did not apply to the case under consideration as the activities performed by Dell Spain for Dell Ireland in Spain were economically significant (as it included activities such as sales and delivery). As a result, the Court ruled that Dell Ireland had a fixed place of business in Spain, and hence a PE, through the operative settlement provided by Dell Spain's facilities and activities.⁷⁰

VI CRITIQUE OF THE CURRENT OECD APPROACH

There are many authors of tax literature that criticise the current OECD approach in utilising servers to establish a tax nexus in the digital economy. The greatest criticism is that the location of servers and the functions performed by software code within the servers are highly flexible and mobile, with the result that allocating taxing rights to countries in which servers are located can easily give rise to tax arbitrage opportunities.⁷¹

The location of servers can easily be moved between countries without affecting the underlying transaction.⁷² Servers can also almost instantaneously transfer their programs to a server in a different location.⁷³ Functions can easily be dispersed between servers over many different jurisdictions so as to distort the lines between core and auxiliary functions.⁷⁴ A server need not have any geographic connection to the income producing activities of an enterprise, and a server does not need to be

⁷⁰ The Court also ruled that Dell Spain constituted an Agency PE for Dell Ireland in Spain as it had the authority to conclude contracts that were legally binding on Dell Ireland.

⁷¹ Cockfield *Transforming the internet into a taxable forum: A case study on E-Commerce Taxation* (2001) p. 1192.

⁷² Oguttu & Tladi *E-commerce: A critique on the determination of a "permanent establishment" for income tax purposes from a South African perspective* (2009) p. 87.

⁷³ Cockfield *Transforming the internet into a taxable forum: A case study on E-Commerce Taxation* (2001) p. 1193.

⁷⁴ *Id* p. 1197.

maintained by employees or agents of the enterprise and can be maintained and programmed remotely by employees located outside the source country.⁷⁵

Accordingly, multinational enterprises that conduct business through a website on a server can easily avoid establishing a PE in a country by taking steps to manipulate their server location or the functions performed by the software on the server.⁷⁶ This is further made possible by the OECD's guidelines (as set out above) which can easily be transposed into the following check list to ensure that no PE is established on the basis of a server:⁷⁷

- (a) enterprises should not own or lease the server on which their website is hosted, instead they should make use of website hosting arrangements with internet service providers who own or lease the server which hosts their website;
- (b) a functional split should be made between core activities and auxiliary activities in multiple host servers;
- (c) servers that perform core business activities should be placed in countries with low or zero tax jurisdictions;
- (d) servers that are situated in high tax jurisdictions should perform mere preparatory or auxiliary functions;
- (e) the websites should be hosted on servers for a short period of time and then be moved to a different server so as to not become "fixed", alternatively mirror servers or the like can be used; and
- (f) companies that need personnel in order to establish a server or install a website should restrict the activities of these persons to mere start-up activities.

Even if a server establishes a PE for an enterprise in a particular or multiple countries, tax authorities will face significant challenges in attributing profits to the server or software functions within servers as tax authorities would somehow have to determine

⁷⁵ *Id* p. 1193.

⁷⁶ *Id* p. 1199.

⁷⁷ See *Id* pp. 1199-1200; Oguttu & Tladi *The Challenges E-Commerce Poses to the Determination of a Taxable Presence: The "Permanent Establishment" Concept Analyzed from a South African Perspective* (2009) pp. 219-220; See also Gárate *The "fixed place of business" in the Context of Electronic Commerce* p 30.

the amount of added value through server functions.⁷⁸ In this regard, the OECD issued a discussion paper in 2001 on the attribution of profits to a server which provided guidance on how Article 7 needs to be applied in this context.⁷⁹ This discussion paper was followed by a final report in 2005,⁸⁰ and a subsequent report in 2010 on the attribution of profits to PEs.⁸¹ In relation to the attribution of profits to a server, the 2010 report notes as follows:⁸²

Both the discussion draft from the Business Profits Technical Advisory Group entitled “Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions” released in 2001 and the BP TAG’s final report entitled “Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?” completed in 2004 have concluded that the automated nature of the functions means that the assets or risks attributed to the PE are only likely to be those directly associated with the server hardware. In fact, since a server-PE will not be carrying out any significant people functions relevant to the attribution of economic ownership of assets and/or the assumption of risks in the absence of personnel acting on behalf of the enterprise, no asset or risk could be attributed to it under the authorised OECD approach, supporting the conclusion that little or no profit would be attributed to such a PE.

Accordingly, apart from the flexible and mobile nature of servers which potentially give rise to tax arbitrage opportunities, the OECD has acknowledged that little or no profits would be attributable to servers that constitute PEs (if no personnel are associated with the server). This in itself illustrates that extending the PE concept to servers is an unsuitable solution to effectively tax business profits derived in the digital economy.

⁷⁸ Cockfield *Transforming the internet into a taxable forum: A case study on E-Commerce Taxation* (2001) pp. 1197-1198.

⁷⁹ OECD 2001, *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions*, Discussion Paper, Technical Advisory Group of Monitoring the Application of Existing Treaty Norms for the Taxation of business profits.

⁸⁰ OECD 2005, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce?*, Committee on Fiscal Affairs Final Report.

⁸¹ OECD 2010, *2010 Report on the Attribution of Profits to Permanent Establishments*, Committee on Fiscal Affairs.

⁸² Refer to *Id* p. 26.

VII SUBSEQUENT WORK OF THE OECD ON TAXATION OF THE DIGITAL ECONOMY PRIOR TO LAUNCHING THE OECD/ G20 BEPS PROJECT

In the 2005 report referred to above⁸³, the OECD's Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits ("**TAG**") recognised that aspects of the existing international tax rules presented concerns in the realm of the digital economy. As a means to address these concerns the report considered several amendments to the OECD MTC which entailed some fundamental and some minor changes to the existing international tax rules.

In relation to the proposals that would result in fundamental changes to the existing international tax rules⁸⁴, the TAG concluded that it would not be appropriate to embark on such changes at the time, as electronic commerce and other business models resulting from new communication technologies did not, by themselves, justify a dramatic departure from the current rules.⁸⁵ In this regard, the TAG noted that:⁸⁶

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.

Furthermore, it was noted that fundamental changes should only be undertaken if there was broad agreement that a particular alternative was clearly superior to the existing rules, which was not the case.⁸⁷

The TAG also did not recommend that any of the proposals that would lead to less fundamental changes to the existing international tax rules⁸⁸ be implemented as a means to deal with the concerns raised in relation to the digital economy.⁸⁹

⁸³ OECD 2005, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce?*, Committee on Fiscal Affairs Final Report.

⁸⁴ See *Id* pp. 51-71 for a discussion and assessment on the proposed alternatives that would require a fundamental modification of the existing rules; See also Annex A to OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, pp. 167-168 for a summary in this regard.

⁸⁵ OECD 2005, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce?* Committee on Fiscal Affairs Final Report, p. 72.

⁸⁶ *Ibid.*

⁸⁷ *Ibid.*

⁸⁸ See *Id* pp. 30-51 for a discussion and assessment on the proposed alternatives that would not require a fundamental modification of the existing rules; See also OECD 2014, Annex A to *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, pp. 165-167 for a summary in this regard.

Despite not recommending any changes to the OECD MTC to cater for the digital economy, the TAG recognised the need to continuously monitor the impact of changing business models as a result of ICT developments on direct tax revenues.⁹⁰

After publishing the abovementioned report, the OECD did not publish anything further on the digital economy until it launched the BEPS Project during 2013. As part of this work, the OECD is considering both the impact that the digital economy has on BEPS as well as its impact on existing international tax rules. The OECD's work in this regard will be discussed in subsequent chapters.

VIII CONCLUSION

Due to the flexible, mobile and intangible nature of the modern business environment brought about by ICT developments in recent years, businesses are operating fundamentally different today than in the 19th and 20th century when the PE concept was developed. In particular, a non-resident no longer necessarily needs to maintain some form of regular physical presence in a source country in order to engage in substantial business activities in that country, as functions that were traditionally performed by in-country offices or personnel can now be conducted via a website on the Internet or via independent agents and from multiple jurisdictions. Accordingly, enterprises are increasingly able to reduce their existing source country business activities whilst still actively participating in the economic life of that source country.

This raises serious concerns for source countries due to the fact that the PE concept relies on a physical presence of a non-resident in a source country to establish a tax nexus. Consequently, business models which would originally have given rise to a PE in the absence of ICT developments no longer necessarily give rise to a PE, or to the extent that it does the profits attributable to that PE can easily be manipulated. In addition, ICT developments are also resulting in completely new business models that are wholly digital.

Technology advances have, however, been challenging tax laws based on physical nexus requirements even before the advent of the digital era. As a result, the question has been raised whether the digitalisation of the economy is merely a natural evolution

⁸⁹ OECD 2005, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce?*, Committee on Fiscal Affairs Final Report, p. 72.

⁹⁰ *Ibid.*

of business with which the existing PE concept can cope, or if it is so revolutionary that amendments to the existing PE concept are warranted.

Prior to the BEPS Project it has certainly been the OECD's view that the existing PE concept remains adequate to tax business profits derived in the digital economy, and therefore, the OECD simply extended the Commentary on Article 5 to provide for the digital economy. This is the same approach taken by the OECD in the past in relation to other technology advances such as satellites, telecommunications networks, automatic equipment, cables and pipelines. Consequently, the OECD has held the view that the digital economy is simply the natural evolution of business and not so revolutionary that it warrants amendments to Article 5.

It is the author's view that the OECD's extension of the PE concept to servers does not assist in addressing any of the challenges raised by the digital economy when applying the PE concept, but in fact, potentially contributes to the erosion of source countries' income tax bases. This is because the highly flexible and mobile nature of servers provides various tax planning opportunities for taxpayers. For example, a server can easily be removed geographically from both the income producing activities of a business and its customers, and accordingly, taxing rights are not necessarily aligned with value creation. It is submitted that the OECD has acknowledged the ineffectiveness of this approach, as it has conceded that the amount of income that would be attributable to functions performed through a server would be minimal. Accordingly, it is submitted that the OECD's current guidelines in applying the existing PE concept to the digitalised economy is unsatisfactory and outdated.

Moreover, it is submitted that the digitalisation of the economy is not merely the natural evolution of business but in fact revolutionary as businesses across all sectors are now able to design and build their operating models around technological capabilities to such an extent that it has become embedded and central to the business models of enterprises operating across the globe in all sectors. In contrast, the examples set out above of case law that challenged existing tax laws based on physical nexus requirements before the advent of the digital era were sector specific, i.e. telegrams, mail orders, radio broadcasting, and the technological advances in this regard did not fundamentally influence the manner in which businesses across multiple sectors conducted their businesses.

Although radio and television enabled enterprises to advertise their businesses across borders, it did not materially influence the manner in which they conducted their business. For example, an enterprise cannot conclude a sale with a customer over the radio or television as is the case with the Internet. The advertising service provided by radio and television broadcasters is arguably merely auxiliary to the main business of the enterprise.

Accordingly, it is submitted that the digital economy is fast becoming the economy itself, with the necessity that existing tax laws, and particularly the existing PE concept, need to be aligned with this "new economy". It is the author's view that the existing PE concept does not have the ability to cope with the scale of ICT developments that is rapidly and continuously negating physical presence requirements in the business environment, and therefore, changes to Article 5 are not only warranted, but also necessary to preserve the income tax base of source countries. One scholar summarises the difficulty faced in taxing businesses on the basis of traditional tax rules in the digital economy as follows: "*Businesses used to be like cows in a field, waiting to be milked. Now the cows have wings.*"⁹¹

The merits of the arguments put forward in this chapter are further considered in light of the OECD/ G20 BEPS Project discussed in following chapters.

⁹¹ Li & See *Electronic Commerce and International Taxation* (2002) p.103.

CHAPTER 4

THE IMPACT OF THE DIGITAL ECONOMY AND THE EXISTING PE CONCEPT ON BEPS

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I INTRODUCTION

The BEPS concept is considered in this chapter, and in particular, the impact of the digital economy on BEPS in light of existing international tax rules. The OECD's role in combatting BEPS is also considered as well as the OECD's proposals to address BEPS practices in the digital economy.

II WHAT IS BEPS?

The interaction of domestic tax rules in relation to cross-border activities often lead to overlaps in countries exercising their respective taxing rights.¹ These overlaps, in turn, often give rise to double taxation which can have harmful effects on cross-border economic activities and capital flows, and can result in trade distortions and impede sustainable economic growth.

For ages countries have recognised the potential harmful effects of double taxation and have continually collaborated in order to eliminate it. This is generally achieved through the introduction of unilateral tax relief measures in the form of domestic legislation or through bilateral tax relief measures such as entering into tax treaties which co-ordinate their respective domestic taxing rights in order to avoid double taxation. These tax treaties are largely based on agreed international standards captured in model tax conventions, such as the OECD MTC and the UN MTC.²

Unfortunately, the discrepancies brought about by the interaction of domestic tax rules as well as rules adopted in accordance with international standards to relieve double taxation (such as bilateral tax treaties) often also result in double non-taxation or unduly low taxation, which is inconsistent with the policy objectives of such domestic tax rules and international standards.³

These unintended consequences are of particular concern where taxpayers intentionally identify and exploit the discrepancies (albeit legally) and enter into co-ordinated strategies (discussed below) to achieve double non-taxation or undue low taxation, especially where profits are artificially shifted away from the jurisdictions

¹ OECD 2013, *Action Plan on Base Erosion and Profit Shifting* p. 9; OECD 2013, *Addressing Base Erosion and Profit Shifting*, p. 5.

² The importance of the elimination of double taxation has been recognised since as early as the 1920s when the League of Nations published the first model tax convention for this purpose.

³ OECD 2013, *Addressing Base Erosion and Profit Shifting*, pp. 5-6.

where the activities giving rise to those profits take place to low or no-tax jurisdictions where there is little or no economic activity, thereby significantly reducing or even eliminating their tax burden.⁴

This behaviour is globally referred to as BEPS and raises many concerns due to the fact that it undermines the integrity of tax systems and is harmful to governments, individual taxpayers and businesses as it causes *inter alia* erosion of countries' tax bases, trade distortions in that companies which refrain from BEPS activities may face a competitive disadvantage relative to companies that engage in it, and tax unfairness as it may cause other taxpayers to ultimately bear a greater share of the tax burden.⁵

III THE OECD'S ROLE IN COMBATting BEPS

During 2012 the G20 called on the OECD to consider BEPS concerns and to provide suggested solutions, and in early 2013 the OECD issued a report in this regard entitled *Addressing Base Erosion and Profit Shifting* (hereinafter referred to as "**the BEPS Report**").⁶

The BEPS Report notes that corporate tax affairs have enjoyed significant attention by governments, politicians, civil society, non-governmental organisations and mainstream media, and that there is a growing perception that governments are losing out on substantial corporate tax revenues due to the aggressive tax planning strategies of multinationals aimed at shifting profits in ways that erode the tax base to locations where they are subject to a more favourable tax treatment.⁷

Indeed, in taking a closer look at the various news and related articles on how multinational enterprises have managed to legally structure their affairs in such a way that they pay relatively little tax in relation to their revenues, one can understand the global outrage. To name but a few examples, one article notes that as a result of clever tax planning strategies, Amazon paid an average of just 0.05%, Google 0.45%, and

⁴ *Ibid*; See also the OECD website for a discussion on BEPS, available at: <http://www.oecd.org/tax/beps-about.htm> (accessed 20 June 2015).

⁵ See OECD 2013, *Action Plan on Base Erosion and Profit Shifting*, p. 8 for a discussion on the effects of this behaviour on governments, individual taxpayers and businesses; See also OECD 2014 *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, p. 100.

⁶ OECD 2013, *Addressing Base Erosion and Profit Shifting*, Paris, OECD Publishing, DOI: <http://dx.doi.org/10.1787/9789264192744-en>.

⁷ *Id* pp. 13-14.

Starbucks 0.12% corporation tax in the UK relative to the revenues they derived in the UK during the period 2009 to 2013.⁸ Other articles aver that through legal tax avoidance schemes during 2011, Amazon generated £ 3.3 billion in the UK but paid no UK corporation tax on these profits,⁹ and Google avoided USD 2 billion in worldwide income taxes.¹⁰ It is also reported that Apple managed to shelter USD 44 billion during the period 2009 to 2012 from taxation anywhere in the world due to their creative tax structure,¹¹ and that Starbucks managed to generate sales of £ 400 million in the UK during 2012 without having to pay any UK corporation tax thereon.¹² Similar articles were also published in relation to Facebook¹³ and E-Bay.¹⁴ Another article reports that it is estimated that EU governments alone miss out on taxes of € 1 trillion a year as a result of legal tax avoidance schemes and illegal tax evasion.¹⁵

It must be noted that there are some discrepancies between the various articles published on how much taxes certain multinational enterprises actually paid (or rather did not pay) during specific periods. However, all the articles are uniform in their view that although the tax structures of many multinational enterprises may be completely legal (as they are tantamount to tax avoidance and not tax evasion - which is illegal), they have arguably not been paying their "fair share" of taxes for far too long.

It is submitted that the media frenzy in this regard fuelled the resentment of the public, governments and tax authorities towards multinational enterprises that engage in tax avoidance schemes. For example, after the media attention afforded to Amazon, Google and Starbucks regarding their low tax bills, these multinationals were called to

⁸ See Connell *Ending the Free Ride* (2014) p. 13, accessible at: <http://www.civitas.org.uk/pdf/EndingtheFreeRide> (last accessed 13 August 2015).

⁹ See *Amazon: £7bn sales, no corporation tax* featured in *The Guardian* on 4 April 2012, accessible at: <http://www.theguardian.com/technology/2012/apr/04/amazon-british-operation-corporation-tax> (last accessed 15 August 2015).

¹⁰ See *Google Revenues Sheltered in No-Tax Bermuda Soar to \$10 Billion* published in *Bloomberg* on 10 December 2012, accessible at: <http://www.bloomberg.com/news/articles/2012-12-10/google-revenues-sheltered-in-no-tax-bermuda-soar-to-10-billion> (last accessed 15 August 2015).

¹¹ See Ting *iTax-Apple's International Tax Structure and the Double Non-Taxation Issue* (2014) p. 40.

¹² See *Google, Amazon, Starbucks: The rise of "tax shaming"* featured in *BBC News* on 21 May 2013, accessible at: <http://www.bbc.com/news/magazine-20560359> (last accessed 15 August 2015).

¹³ See *Facebook criticised for £ 238,000 UK tax bill last year* featured in *BBC News* on 11 October 2012, accessible at: <http://www.bbc.co.uk/newsbeat/article/19910456/facebook-criticised-for-238000-uk-tax-bill-last-year> (last accessed 15 August 2015).

¹⁴ See *EBay 'pays £1.2m in UK tax' on sales of £800m* featured in *BBC News* on 21 October 2012, accessible at: <http://www.bbc.com/news/business-20022365> (last accessed on 15 August 2015).

¹⁵ See *Europe takes aim at digital giants' tax swerves* featured in *EuroActiv.com* on 28 May 2013, accessible at: <http://www.euractiv.com/infosociety/europe-takes-aim-digital-giants-news-520018> (last accessed 15 August 2015).

appear before the UK Public Accounts Committee during 2013 as part of their investigation into tax avoidance by multinational enterprises. These companies were interrogated on their apparently legal tax planning structures which resulted in low tax bills in the UK despite having substantial operations there, and were held out by the Committee as being tax dodgers and even unethical, evil and immoral.¹⁶ In addition, there are also various reports of consumers boycotting certain brands (such as Starbucks) after the media reports surfaced of their tax avoidance schemes.¹⁷ Many multinational enterprises also received big tax bills for outstanding taxes, for example in relation to Amazon, various articles reported that the French tax authorities claimed USD 252 million in unpaid taxes, interest and penalties for the period 2006 to 2010,¹⁸ for the same period the US state of Arizona claimed USD 53 million in unpaid taxes,¹⁹ and for the period 2005 to 2009 the US state of Texas sought USD 269 million in unpaid taxes.²⁰ There are also various media reports which claim that the French tax authorities have hit Google with a € 1 billion tax bill.²¹

Despite the above, however, from the BEPS Report it seems that the OECD is not entirely convinced that available data supports the view that widespread exploitation of jurisdictional arbitrage is shrinking tax revenues, and therefore, that BEPS is indeed a global problem.²² In this regard, the BEPS Report notes that:²³

¹⁶ See article published on the UK Parliament's website on 13 June 2013 regarding Google's tax avoidance including The Public Accounts Committee's report in this regard, both accessible at <http://www.parliament.uk/business/committees/committees-a-z/commons-select/public-accounts-committee/news/tax-avoidance-google/> (last accessed 15 August 2015); See also the following articles: *MP on Google tax avoidance scheme: I think that you do evil* featured in *The Guardian* on 16 May 2013, accessible at: <http://www.theguardian.com/technology/2013/may/16/google-told-by-mp-you-do-do-evil> (last accessed 15 August 2015), *Google, Amazon, Starbucks: The rise of "tax shaming"* featured in *BBC News* on 21 May 2013, accessible at: <http://www.bbc.com/news/magazine-20560359> (last accessed 15 August 2015), *Starbucks Google and Amazon grilled over tax avoidance* featured in *BBC News* on 12 November 2012, accessible at <http://www.bbc.com/news/business-20288077> (last accessed 15 August 2015).

¹⁷ See *Google, Amazon, Starbucks: The rise of "tax shaming"* featured in *BBC News* on 21 May 2013, accessible at: <http://www.bbc.com/news/magazine-20560359> (last accessed 15 August 2015).

¹⁸ See *Amazon ordered to pay \$252 million in back taxes by French authorities* featured in *Reuters* on 12 November 2012, accessible at: http://www.huffingtonpost.com/2012/11/12/amazon-back-taxes_n_2117697.html (last accessed 15 August 2015).

¹⁹ See *Arizona hits Amazon with \$53 million tax bill* featured in *The Seattle Times* on 1 February 2012, accessible at: <http://www.seattletimes.com/business/arizona-hits-amazon-with-53-million-tax-bill/> (last accessed 15 August 2015).

²⁰ See *Texas sends Amazon.com a \$269 million tax bill* featured in *Reuters* on 22 October 2010, accessible at: <http://www.reuters.com/article/2010/10/22/us-amazon-tax-idUSTRE69L5EC20101022> (last accessed 15 August 2015).

²¹ See *Google slapped with €1 billion tax bill* posted on *taxback.com* on 7 February 2014, accessible at: <https://www.taxback.com/blog/google-slapped-e1-billion-tax-bill> (last accessed 15 August 2015).

²² See Sala *Breaking down BEPS: Strategies, Reforms, and Planning Responses* (2014) p. 577.

With the data currently available, it is difficult to reach solid conclusions about how much BEPS actually occurs. Most of the writing on the topic is inconclusive, although there is abundant circumstantial evidence that BEPS behaviours are widespread.

Notwithstanding this, the OECD acknowledges that BEPS is a pressing and current issue for a number of jurisdictions,²⁴ and although further work on data is needed to provide useful indications on the magnitude of BEPS issues, it is evident that BEPS is indeed taking place and poses a threat in terms of tax sovereignty and tax revenue.²⁵

Importantly, the BEPS Report acknowledges that current international standards may not have kept pace with changes in global business practices, and in particular in the area of intangibles and the development of the digital economy and notes that.²⁶

Domestic rules for international taxation and internationally agreed standards are still grounded in an economic environment characterised by a lower degree of economic integration across borders, rather than today's environment of global taxpayers, characterised by the increasing importance of intellectual property as a value-driver and by constant developments of information and communication technologies.

Accordingly, the BEPS Report proposes that a comprehensive action plan be developed to address BEPS concerns in order to provide concrete solutions to realign international standards with the current business environment, and to provide countries with instruments to better align taxing rights with real economic activity.²⁷

Following the BEPS Report, the OECD published its Action Plan on BEPS during July 2013 (hereinafter referred to as the "**BEPS Action Plan**").²⁸ The BEPS Action Plan contains 15 separate action points with a view to address BEPS concerns and to provide solutions in this regard. The first set of action plans was released during September 2014 (hereinafter referred to as the "**2014 deliverables**"), with the remainder due to be released in 2015.²⁹ Action 1 of the 2014 deliverables is entitled

²³ OECD 2013, *Addressing Base Erosion and Profit Shifting*, p. 15.

²⁴ *Id* p. 5.

²⁵ *Id* p. 47.

²⁶ *Id* p. 7.

²⁷ *Id* pp. 8-9.

²⁸ OECD 2013, *Action Plan on Base Erosion and Profit Shifting*, Paris, OECD Publishing, DOI: <http://dx.doi.org/10.1787/9789264202719-en>.

²⁹ As noted in Chapter 1, the final BEPS reports were released during October 2015. However, as this dissertation was drafted on the basis of available information up to 30 September 2015, these reports do not form part of the scope of this dissertation.

"*Addressing the tax challenges of the digital economy*"³⁰ (hereinafter referred to as "**Action 1**") and addresses tax challenges raised by the digital economy in relation to BEPS as well as broader tax challenges in relation to tax policy (with respect to both direct and indirect taxes). This chapter only deals with the former and the latter will be addressed in the following chapter.

IV KEY FEATURES OF THE DIGITAL ECONOMY THAT EXACERBATE BEPS RISKS

Action 1 notes that the digital economy does not generate unique BEPS issues, but that some of its key features exacerbate BEPS risks.³¹ These key features, as identified in Action 1, are discussed briefly below.³²

(a) Mobility with respect to intangibles, users and business functions³³

ICT developments have increased businesses' flexibility in relation to the location of their business functions and have enabled businesses to spread functions and assets across multiple countries. Accordingly, businesses are increasingly able to choose the optimal location for productive assets and activities even if that location is distant from the location of its customers or other stages of production. Technology developments have also enabled businesses to manage their global operations on an integrated basis from a central location that may similarly be removed geographically from both the location in which the operations are carried out and the locations in which their suppliers and customers are located.

Technology advances also increasingly makes it possible for business to carry on activities with minimum personnel, and to outsource functions to related or unrelated parties. Businesses are also able to increase substantially in size and reach with minimal increases in the number of personnel required to manage the daily operations of the business.

The anonymity of the internet often makes it difficult to identify users and their locations, and the increased connectivity of the digital economy also enables users to

³⁰ OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, Paris, OECD Publishing, DOI: <http://dx.doi.org/10.1787/9789264218789-en>.

³¹ *Id* p. 13.

³² *Id* p. 84.

³³ *Id* pp. 85-88.

carry on commercial activities remotely whilst travelling across borders. In addition, development and exploitation of intangibles, such as software, is also a key feature of the digital economy and a core contributor to its value creation and economic growth. The rights to intangibles can, however, easily be transferred among associated companies, thereby separating legal ownership from the activities that resulted in its development.

(b) Reliance on data³⁴

Technology developments have significantly increased the ability of businesses to collect, store and analyse data at a greater distance and in greater quantities than previously. This has created immense value for businesses as it enables them to rapidly improve their business models, products and services.

(c) Network effects with reference to user participation, integration and synergies³⁵

Where business models encourage interactivity among users the decisions of users may have a direct impact on the benefit received by other users. For example, in certain business models, network effects come from a competitive advantage gained by enabling users to review and comment on products. These user comments then enable other users to make informed decisions in purchasing products.

Other network effects are derived from vertical integration, which rely on synergies between different layers or applications to create added value and consolidate market position. An example in this regard is where a company deploys software on a device and leverages the software to sell goods or services to the owners of those devices or to advertisers.

(d) Use of multi-sided business models³⁶

Digitalised business models make it easier to locate different sides of the same business model in different countries. Multi-sided business models are based on a market in which multiple distinct groups of persons interact through an intermediary or

³⁴ *Id* pp. 89-91.

³⁵ *Id* pp. 91-92.

³⁶ *Id* pp. 92-94.

platform, and the decisions of each group of persons affect the outcome for the other groups of persons through a positive or negative externality.

(e) Tendency toward monopoly or oligopoly³⁷

Some digitalised companies have been able to achieve a dominant position in certain markets, particularly where an intellectual property right has given them the exclusive right to exploit a particular innovation in those markets. However, in other markets many networks operate simultaneously which often give rise to oligopoly.

(f) Volatility³⁸

Technology developments constantly encourage innovation and the development of new business models. Accordingly, companies need to continually evaluate and modify their business models in order to leverage their market position.

V CO-ORDINATED STRATEGIES THAT TAXPAYERS ENTER INTO TO REDUCE/ ELIMINATE THEIR TAX LIABILITY WHICH GIVE RISE TO BEPS

As the digital economy does not generate unique BEPS issues, Action 1 identifies the following co-ordinated strategies as giving rise to BEPS, both in terms of conventional business models and business models in the digital economy:³⁹

(a) Eliminating or reducing tax in the market country by avoiding a taxable presence or minimising the profits attributable in the case of a taxable presence⁴⁰

As mentioned in previous chapters, technology advances are increasingly enabling companies to interact remotely with customers in multiple jurisdictions through digital means (such as websites) without having to maintain a physical presence in those jurisdictions.⁴¹ As a physical presence is essential in order to meet the PE threshold in a source country, and therefore, to establish a taxable presence in that source country, entities are increasingly able to derive substantial business profits from jurisdictions in

³⁷ *Id* p. 94.

³⁸ *Id* pp. 94-95.

³⁹ *Id* p.101.

⁴⁰ See *Id* pp. 102-104 for a detailed discussion in this regard.

⁴¹ *Id* p. 102.

which their customers are located without being liable to tax on such profits in those jurisdictions as they do not meet the requisite PE threshold.⁴²

The avoidance of a PE in a source country, and therefore source taxation on business profits derived in that source country, gives rise to BEPS concerns where it is coupled with strategies that also eliminate taxation on such business profits in the enterprise's state of residence, and as a result, the business profits derived in the source country go untaxed anywhere.⁴³

In addition, the mobility and flexibility of the digital economy enables companies to disperse their functions across multiple jurisdictions which may be geographically removed from both their customers and the locations where their other functions are carried out.⁴⁴ This makes it easy for multinational enterprises to contractually manipulate the allocation of functions, assets and risk (being the factors taken into account to determine the attribution of profits to a PE⁴⁵) to different group companies in order to minimise the overall tax burden of the group.

For example, to the extent that a non-resident company has a PE in a high-tax source state, it is possible to structure the local activities of that PE in such a way that it generates little taxable income.⁴⁶ This can be achieved by contractually outsourcing non-essential functions to the PE (such as marketing or technical support) with other group members operating in low-tax jurisdictions contractually bearing the risks and claiming ownership of intangibles generated by these activities.⁴⁷ The group company in the low-tax jurisdiction can then undervalue the intangible asset while claiming that it is entitled to a large portion of the group's income on the basis of its legal ownership in the asset as well as the risk assumed and the financing it provides.⁴⁸

Apart from manipulating the allocation of functions, assets and risks to group entities, multinational enterprises can also significantly reduce taxable income in a source

⁴² *Ibid.*

⁴³ *Ibid.*

⁴⁴ See *Id* Chapter 4.

⁴⁵ Refer to Article 7 of the 2014 OECD MTC and Chapter 1 of this dissertation.

⁴⁶ OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, p. 103.

⁴⁷ *Ibid.*

⁴⁸ *Ibid.*

country by maximising the amount of deductible payments made to affiliate companies in other countries (for example by way of deductible interest payments).⁴⁹

(b) Eliminating or reducing withholding tax at source⁵⁰

Certain payments made to non-residents from source states may be subject to withholding taxes, such as royalties or interest for example. BEPS often arises in this regard where multinational enterprises interpose shell companies in countries with favourable treaty networks that significantly reduce or eliminate the withholding tax.

(c) Eliminating or reducing tax in the intermediate country⁵¹

Taxes in the intermediate country can similarly as in the source country be reduced by manipulating the functions performed, assets used and risks assumed by the entity in the intermediary country, or by generating excessive deductible payments to related entities that are located in low or no tax jurisdictions. Furthermore, entities can also avoid taxes in an intermediary country by using hybrid mismatch arrangements to generate deductible payments with no corresponding inclusion in the taxable income of the payee in another country.

(d) Eliminating or reducing tax in the country of residence of the ultimate parent⁵²

The same techniques that are used to reduce taxation in the source country can also be used to reduce taxation in the country of the ultimate parent company of the group. However, in addition to this, companies may avoid tax in the residence country of their ultimate parent if that country has an exemption or deferral system in regard to foreign source income and either does not have controlled foreign company ("CFC") rules or has a regime with inadequate coverage of certain categories of passive or highly mobile income, especially in relation to intangibles.

⁴⁹ *Id* p. 104.

⁵⁰ *Ibid*.

⁵¹ *Id* pp. 104-105.

⁵² *Id* p. 105.

VI CASE STUDY ON BEPS IN THE DIGITAL ECONOMY: ONLINE RETAILER⁵³

Action 1 identifies a number of specific tax and legal structures that utilise the aforementioned co-ordinated strategies to implement business models in the digital economy which give rise to BEPS.⁵⁴ The examples include business models of an online retailer, internet advertising, cloud computing and an internet app store.⁵⁵

As the examples are extensive and detailed only one example will be considered in this chapter, namely, that of an online retailer, in order to illustrate how the digital economy has impacted the way in which conventional retail business models can operate in the modern economy and how this can give rise to BEPS (in the context of direct taxes). The example has been adapted slightly from how it appears in Action 1 in order to simplify it.

(a) Background information on the RCo Group

The RCo Group is a multinational enterprise engaged in the online sale of physical goods and digital products to customers via websites. The websites of the Group display the products offered in the markets that they serve in local languages and allow customers to purchase these products online through credit card payments. Physical goods sold to customers via the websites are delivered through independent courier services, and digital products are directly downloaded from one of the RCo Group's websites to the consumer's computer.

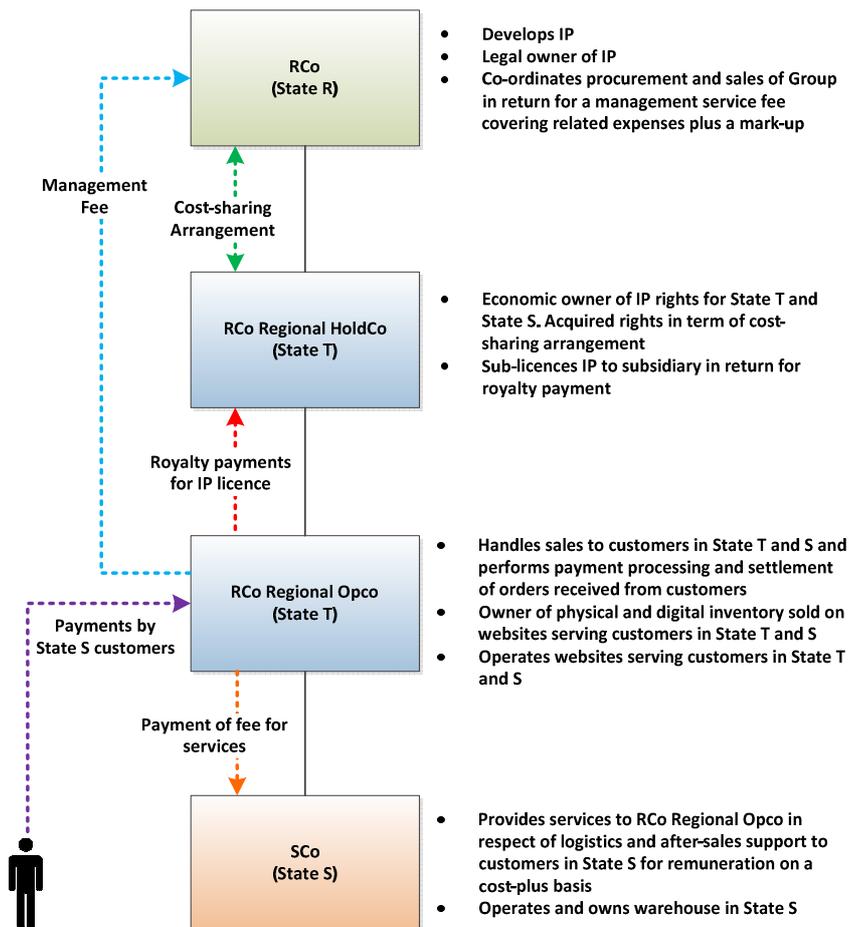
The RCo Group collects data on customer preferences on the basis of goods purchased, added to a list of "favourites", or browsed by customers. Using sophisticated proprietary software, RCo Group then analyses the data it collects in order to make recommendations of goods to potential customers and provide personalised advertising.

Before expanding upon each of the entities' functions in the RCo Group, the group structure can schematically be illustrated as follows:

⁵³ Refer to *Id* pp. 182-186 for the case study.

⁵⁴ *Id* p. 13.

⁵⁵ *Id* pp.181-198.



(b) Overview of RCo's activities (ultimate parent)

- (i) RCo is tax resident in State R;
- (ii) all intellectual property ("IP") used in operating the RCo Group's websites and fulfilling orders are developed by employees of RCo;
- (iii) RCo is the legal owner of all the RCo Group's IP; and
- (iv) RCo remotely co-ordinates the procurement and sale activities of the RCo Group by rendering services to RCo Regional Opco in return for a management service fee covering related expenses plus a mark-up.

(c) Overview of RCo Regional HoldCo's activities (intermediary holding company)

- (i) RCo Regional Holdco is a subsidiary of RCo and is tax resident in State T;
- (ii) RCo Regional Holdco holds the economic rights of the RCo Group's IP. It acquired these rights by entering into a cost-sharing arrangement with RCo in terms of which it made a "buy in" payment to RCo equal to the value of

- the existing intangibles and agreed to share the cost of future development (to be performed exclusively by RCo personnel in State R) on the basis of the anticipated future benefit from the use of the technology in the State T and State S region ("**T/S region**"). RCo Regional HoldCo does not perform any supervision of the development activities carried out by RCo in State R;
- (iii) RCo Regional HoldCo also acts as a holding company for all subsidiaries in the T/S region, although in practice, most co-ordination services continue to be performed at the level of RCo, and RCo Regional HoldCo's involvement with the subsidiaries is very limited;
 - (iv) RCo Regional HoldCo sublicenses the IP to RCo Regional Opco (and other operating companies) in return for a royalty payment; and
 - (v) RCo Regional HoldCo has only one employee on its payroll, and the premises are limited to an "office hotel" where the company regularly rents different offices for the purpose of organising board meetings.

(d) Overview of RCo Regional Opco's functions (intermediary operating company)

- (i) RCo Regional Opco is a subsidiary of RCo Regional Holdco and is also tax resident in State T;
- (ii) RCo Regional Opco is the legal owner of the physical and digital products sold to the customers via websites in the T/S region;
- (iii) RCo Regional OpCo handles the sales, payment processing and settlement from customers in the T/S region;
- (iv) RCo Regional OpCo is a hybrid entity that is treated as a company for tax purposes under the domestic law of State T, and as a transparent entity under the domestic law of State R;
- (v) changes and updates to the websites are done from State T by employees of RCo Regional OpCo, who have overall responsibility for managing the various websites serving customers in the region. These functions are performed with minimal skilled personnel. Other functions related to the online sale activity rely on automated processes conducted by sophisticated Internet-powered software applications regularly upgraded by employees of RCo in State R; and
- (vi) orders and sales are concluded electronically by customers in the T/S region on the basis of standardised contracts, the terms of which are set by

RCo, and require no intervention from RCo Regional OpCo. Mirrors of the websites are hosted on servers in a number of countries in the region. The staff of RCo Regional OpCo rarely has any contact with customers in the local market jurisdiction.

(e) Overview of SCo's activities (company in market country)

- (i) SCo is a subsidiary of RCo Regional OpCo and is tax resident in State S;
- (ii) SCo provides services to RCo Regional OpCo in respect of logistics and after sales support with respect to orders from customers in State S. After-sales support is handled by SCo through a call centre. RCo Regional OpCo remunerates SCo for these services on a cost-plus basis;
- (iii) orders for physical goods placed by customers in State S via the website managed by RCo Regional OpCo are generally fulfilled from a warehouse located in State S which is owned and operated by SCo. Where products are not available in a State S warehouse, the order is generally fulfilled from the closest warehouse to the customer; and
- (iv) orders for digital products placed by State S customers are generally downloaded from servers located in State S or in neighbouring countries, depending on network traffic at the time of the transaction. These servers are owned and operated by third parties through hosting arrangements with RCo Regional OpCo.

(f) Tax implications for the RCo Group

According to the OECD, the manner in which the RCo Group's activities are structured significantly reduces the group's tax burden and gives rise to BEPS, as set out in the below table.

Co-ordinated activities that achieve BEPS	Tax implications of Case Study
Eliminating or reducing tax in the market country	<p>SCo is allocated minimal taxable income based on the fact that SCo's risk and function profile is limited to routine services provided to RCo Regional OpCo.</p> <p>All revenues derived from the online sales of products to customers in State S are treated as income of RCo Regional OpCo, due to its role as the counterparty to the transactions. However, as RCo Regional OpCo does not have a physical presence in State S, and SCo has no interaction with State S customers, State S does not tax the profits derived from these activities either because it has no right to do so under its domestic law or because the</p>

	<p>relevant tax treaty prevents it from doing so in the absence of a PE of RCo Regional OpCo in State S to which the income is attributable.</p>
<p>Eliminating or reducing withholding tax at source</p>	<p>The royalty payments made by RCo Regional OpCo to RCo Regional HoldCo are not subject to any withholding taxes since the royalty income is paid to a company which is a resident of the same state (State T).</p> <p>No withholding tax is imposed under the relevant tax treaty between State T and State R on the payments made by RCo Regional HoldCo to RCo in terms of the cost sharing arrangement. Similarly, the treaty does not impose any withholding tax on the management fee payments made by RCo Regional OpCo to RCo.</p>
<p>Eliminating or reducing tax in the intermediate country</p>	<p>State T imposes corporate tax. Therefore, the royalties earned by RCo Regional HoldCo will be subject to corporate tax. However, by virtue of a preferential regime available in State T for income derived from certain intangibles, RCo Regional HoldCo is entitled to a rate substantially less than the generally applicable corporate tax rate for the royalties included in its taxable income.</p> <p>Similarly, RCo Regional OpCo will be liable for corporate tax on the income earned from its online sales activities. However, this income is almost entirely set-off by the deductible royalty payments made to RCo Regional HoldCo and the deductible management fees paid to RCo.</p>
<p>Eliminating or reducing tax in the country of residence of the ultimate parent</p>	<p>State R imposes corporate income tax on the buy-in payment received from RCo Regional HoldCo for the transfer of the economic rights to the IP. However, because of the absence of a significant track record of RCo's performance at the time of the transaction, RCo may argue that the value of the IP was very low with the result that the actual amount of gain subject to corporate tax in State R would be minimal.</p> <p>Under the cost sharing arrangement, RCo receives annual payments from RCo Regional HoldCo, however, this may be much lower than the amount of royalties received by RCo Regional HoldCo from RCo Regional OpCo. Depending on the domestic law of State R, RCo may also be entitled to Research and Development tax credits for a significant fraction of its expenditures, thereby significantly reducing its tax liability for corporate tax purposes.</p> <p>Under its CFC rules State R would under some circumstances treat royalties received by RCo Regional HoldCo as passive income subject to current taxation in the hands of RCo. However, because RCo Regional OpCo is treated as a transparent entity for tax purposes in State R, the income of RCo Regional OpCo is treated as having been earned directly by RCo Regional HoldCo and is therefore only treated as active income taxable in State R when it is paid to RCo. The same result can be achieved if State R imposed tax only on a territorial basis and did not have CFC rules.</p>

VII ADDRESSING BEPS IN THE DIGITAL ECONOMY

As mentioned, Action 1 notes that the digital economy does not generate unique BEPS issues, but that it has certain key features which exacerbate BEPS. As a result, Action 1 identifies these key features, but notes that BEPS in relation the digital economy will

be addressed as part of the various other actions that will address BEPS by introducing measures to broadly restore taxing rights at the level of both the market jurisdiction and the ultimate parent jurisdiction, so as to align taxing rights with value creation.⁵⁶ The points set out in Action 1 in this regard are briefly discussed below.

(a) Measures that will restore taxation in the market jurisdiction⁵⁷

Taxation in the market jurisdiction can be restored by preventing treaty abuse (Action 6) and preventing the artificial avoidance of PE Status (Action 7).

(i) Preventing treaty abuse (Action 6)⁵⁸

Action 1 endorses the establishment of effective rules to tackle the abuse of tax treaties. This includes curbing treaty shopping arrangements where companies are set up in a jurisdiction for the sole purpose of taking advantage of that country's treaty network rather than carrying on business activities in that jurisdiction, and unintended cases of non-taxation. In this regard, the denial of treaty benefits in cases that will otherwise result in double non-taxation will ensure that the market country will be able to apply its domestic tax law unconstrained by treaty rules aimed at preventing double taxation. This will be the case where a foreign company either does not meet the PE threshold, or where it does, the profits attributable to that PE are minimised especially through deductible payments. In cases where such deductible payments would be subject to withholding tax under domestic law, the market country will be able to apply such withholding tax without being limited by treaty provisions.

(ii) Preventing the artificial avoidance of PE status (Action 7)⁵⁹

Action 7 considers whether and how the PE definition should be modified in order to ensure that the PE threshold is not circumvented through artificial arrangements in relation to the sale of goods and services in multinational groups. The OECD states that the work should also consider whether certain activities that are traditionally

⁵⁶ See *Id* pp. 112-121.

⁵⁷ See *Id* pp. 112-114.

⁵⁸ See *Id* p. 113; The report on Action 6 was released together with the report on Action 1 during September 2014 - see OECD 2014, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* OECD/G20 Base Erosion and Profit Shifting Project, Paris, OECD Publishing, Paris, DOI: <http://dx.doi.org/10.1787/9789264219120-en>.

⁵⁹ See OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, pp. 113-114. Action 7 is comprehensively discussed in the following chapter.

considered preparatory or auxiliary in nature for purposes of the exemptions to the PE threshold may constitute core components of businesses in the digital economy, and if so, measures must be taken to ensure that such core activities cannot inappropriately benefit from the exemptions. Furthermore, measures must also be taken to ensure that it will not be possible for multinational enterprises to benefit from the exemptions to the PE definition through the fragmentation of business activities.

(b) Measures that will restore taxation in both the market jurisdiction and residence jurisdiction of the ultimate parent⁶⁰

Both market and residence taxation can be restored by neutralising the effects of hybrid mismatch arrangements (Action 2), by limiting the base erosion via interest deductions and other financial payments (Action 4), by countering harmful tax practices more effectively (Action 5), and by assuring that transfer pricing outcomes are in line with value creation (Actions 8-10).

(i) Neutralising the effects of hybrid mismatch arrangements (Action 2)⁶¹

Structures often take advantage of hybrid mismatch arrangements to achieve BEPS by stripping income from a market or intermediate jurisdiction or by avoiding application of CFC rules or other anti-abuse regimes. These types of arrangements should be addressed in the context of Action 2.

(ii) Limit base erosion via interest deductions and other financial payments (Action 4)⁶²

Taxpayers often establish and capitalise entities in low-tax jurisdictions that then engage in transactions with associated enterprises that have the effect of eroding the tax base. This can also be the case in the digital economy, where an affiliate in a low-tax jurisdiction is used to provide debt and licence intangibles to operating entities situated in high-tax jurisdictions. Excessive interest deductions on such loans, or excessive deductions for royalties paid to such low-tax entities can present BEPS

⁶⁰ See OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, pp. 114-119.

⁶¹ *Id* pp. 114-115. The report on Action 2 was released together with the report on Action 1 during September 2014 - see OECD 2014, *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, Paris, OECD Publishing, DOI: <http://dx.doi.org/10.1787/9789264218819-en>.

⁶² See OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, pp. 115-116.

concerns in countries where business operations take place. This is especially concerning where there is no corresponding income inclusion in the other country (due to for example preferential regimes, the use of hybrid instruments, and the availability of generous deductions). Action 4 is intended to make recommendations regarding best practices in the design of domestic rules to reduce opportunities for BEPS via deductibility of interest and other financial payments. In co-ordination with this work, the work under Action 9 of the BEPS Action Plan is intended to consider whether these behaviours have any transfer pricing implications and, as necessary, identify mechanisms to address those implications.

(iii) Counter harmful tax practices more efficiently (Action 5)⁶³

Many countries have preferential tax regimes for certain income arising from the exploitation of Internet Protocol. In the view of the OECD, the work in the context of Action 5 should examine these regimes in order to determine whether they constitute harmful preferential tax regimes.

(iv) Assure that transfer pricing outcomes are in line with value creation (Actions 8-10)⁶⁴

The BEPS work on transfer pricing is intended to align the allocation of income within a multinational group with the jurisdiction where the economic activity that gives rise to that income is performed. In relation to the digital economy, work in this area should consider the implications of the increased integration of multinational enterprises and the spread of global value chains in terms of which various stages of production are spread across multiple countries.

Companies in the digital economy rely heavily on intangibles in creating value and producing income and a key feature of many BEPS structures involves the transfer of intangibles or rights to intangibles to group companies in low tax jurisdictions. It is then

⁶³ *Id* p. 116; The report on Action 5 was released together with the report on Action 1 during September 2014 - see OECD 2014, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, DOI: <http://dx.doi.org/10.1787/9789264218970-en>.

⁶⁴ See OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, pp. 116-119; The report on Action 8 "Guidance on transfer pricing aspects of intangibles" was released together with the report on Action 1 during September 2014 - see OECD 2014, *Guidance on Transfer Pricing Aspects of Intangibles*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, DOI: <http://dx.doi.org/10.1787/9789264219212-en>. A discussion draft was also published during December 2014.

often argued that these contractual allocations, together with legal ownership of intangibles, justify large allocations of income to the entity allocated the risk even if it performs little or no business activity. This can be accomplished by arguing that other entities in the group are contractually insulated from risk so that a low-tax affiliate is entitled to all residual income after compensating other low risk group members for their functions even if this affiliate has no capacity to control the risk.

(c) Measures that will restore taxation in the jurisdiction of the ultimate parent⁶⁵

Taxation in the ultimate residence jurisdiction will be restored in the view of the OECD by strengthening CFC rules (Action 3). Income from digital products and services provided remotely is often not subject to current taxation under CFC rules. In this regard, consideration should be given to CFC rules that target income typically earned in the digital economy, such as income earned from the remote sale of digital goods and services.

VIII CONCLUSION

This chapter illustrated that the digital economy does not generate unique BEPS issues, but that its key features exacerbate BEPS risks. Accordingly, BEPS potentially arises when taxpayers exploit these key features and enter into co-ordinated strategies to reduce or even eliminate their global tax burden.

In the context of this dissertation, the most important key feature of the digital economy identified in Action 1 is the flexibility and mobility that ICT developments are progressively affording to businesses. Due to this, businesses are increasingly able to interact remotely with customers in multiple jurisdictions through digital means with little, or even no, physical presence in those jurisdictions. As a physical presence in a source country is essential to meet the existing PE threshold, entities are increasingly able to derive substantial business profits from jurisdictions in which their customers are located without being liable to tax on such profits in those jurisdictions as they do not meet the requisite PE threshold. When this is combined with certain strategies (as discussed in this chapter) so that the business profits derived in the source country go

⁶⁵ See OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, pp. 119-120.

untaxed anywhere or is subjected to unduly low taxation, BEPS concerns arise on a global scale.

Accordingly, it is submitted that the application of the existing PE concept in the digitalised economy exacerbates BEPS risks. It is interesting that Action 1 does not consider whether the OECD's approach in extending the PE concept to include servers gives rise to BEPS. It is, however, submitted that this approach indeed exacerbates BEPS risks due to the mobile and flexible nature of servers which give rise to various tax planning opportunities for taxpayers (as discussed in the previous chapter).

The conclusion reached in this chapter supports the author's view expressed in the previous chapter that the existing PE concept is no longer coping with increasingly sophisticated ICT developments that are progressively negating physical presence requirements. Accordingly, it is submitted that the existing PE concept no longer appropriately aligns taxing rights with value creation.

CHAPTER 5

APPROPRIATENESS OF THE PE CONCEPT IN THE DIGITALISED ECONOMY: OECD VIEW

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I INTRODUCTION

Action 1 of the BEPS Action Plan is twofold. Firstly, it addresses concerns that the digital economy is giving rise to BEPS (which has been discussed in the previous chapter), and secondly, it addresses tax policy concerns raised by the digital economy. In this regard, there is a widespread concern that the current international tax rules have not kept pace with the manner in which businesses operate in the 21st century. Indeed, the OECD has acknowledged that developments brought about by the digital economy are placing increased pressure on well-established international tax principles, such as the PE concept.¹

The tax policy concerns brought about by the digital economy, as identified in Action 1, will be considered in this chapter as well as the OECD's proposed solutions to address these concerns. Based on this, it will be considered whether the OECD still maintains the view that the existing PE concept can adequately tax business profits derived in the digitalised economy.

II TAX POLICY CONCERNS RAISED BY THE DIGITAL ECONOMY

As illustrated in previous chapters, ICT developments have significantly evolved the manner in which conventional businesses carry out their activities and have also given rise to a number of new business models which are not based on conventional business models. Action 1 recognises this and acknowledges that businesses are operating in a fundamentally different manner today than in the era when international tax rules were designed.²

This has led to tax policy concerns as to whether the current international tax framework remains appropriate to fairly allocate taxing rights where economic activities occur, and hence, where value is created for tax purposes.³ In this regard, Action 1 identifies particular tax policy concerns which the digital economy raises and divides

¹ OECD 2013, *Addressing Base Erosion and Profit Shifting*, p. 35.

² OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, p. 124.

³ *Id* p. 17.

these concerns into three broad categories, namely, nexus, data and characterisation,⁴ although the challenges raised under each category may overlap with one another.⁵

(a) Nexus⁶

(i) The digital economy enables non-resident enterprises to participate in the economic life of a source country without establishing a physical presence

Technology developments have impacted the manner in which businesses conduct cross-border activities in such a way that a physical presence is no longer necessarily required in order to conduct sales of goods and services in a country. This is achieved, for example, by the enhanced ability of businesses to carry out activities remotely, by replacing personnel with automated equipment, and by implementing sophisticated software programmes with decision-making capabilities.⁷ This reduced reliance on a physical presence is raising concerns as to whether the existing PE concept remains an appropriate mechanism to determine a tax nexus with a source country.⁸

Technology developments now also enable customers and users to enter into on-going relationships with service providers which extend beyond the point of sale.⁹ Such relationships generate network effects that can increase the value of a particular business to other potential customers or users.¹⁰ For example, in the case of a retail business operated via a website that provides a platform for customers to review and tag products, the interactions of those customers with the website can increase the value of the website to other customers by enabling them to make more informed choices about products and to find products more relevant to their interests.¹¹ In addition, where users of a participative networked platform contribute user created content the value of the platform to existing users is enhanced as new users join and contribute.

⁴ See *Id* p. 125.

⁵ See *Id* p. 126.

⁶ See *Id* pp. 127-129.

⁷ *Id* p. 127.

⁸ *Id* pp. 17 and 128.

⁹ *Id* p. 128.

¹⁰ *Ibid.*

¹¹ *Ibid.*

Concerns are being raised that the changing nature of customer/ user and service provider interactions allow greater participation in the economic life of countries by non-resident enterprises without those enterprises establishing a physical presence in such countries.¹² Similarly, this raises the question whether the existing PE concept, which relies on physical presence requirements, remains appropriate to determine jurisdictional nexus for tax purposes.¹³

The OECD also notes in action 1 that the issue of nexus raised by the digital economy extends beyond the PE concept in tax treaties and also relates to domestic rules for the taxation of non-resident enterprises. This is due to the fact that many jurisdictions will not, in terms of their domestic tax laws, tax income derived by a non-resident enterprise within its jurisdiction from remote sales to customers located in its jurisdiction unless that enterprise maintains some degree of physical presence in its jurisdiction.¹⁴

(ii) Activities which were previously considered preparatory or auxiliary in nature are becoming significant components of the digital economy

The existing PE concept exempts certain activities that are regarded preparatory or auxiliary in nature from establishing a PE (these activities are listed in Article 5(4) of the OECD MTC). The changing manner in which businesses operate in the digital economy, however, raises concerns whether these activities which are considered to be preparatory or auxiliary in nature under conventional business models are increasingly becoming significant components of businesses in the digital economy.¹⁵ For example, proximity to customers and the need for quick delivery to clients may be key components of the business model of an online seller of physical goods, and as a result, the maintenance of a local warehouse constitutes a core activity of that seller (where traditionally it would constitute a preparatory or auxiliary activity).¹⁶ The concern in this regard is that certain businesses in the digital economy are inappropriately benefitting from the exemptions to the PE rule contained in Article 5(4).

¹² *Id* pp. 128-129.

¹³ *Ibid.*

¹⁴ *Id* p. 129.

¹⁵ *Ibid.*

¹⁶ *Ibid.*

(b) Data¹⁷

Information technologies have enabled companies to collect and use data to a significant degree.¹⁸ In the digital economy particularly, data gathered from various sources are often a primary input in value creation.¹⁹ Accordingly, concerns arise as to the attribution of value created from the generation of data through digital products and services and whether remote collection of data should give rise to nexus in the absence of a physical presence for tax purposes.²⁰ In addition, concerns arise on how to characterise, for tax purposes, the supply of data by a person in a transaction.²¹

(c) Characterisation²²

Concerns arise in relation to the characterisation of payments made in the digital economy. For example, in a tax treaty context, if a payment to a non-resident enterprise is classified as business profits it would only be taxable in the source country to the extent that it is attributable to a PE of the non-resident in that source country, however, if it is classified as other types of income such as royalties, it may be subject to withholding tax in the source country without the need to first be attributable to a PE.²³ Therefore, the characterisation of a payment may impact the allocation of taxing rights in a tax treaty context.²⁴

III POTENTIAL OPTIONS TO ADDRESS THE TAX POLICY CONCERNS RAISED BY THE DIGITAL ECONOMY

The OECD has acknowledged that the abovementioned concerns are not unwarranted, and as a result, it has set out the following potential solutions to address these concerns.²⁵

¹⁷ See *Id* pp. 129-132.

¹⁸ *Id* p. 125.

¹⁹ *Id* p. 130.

²⁰ *Id* p.18.

²¹ *Ibid.*

²² See *Id* pp. 132-133.

²³ *Ibid.*

²⁴ *Id* p. 133.

²⁵ See *Id* pp. 141-147.

(a) Modifications to the existing PE concept²⁶

Various alternatives are proposed to modify the existing PE concept to cater for the tax policy concerns brought about by the digital economy. This includes updating or removing the list of exemptions to the PE rule contained in Article 5(4) of the OECD MTC, introducing a new nexus rule specifically for the digital economy, and replacing the existing PE concept with a "significant presence" concept.

(i) Modifying or removing the list of exemptions to the PE definition²⁷

Modifications to Article 5(4) of the OECD MTC may be necessary where the listed activities that are regarded preparatory and auxiliary in relation to conventional business models have become core functions of businesses in the digital economy. Alternatively, the article could be eliminated in its entirety.

(ii) Introducing a new nexus rule for enterprises that require a minimal physical presence in the market jurisdiction for the performance of their core activities²⁸

Another option is to introduce a new nexus rule for enterprises that require minimal physical elements in the market jurisdiction for the performance of their core activities, regardless of the fact that physical elements such as offices, buildings or personnel may be present in the market jurisdiction to conduct secondary functions.²⁹ The proposal in this regard is to deem an enterprise engaged in "*fully dematerialised digital activities*" to have a taxable presence in another country if it maintains a "*significant digital presence*" in that country.³⁰

Action 1 sets out the following potential elements of a test to determine when a "*fully dematerialised digital activity*" has been concluded:³¹

²⁶ See *Id* pp. 143-146. Work under Action 7 of the BEPS Action Plan (Artificial avoidance of a PE) has commenced and proposes modifications to the existing PE concept. A revised discussion draft on Action 7 is currently in circulation - see OECD 2015, *Preventing the artificial avoidance of PE Status*, Revised Discussion Draft, available at: <http://www.oecd.org/tax/treaties/revised-discussion-draft-action-7-prevent-artificial-avoidance-pe-status.htm> (last accessed 30 August 2015).

²⁷ *Id* p. 143.

²⁸ See *Id* pp. 143-145.

²⁹ *Id* p. 144.

³⁰ *Id* pp. 143-144.

³¹ *Id* p. 144.

- a. the core business of the enterprise relies completely or in a considerable part on digital goods or digital services;
- b. no physical elements or activities are involved in the actual creation of the goods or of the services and their delivery other than the existence, use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialisation of location-relevant data;
- c. contracts are generally concluded remotely via the Internet or by telephone;
- d. payments are made solely through credit cards or other means of electronic payments using on-line forms or platforms linked or integrated to the relative websites;
- e. websites are the only means used to enter into a relationship with the enterprise, no physical stores or agencies exist for the performance of the core activities other than offices located in the parent company or operating company countries;
- f. all or the vast majority of profits are attributable to the provision of digital goods or services;
- g. the legal or tax residence and the physical location of the vendor are disregarded by the customer and do not influence its choices; and/ or
- h. the actual use of the digital good or the performance of the digital service do not require physical presence or the involvement of a physical product other than the use of a computer, mobile devices or other IT tools.

Furthermore, Action 1 notes that for an enterprise engaged in a "*fully dematerialised business*" a "*significant physical presence*" could be deemed to exist in a country when for example:³²

- a. a significant number of contracts for the provision of fully dematerialised digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country;
- b. digital goods or services of the enterprise are widely used or consumed in the country;

³² *Id* p. 145.

- c. substantial payments are made from clients in the country to the enterprise in connection with contractual obligations arising from the provision of digital goods or services as part of the enterprise's core business; and/ or
- d. an existing branch of the enterprise in the country offers secondary functions such as marketing and consulting functions targeted at clients resident in the country that are strongly related to the core business of the enterprise.

To address administrative concerns in relation to businesses that perform "*dematerialised digital activities*" in a market country, such businesses would only be deemed to have a PE in a market country if they exceeded certain thresholds which would indicate a substantial on-going interaction with such market country.³³ These thresholds could, for example, be measured on the basis of the total contracts concluded remotely or the number of users or visitors to a website.

Action 1 also notes that in order to address concerns that the existing tax rules do not adequately address the challenges posed by increased reliance on data and users participation in the digital economy, a variation to this potential option was also considered where an entity does significant business in the country using personal data obtained by regular and systematic monitoring of Internet users in that country.³⁴ Action 1, however, does not expand upon this variation.

(iii) Replacing the existing PE concept with a "significant presence" test³⁵

In order to respond to the on-going nature of customer and user relationships with service providers in the digital economy, another proposed option is to replace the existing PE concept with a "significant presence test", whilst continuing to rely partly on physical presence. The criteria for this test intend to reflect the value contributed to the business by interactive customer/ user relationships and would include:

- a. relationships with customers or users extending over six months, combined with some physical presence in the country, directly or via a dependent agent;
- b. sale of goods or services by means involving a close relationship with customers in the country, including (i) through a website in the local language, (ii) offering

³³ *Ibid.*

³⁴ *Ibid.*

³⁵ *Id* p. 146.

delivery from suppliers in the jurisdiction, (iii) using banking and other facilities from suppliers in the country, or (iv) offering goods or services sourced from suppliers in the country; and/ or

- c. supplying goods or services to customers in the country resulting from or involving systematic data-gathering or contributions of content from persons in the country.

(b) Imposing a withholding tax on digital transactions³⁶

Due to the existing PE concept's reliance on a physical presence, it is proposed to rather impose a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a non-resident. To relieve the administration burden on consumers, the withholding obligation can be imposed on the financial institutions involved with those payments. Alternatively, such a withholding tax could be used as a primary enforcement tool for one of the new nexus standards described above. If such an approach were taken, taxpayers providing digital goods and services covered by the withholding tax could file returns in order to ensure that they are ultimately taxed on a net basis.

(c) Introducing a bandwidth or "bit tax"³⁷

Another potential option would be to impose tax on websites' bandwidth use. This will entail taxing the number of bytes used by the website, although in order to introduce an element of progressivity, different tax levels would apply depending on the enterprise's size or turnover. In order to maintain equity between digital businesses and traditional businesses the bandwidth tax should be creditable against corporate income tax.

IV INITIAL EVALUATION BY THE OECD OF THE POTENTIAL OPTIONS

For the purposes of evaluating the abovementioned potential options to address the broader tax challenges raised by the digital economy, the OECD agreed on a framework based on the overarching tax principles of neutrality, efficiency, certainty, simplicity, effectiveness and fairness, flexibility and sustainability.³⁸ Action 1 notes that

³⁶ *Ibid.*

³⁷ *Id* pp. 146-147.

³⁸ See *Id* pp. 149-151.

the purpose of evaluating the potential options against this framework is to ensure that the analysis can be done consistently and objectively.³⁹

Notwithstanding this, Action 1 does not apply the framework against the potential options set out in the report, and notes that it would be premature to do so as the work under the BEPS Project has the potential to affect the scope of several of the broader tax challenges raised by the digital economy and is expected to result in substantial changes to existing international tax rules.⁴⁰ In this regard, the OECD acknowledges that the work on Action 1 will be impacted by work on *inter alia* Action 7 which will propose changes to the existing PE concept.

Rather, the OECD recommends that additional work to develop and evaluate potential options to address the broader tax challenges raised by the digital economy should be carried out alongside the work being done in relation to the rest of the BEPS Action Plan.⁴¹ In particular, Action 1 lists specific further work that needs to be undertaken in relation to the options to create or modify standards for nexus⁴² as well as the proposed withholding tax on digital goods and services,⁴³ and notes that work in this regard should be completed by 2015.⁴⁴ Action 1 notes that this work coupled with outcomes of the BEPS Project will allow the OECD to take an informed decision on the relevance, urgency, and scope of the broader tax challenges raised by the digital economy and the potential options to address them.⁴⁵

Accordingly, Action 1 concludes that because all the potential options under consideration to address the broader tax challenges raised by the digital economy requires additional discussion or the completion of additional work in order to permit full evaluation, neither final evaluation nor adoption of any of the options will be made at this point in time.⁴⁶

³⁹ *Id* p. 149.

⁴⁰ *Id* p. 151.

⁴¹ *Ibid.*

⁴² *Id* p. 153.

⁴³ *Id* p. 154.

⁴⁴ As at 30 September 2015, the OECD had not yet released any publications in this regard.

⁴⁵ OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, p. 154.

⁴⁶ *Id* p. 152.

V BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS

After the publication of Action 1 and during May 2015 the OECD published a revised discussion draft on Action 7⁴⁷ ("**Action 7**").⁴⁸ Action 7 proposes updates to Article 5 of the OECD MTC and its Commentary in order to *inter alia* counteract (a) the artificial avoidance of PE status through commissionaire arrangements and similar strategies, and (b) the artificial avoidance of PE status through the specific activity exemptions.⁴⁹

(a) Artificial avoidance of PE status through commissionaire arrangements and similar strategies⁵⁰

A commissionaire arrangement is defined in Action 7 as being:⁵¹

An arrangement through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products. Through such an arrangement, a foreign enterprise is able to sell its products in a State without having a permanent establishment to which such sales may be attributed for tax purposes; since the person that concludes the sales does not own the products that it sells, it cannot be taxed on the profits derived from such sales and may only be taxed on the remuneration that it receives for its services (usually a commission).

Accordingly, a commissionaire is typically an agent who concludes contracts in his own name, but on behalf of a principal. For tax purposes, the commissionaire is treated

⁴⁷ OECD 2015, *Preventing the artificial avoidance of PE Status*, Revised Discussion Draft, available at: <http://www.oecd.org/tax/treaties/revised-discussion-draft-action-7-prevent-artificial-avoidance-pe-status.htm> (last accessed 30 August 2015).

⁴⁸ The final report on Action 7 was published during October 2015, however, as noted previously this does not form part of the scope of this dissertation as this dissertation only deals with publications up until 30 September 2015.

⁴⁹ The revised discussion draft on Action 7 also deals with the splitting-up of contracts to circumvent the creation of a PE under Article 5(3) of the OECD MTC which provides that a building site, construction or instillation project will constitute a PE only if it lasts more than twelve months. This is, however, not relevant for the purposes of this dissertation and the proposals in this regard are therefore not discussed.

⁵⁰ See OECD 2015, *Preventing the artificial avoidance of PE Status*, Revised Discussion Draft, Section A, pp. 13-21 for the proposed amendments to Article 5(5) and Article 5(6) of the OECD MTC as well as the related Commentary.

⁵¹ *Id* p. 10.

similar to an independent agent who does not constitute a PE for the principal. This has been confirmed by numerous court rulings in various jurisdictions.⁵²

Action 7 notes that, as a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business.⁵³ Accordingly, Action 7 proposes changes to Article 5(5) and Article 5(6) of the OECD MTC to reflect this policy.

Broadly, it is proposed that the scope of Article 5(5) (Dependent Agent PE) be widened from an agent who habitually exercises an authority to conclude contracts in the name of the enterprise to an agent that habitually concludes contracts, or negotiates the material elements of contracts, that are: (a) in the name of the enterprise, or (b) for the transfer of ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or (c) for the provision of services by that enterprise.⁵⁴ In addition, it is proposed that the independent agent exclusion in Article 5(6) be narrowed to exclude an independent agent that acts exclusively or almost exclusively on behalf of one or more enterprises to which it is connected.⁵⁵

Action 7 also includes related amended Commentary, which has some helpful guidance on the OECD's views on how to interpret the proposed amendments to Article 5(5) and Article 5(6).

(b) Artificial avoidance of PE status through the specific activity exemptions⁵⁶

Article 5(4) of the OECD MTC includes several specific exemptions from the PE definition. It is proposed that Article 5(4) be modified to make it clear that each of the

⁵² See for example the French Supreme Court decision in *Zimmer Limited*, Conseil d'État N 304715, and that of the Borgarting Court of Appeals in *Dell Products v. Staten v/Skatt øst*, Case HR-2011-02245-A.

⁵³ OECD 2015, *Preventing the artificial avoidance of PE Status*, Revised Discussion Draft, p. 11.

⁵⁴ *Id* p. 13.

⁵⁵ *Ibid*. A person will be "connected" to an enterprise for purposes of Article 5(6) *inter alia* if it holds at least 50% of the beneficial interest in the other, or in the case of a company, at least 50% of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company. In any case, a person shall be considered to be connected to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises.

⁵⁶ See *Id* pp. 21-33.

exemptions is restricted to activities that are of a "preparatory or auxiliary" character.⁵⁷ In addition, it is proposed that additional Commentary be added to Article 5(4) in order to provide guidance on the meaning of the phrase "preparatory or auxiliary".⁵⁸

Furthermore, it is proposed that Article 5(4) be modified to include an anti-fragmentation rule in order to provide for the situation where cohesive business activities are fragmented between related parties in order to improperly benefit from the exemptions contained in Article 5(4).⁵⁹ The proposal in this regard is to view the activities of related parties in combination, rather than in isolation, when determining whether the "preparatory and auxiliary" threshold is exceeded.

VI CONCLUSION

From the above, it is clear that the OECD agrees that international tax rules have not kept pace with the manner in which businesses operate in the 21st century, especially in the realm of the digital economy, and that certain amendments are required to realign the international tax rules with economic realities.

Importantly, the OECD acknowledges in Action 1 that the digital economy is challenging the existing PE concept and related profit attribution rules. To address this, the OECD has proposed modifications to the existing PE concept to a minor and more fundamental extent, ranging from modifying the list of exemptions to introducing a new nexus rule specifically for the digital economy. In addition, other alternatives to the PE concept are also being proposed such as imposing a withholding tax on digital goods and services or introducing a bandwidth tax. The OECD has, however, refrained from evaluating these options until the finalisation of the BEPS Project as it expects the outcomes of the project to result in substantial changes to existing international tax rules.

Notwithstanding this, by virtue of proposing these solutions it seems that the OECD is no longer convinced of its prior view that the existing PE concept has the ability to adequately tax business profits derived in the digitalised economy. Consequently, the OECD's work on Action 7, which proposes amendments to the existing PE concept, was considered in an attempt to establish the OECD's view in this regard.

⁵⁷ See *Id* Section B(1), pp. 21-30.

⁵⁸ *Ibid.*

⁵⁹ See *Id* Section B(2), pp. 30-33.

In considering the revised discussion draft on Action 7, it is noted that the OECD has incorporated one of the more conservative options proposed in Action 1 to address the tax policy concerns brought about by the digital economy, namely, modifying the PE concept by making modifications to the list of exemptions in Article 5(4). The amendments in this regard merely reaffirm the understanding that has been accepted widely, namely, that the exemptions afforded in Article 5(4) are only available to activities which are preparatory or auxiliary in nature. In addition, an anti-fragmentation rule is introduced to prevent taxpayers from artificially fragmenting their activities in order to make use of the listed exemptions. The revised discussion draft on Action 7 also proposes amendments to Article 5(5) and Article 5(6) of the OECD MTC so as to widen the scope of the Agency PE in order to ensure that commissionaire and related arrangements cannot circumvent the Agency PE threshold.

The revised discussion draft on Action 7, therefore, does not introduce any of the more radical proposals in Action 1 to provide for the digital economy, such as the introduction of a new nexus rule. Accordingly, it is submitted that the proposed amendments to the existing PE concept set out in the revised discussion draft on Action 7 do not depart fundamentally from the existing PE concept, but merely strengthen the existing PE concept by expanding the concept to cater for strategies that artificially avoid the establishment of a PE under the existing rules. Therefore, the proposed amendments to the existing PE concept in Action 7 do not in any way alter the fundamental underlying principles of the concept, but arguably merely introduce anti-avoidance measures when the existing concept is applied.

Accordingly, based on the contents of the revised discussion draft on Action 7 it seems that the OECD still deems the existing PE concept appropriate to effectively tax business profits derived in the digitalised economy, provided minor conservative modifications are made. If these proposed modifications are adopted (which is expected) the OECD is at least acknowledging that ICT developments are having a significant impact on the way that businesses operate so as to warrant changes to Article 5 itself and not merely to the Commentary. On this basis it is submitted that the OECD is gradually accepting what is being advocated by this dissertation, namely, that technology advances in the digital economy is not merely the natural evolution of business, but is in fact revolutionising the way in which enterprises conduct their businesses. It is submitted that the OECD will not at this time, however, readily embrace more far reaching solutions to address the tax policy concerns raised by the

digital economy, especially the question whether the existing PE concept remains an appropriate tax nexus rule to allocate taxing rights on business profits derived in the digitalised economy.

CHAPTER 6

ANALYSIS OF UNILATERAL LEGISLATIVE ACTIONS TAKEN IN THE MIDST OF THE BEPS PROJECT SPECIFICALLY IN RELATION TO THE ARTIFICIAL AVOIDANCE OF PEs

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I INTRODUCTION

After the OECD released its BEPS Report and the BEPS Action Plan, many countries, including South Africa, compiled their own BEPS reports which considered the applicability of the aforementioned work in relation to their jurisdictions.

From the outset the OECD has held that it is critical for the success of the BEPS Project that governments reach consensus on actions to deal with BEPS as failure to do so could result in the replacement of the current consensus-based framework by unilateral measures which could lead to global tax chaos marked by the massive re-emergence of double taxation. The BEPS Report, in particular, strongly discourages unilateral and uncoordinated actions by governments in an attempt to address BEPS.

For the most part countries have refrained from taking unilateral actions until the finalisation of the BEPS Project, however, some countries have indeed implemented unilateral measures in the midst of the BEPS Project. The UK and Australia have been at the forefront in this regard and are attempting to position themselves as leaders in combatting BEPS. Joe Hockey, Australia's Treasurer has, for example, announced that Australia and the UK want to go "*further and faster*" than the OECD by stating that:¹

While we recognise that the OECD is undertaking work which Australia initiated and promoted last year, we obviously want to go further and faster. So, the chancellor of the exchequer, George Osborne, and myself have announced that Australia and the UK will work together to drive global agenda, going after multinationals that are shifting profits away from the countries where they earn the income.

Accordingly, the BEPS reports of the UK and Australia will be considered in this chapter, as well as South Africa's report. More importantly, the unilateral legislative measures introduced by the UK and Australia to address BEPS will be considered in this chapter, as these measures specifically target the artificial avoidance of a PE, which is the subject matter of Action 7. In this regard, it will be considered whether these measures are inconsistent with the proposals of Action 7 (as discussed in the previous chapter), and therefore, whether it could potentially undermine the BEPS Project.

¹ See article featured in *International Tax Review* on 27 April 2015 available at: <http://www.internationaltaxreview.com/Article/3448729/Australia-and-UK-want-to-go-further-and-faster-than-the-OECD-on-diverted-profits-action.html> (last accessed 24 August 2015).

II COUNTRY SPECIFIC BEPS REPORTS

(a) South Africa

During December 2014, the Davis Tax Committee released its interim report on BEPS ("**DTC Report**"),² including individual interim reports on the 2014 deliverables. In relation to South Africa taking unilateral action in the midst of the BEPS Project, the DTC Report notes as follows:³

The unilateral introduction of domestic legislation in anticipation of global reforms could result in a less investor friendly tax environment and may place South Africa at a disadvantage compared to other jurisdictions without BEPS legislation in attracting much needed foreign direct investment.

Accordingly, the DTC Report recommends that South Africa should not pre-empt or unilaterally respond to the BEPS action points until OECD member states have reached consensus on measures to address BEPS and clear guidance has been issued in this regard.⁴

The Davis Tax Committee's interim report on Action 1⁵ ("**SA Report**"), however, recommends the enactment of *inter alia* new source rules that deal specifically with the taxation of the digital economy.⁶ In this regard, it is recommended that the current scope of the source rules under section 9 of the Income Tax Act, 1962 be expanded to include rules that cover proceeds derived from the supply of digital goods and services derived from a source in South Africa, the source being where consumption takes place.⁷ Furthermore, it is recommended that these rules also clarify the characterisation of the typical income flows from digital transactions.⁸ The SA Report notes that the

² Davis Tax Committee Interim Report, *Addressing Base Erosion and Profit Shifting in South Africa* (2014), accessible at: <http://www.taxcom.org.za/library.html> (last accessed 30 August 2015).

³ *Id* p. 27.

⁴ *Ibid*.

⁵ Davis Tax Committee Interim Report, *Addressing Base Erosion and Profit Shifting in South Africa, Action 1: Address the Challenges of the Digital Economy* (2014), accessible at: <http://www.taxcom.org.za/library.html> (last accessed 30 August 2015).

⁶ *Id* p. 28.

⁷ *Ibid*.

⁸ *Ibid*.

enactment of such rules would establish the basis from which South Africa can apply the OECD recommendations on the taxation of the digital economy.⁹

From an administration point of view, the SA Report recommends that rules be enacted requiring non-resident companies with South Africa sourced income (excluding certain passive income) to submit income tax returns, even if they do not have a PE in South Africa.¹⁰ To ensure that such non-residents register with SARS, it is further recommended that a system be created that imposes an obligation on a resident that transacts with a non-resident to withhold tax on any payment to a non-resident otherwise they would be penalised.¹¹ It is submitted that this will greatly increase the compliance burden on both resident and non-resident taxpayers.

In relation to the appropriateness of the PE threshold in the digital economy, the SA Report notes that the challenges South Africa faces in respect of the taxation of the digital economy are of an international nature, and therefore, it is recommended that South Africa awaits the outcomes of the OECD's on-going work on the PE threshold.¹² In addition, it is noted that South Africa should not take a unilateral approach to rework the PE rules, and that it is best to address the matter in a multilateral co-ordinated manner.¹³

The DTC Report and SA Report are, however, only interim reports and therefore, the recommendations contained therein are not yet finalised. Furthermore, South Africa has not yet implemented any specific legislation targeting BEPS, particularly in relation to Action 1 and Action 7.

(b) United Kingdom

In March 2014, a joint report was published by the UK Treasury and HMRC entitled: "*Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for counteracting Base Erosion and Profit Shifting*" ("**UK Report**").¹⁴

⁹ *Ibid.*

¹⁰ *Id* p. 28.

¹¹ *Ibid.*

¹² *Id* p. 27.

¹³ *Ibid.*

¹⁴ HM Treasury and HM Revenue & Customs, *Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for counteracting Base Erosion and Profit Shifting* (2014), accessible at: <https://www.gov.uk/government/publications/tackling-aggressive-tax-planning-in-the>

Specifically on Action 1, the UK Report notes that the digitisation of the economy is challenging the way that international tax rules are applied and that there is a need to seriously consider revising the PE concept in order to take account of technological advances.¹⁵ In this regard, the UK Report notes that these challenges should adequately be addressed by the OECD's work on updating the threshold at which a company becomes taxable in a foreign country as well as updating transfer pricing guidelines to take into account technological advances.¹⁶ However, the UK Report also notes that if progress on updating the existing international framework fails to materialise, the UK will propose supplementary rules to tackle specific issues raised by digitisation.¹⁷

In relation to Action 7, the UK Report notes that the UK fully supports the OECD's work to re-examine and update the international rules governing the threshold at which a company becomes taxable in a foreign country, as well as the work to prevent businesses from artificially fragmenting their operations to avoid breaching this threshold. The UK Report emphasises that this work needs to take into account technological advances, modern business practices and the particular needs of small businesses.¹⁸

Apart from considering the various actions of the BEPS Action Plan, the UK Report does not propose specific unilateral measures by the UK to address BEPS in relation to Action 1 or Action 7. Indeed, the UK Report notes that the UK government recognises the importance of a multilateral approach to tackle BEPS, and that it is committed to consider negotiations to achieve a fair and consistent framework of international rules.¹⁹ Furthermore, it states that acting unilaterally will not only be ineffective, but also counterproductive.²⁰ Bearing these comments in mind and the UK's commitment to the BEPS Project, it is surprising that within a year of releasing the UK Report the UK enacted unilateral legislation aimed at combating BEPS, well before the completion of the BEPS Project (discussed below).

global-economy-uk-priorities-for-the-g20-oecd-project-for-counteracting-base-erosion-and-profit-shifting (last accessed 24 August 2015).

¹⁵ *Id* p. 16, paragraph 2.6.

¹⁶ *Id* p. 17.

¹⁷ *Ibid*.

¹⁸ *Id* p. 29.

¹⁹ *Id* p. 39, paragraph 5.2.

²⁰ *Id* p. 4.

(c) **Australia**

During July 2013 the Australian Treasury issued a scoping paper on the risks to the sustainability of Australia's corporate tax base ("**Aus Report**").²¹

The Aus Report considers the OECD Action Plan and recommends that Australia endorses it. In relation to the artificial avoidance of a PE, the Aus Report notes that the PE rules need to be modified to ensure that an appropriate share of tax revenues between jurisdictions is achieved in the changing environment and to prevent the artificial avoidance of PE.²² The Aus Report suggests that one option to explore in this regard is whether a better balance can be achieved by changing the rules so that they rely on the level of economic activity rather than on a physical presence.²³ Apart from this, the Aus Report does not propose any specific unilateral measures to be introduced by Australia in order to combat BEPS strategies.

Furthermore, the Aus Report notes that the underlying drivers of corporate tax base erosion are international in nature and beyond the scope of any one country to resolve, and therefore, addressing the threat posed to the corporate tax bases of countries from base erosion and profit shifting will inevitably require effective multilateral action.²⁴ It is also noted that an effective strategy of international engagement on BEPS will be critical to achieving an improved international tax framework and avoiding outcomes that are inconsistent with Australia's national interest.²⁵ Notwithstanding these comments, similar to the UK, Australia has implemented unilateral legislation aimed at combatting BEPS prior to the finalisation of the BEPS Project (discussed below).

III **UNILATERAL ANTI-BEPS MEASURES**

(a) **United Kingdom: Diverted Profits Tax**

On 1 April 2015 the UK enacted a new tax called the Diverted Profits Tax ("**DPT**") for purposes of counteracting aggressive tax planning techniques used by multinational enterprises to divert profits from the UK to other jurisdictions and to prevent the erosion

²¹ Australia Treasury, *Scoping paper on the risks to the sustainability of Australia's corporate tax base* (2014), accessible at: <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Aus-Corporate-Tax-Base-Sustainability> (last accessed 29 August 2015).

²² *Id* p. 38, paragraph 172.

²³ *Ibid*.

²⁴ *Id* p. 41, paragraph 184.

²⁵ *Id* p. 41, paragraph 185.

of the UK tax base.²⁶ The legislation is in response to the perception that large companies are generating significant profits from the UK, but paying very little UK tax.²⁷ DPT has been described as the "Google Tax" since the type of tax planning principally targeted has been mostly used by technology and web-based businesses, however, it has a much wider scope and applies to all types of businesses that meet the relevant conditions.²⁸

Broadly, and subject to various conditions and exemptions,²⁹ DPT targets the following specific situations:³⁰

- (i) *The avoidance of a PE in the UK.*³¹ This is aimed at the situation where a person (whether a UK resident or not) carries on activities in the UK in connection with the supply of goods, services or other property by a foreign company, and it is reasonable to assume that the activity is designed to ensure that such foreign company does not create a PE in the UK and that the purpose of the arrangement is either to wholly or mainly avoid UK tax³² or to secure a tax mismatch³³ where the arrangement has insufficient economic substance³⁴, such that the total tax derived from UK activities is significantly reduced; or

²⁶ See the guidance document published by HM Revenue & Customs on Diverted Profits Tax, pp. 3-4, available at: <https://www.gov.uk/government/publications/diverted-profits-tax-guidance> (last accessed 24 August 2015).

²⁷ See http://www.eversheds.com/global/en/what/articles/index.page?ArticleID=en/Tax_planning_and_consultancy/Diverted-Profits-Tax-QA#1 (last accessed 24 August 2015).

²⁸ *Ibid.*

²⁹ DPT will, for example, not apply to an arrangement if both persons involved in the relevant arrangement are small or medium sized enterprises, or where the arrangement gives rise to a loan relationship solely.

³⁰ Refer to guidance document published by HM Revenue & Customs on Diverted Profits Tax, Chapter 1 and Chapter 2.

³¹ An exemption applies in this regard where the UK-related sales are less than £10 million in any 12 month accounting period or the UK-related expenses are under £1 million, or where the person who operates in the UK (and prevents the non-UK person from having a UK PE) is an agent of independent status that is not connected with the non-UK person.

³² The main purpose test would be met where (for example) the arrangement would not have been carried out at all were it not for the anticipated tax advantage or any non-tax objective was secondary to the tax advantage.

³³ A tax mismatch will broadly exist where the UK tax reduction derived from the arrangements by one party exceeds any increase in tax payable by the other relevant party to the arrangements, and the tax payable by the other party is less than 80% of UK tax reduction derived by the first party.

³⁴ Broadly, arrangements will have insufficient economic substance where either (i) it is reasonable to assume that the transaction was designed to secure the tax reduction and the non-tax benefits of the transaction do not exceed the financial benefits of the tax reduction; or (ii) it is reasonable to assume that a person that is party to the transaction is involved in order to secure the tax reduction and the

- (ii) *Insufficient economic substance*. This is aimed at the situation where a UK company or a foreign company with a PE in the UK transacts with a connected person with insufficient economic substance in order to exploit tax mismatches³⁵, either through the creation of intra-group expenditure or the diversion of income intra-group where it is reasonable to assume that, in the absence of a tax benefit, the expenditure would not have been incurred or the income would have been within the charge to UK corporation tax.

An example in relation to (i) would be where a foreign company makes sales to UK customers which are generated by the activities of UK based sales and marketing personnel, but the sales/marketing activities undertaken by such personnel are specifically designed not to amount to concluding contacts in the UK. In this regard, it may be reasonable to assume that the activities are designed so as to ensure that the foreign company is not carrying on a trade in the UK through a PE and that the purpose of the arrangement is to avoid UK corporation tax.³⁶

In relation to (ii) an example would be where a UK company transfers intellectual property to a related entity in a low-tax jurisdiction and then pays a tax deductible royalty to such related entity. If the related entity does not have the technical and management capacity to develop, maintain and exploit such intellectual property it may be reasonable to assume that the transfer was only undertaken to secure the tax reduction.³⁷

DPT is levied at a rate of 25%, however, calculating the quantum of taxable diverted profits is relatively complex and largely relies upon transfer pricing principles with the requirement to recharacterise the relevant arrangements in certain instances and to determine the DPT charge with reference to such recharacterised arrangements.³⁸ Put simply, the UK will seek to impose DPT in relation to the situation in (i) on the amount

non-tax benefit of the contribution made to the transaction by that person (in terms of the functions or activities of that person's staff) does not exceed the financial benefit of the tax reduction.

³⁵ Refer to note 33 above for an explanation on what constitutes a "tax mismatch" and note 34 for an explanation on what constitutes "insufficient economic substance".

³⁶ See http://www.eversheds.com/global/en/what/articles/index.page?ArticleID=en/Tax_planning_and_consultancy/Diverted-Profits-Tax-QA#1 (last accessed 24 August 2015); Refer also to Chapter 2 of the guidance document published by HM Revenue & Customs on Diverted Profits Tax for more detailed examples.

³⁷ *Ibid.*

³⁸ See guidance document published by HM Revenue & Customs on Diverted Profits Tax p. 5 and Chapter 2 in general; See also http://www.eversheds.com/global/en/what/articles/index.page?ArticleID=en/Tax_planning_and_consultancy/Diverted-Profits-Tax-QA#1 (last accessed 24 August 2015).

of profits that is just and reasonable to assume would have been chargeable profits of the foreign company attributable to the PE had the avoided PE been an actual PE in the UK (unless subject to recharacterisation), and in relation to (ii), on the amount of profits that would have arisen if the arrangement which gave rise to the tax mismatch had been replaced with one that is just and reasonable to assume would have existed had tax on income not been a relevant consideration at the time.³⁹

DPT is not part of the UK corporate tax self-assessment system and is an assessed tax for which HMRC issues a notice of the DPT charge.⁴⁰ Companies must disclose to HMRC if they are potentially within the scope of DPT within three months of the end of the relevant accounting period, unless it is reasonable for them to conclude that there will be no charge arising in the period.⁴¹ A penalty may apply if the company fails to make the required notification.⁴²

DPT is not UK corporation tax or income tax, and as a result, losses cannot be set-off against DPT.⁴³ Rather, DPT is intended to act as a penal charge to encourage businesses to restructure relevant arrangements such that profits are not diverted from the UK but instead subjected to the lower 20% rate of corporation tax.⁴⁴ However, where a company has paid UK corporation tax or a non-UK tax which corresponds to corporation tax on profits that are also subject to DPT, the UK should allow a credit for those taxes against the DPT liability, to the extent deemed just and reasonable.⁴⁵ Notwithstanding this, HMRC's view is that DPT falls outside the scope of the UK's existing tax treaties (as it is not an income or corporation tax) and therefore relief is not available in terms of any UK tax treaty currently in place.⁴⁶ It is arguable, however, that where any treaty is intended to apply to corporation tax and "other similar taxes", DPT could potentially be covered by the treaty and the UK government may face challenges

³⁹ See guidance document published by HM Revenue & Customs on Diverted Profits Tax pp. 19-21.

⁴⁰ See *Id* Chapter 4 which explains the DPT process in relation to notification, charging and payment.

⁴¹ Refer to *Ibid*, but see specifically *Id* pp. 66-67.

⁴² *Id* p. 67.

⁴³ *Id* p. 75.

⁴⁴ See http://www.eversheds.com/global/en/what/articles/index.page?ArticleID=en/Tax_planning_and_consultancy/Diverted-Profits-Tax-QA#1 (last accessed 24 August 2015).

⁴⁵ See guidance document published by HM Revenue & Customs on Diverted Profits Tax, p. 76.

⁴⁶ See article featured in *Lexology* on 20 April 2015, accessible at: <http://www.lexology.com/library/detail.aspx?g=458138e2-9011-425f-a34b-580752487510> (last accessed 24 August 2015).

from treaty counterparties and taxpayers.⁴⁷ Furthermore, the EU Commission is currently considering DPT and its compatibility with EU law, as there is a concern that DPT may be incompatible with the EU rights of freedom of establishment or the freedom to provide services.⁴⁸

The timing of the introduction by the UK government of DPT as a unilateral measure seems surprising given its strong support for the OECD's BEPS Project and the fact that the project is due to reach finality by the end of this year. Indeed as mentioned above, the BEPS Project strongly discourages unilateral actions by governments and the UK Report itself acknowledged that acting unilaterally will not only be ineffective, but also counterproductive. When prompted for his view in relation to the introduction of DPT by the UK government in the wake of the BEPS Project, the director of the OECD's centre for tax policy and administration, Pascal Saint-Amans, stated that "*it is an embarrassing view*" and that "*unilateral actions are not exactly in the sense of what [the OECD is] trying to develop*".⁴⁹ Notwithstanding their unilateral action, the UK government has indicated that they remain committed to the BEPS Project.⁵⁰

The UK's unilateral action raises concerns that it may encourage further unilateral action by other jurisdictions which will undermine the OECD's initiatives in trying to develop co-ordinated strategies to provide solutions to address BEPS. Indeed, since the introduction of DPT by the UK, Australia has introduced draft legislation to prevent multinationals from diverting profits earned in Australia to low-tax jurisdictions.

(b) Australia: Tax Integrity Multinational Anti-Avoidance Law

After the introduction of DPT by the UK, the Australian government consulted with the UK government and ultimately made a decision that Australia did not have the need to introduce a similar separate tax for purposes of addressing the diversion of profits from

⁴⁷ *Ibid.*

⁴⁸ *Ibid.*

⁴⁹ See article featured in *Tax Journal* on 16 April 2015, accessible at: <http://www.taxjournal.com/tj/articles/oecd-embarrassed-uk-diverted-profit-tax-16042015> (last accessed 24 August 2015).

⁵⁰ See article featured in *Lexology* on 20 April 2015, accessible at: <http://www.lexology.com/library/detail.aspx?g=458138e2-9011-425f-a34b-580752487510> (last accessed 24 August 2015).

Australia.⁵¹ Rather, Australia will simply strengthen their existing anti-avoidance rules by introducing a so-called "Tax Integrity Multinational Anti-avoidance Law" ("**TIMAL**") with effect from 1 January 2016.⁵² The reason for taking this approach is partly that Australia's existing anti-avoidance rules are not overridden by their tax treaties⁵³, and therefore, they believe that there is no argument as to whether or not the treaties could override TIMAL (where in the case of DPT, there is such an argument).

TIMAL is specifically intended to counter the erosion of the Australian tax base by multinational entities using artificial or contrived arrangements to avoid the attribution of business profits to a PE in Australia.⁵⁴ The Australian government has acknowledged that TIMAL will initially look to 30 identified, but unnamed companies.

Broadly, TIMAL will apply to schemes if under or in connection with the scheme the following conditions are met:⁵⁵

- (i) a non-resident entity derives income from the making of a supply of goods or services to unrelated Australian customers, with a related entity in Australia supporting that supply;
- (ii) the non-resident avoids the attribution of the income from the supply to a PE in Australia;
- (iii) it is reasonable to conclude that the division of activities between the non-resident entity, the Australian entity, and any other related parties have been designed so as to ensure that the non-resident entity is not deriving income from making supplies that would be attributable to a PE in Australia; and
- (iv) the relevant taxpayer, who entered into or carried out the scheme, must have done so for the principal purpose or for one of the principal purposes of enabling

⁵¹ See article published in *Tax Journal* on 22 May 2015, accessible at: <http://www.taxjournal.com/tj/articles/australias-answer-diverted-profits-tax-22052015> (last accessed 24 August 2015).

⁵² See Explanatory Material on the Exposure Draft: Tax Laws Amendment (Tax Integrity Multinational Anti-avoidance Law) Bill 2015 at pp. 3-4, accessible at: <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Tax-Integrity-Law> (last accessed 24 August 2015).

⁵³ See <http://www.allens.com.au/pubs/tax/fotax14may15-2.htm> (last accessed 24 August 2015).

⁵⁴ See Explanatory Material on the Exposure Draft p.4.

⁵⁵ *Id* pp. 4-5.

a taxpayer to obtain a tax benefit, or both to obtain a tax benefit and to reduce other tax liabilities under Australian law or under a foreign law.

To reduce compliance costs and provide certainty, the scope of TIMAL is limited as follows.⁵⁶

- (i) it will only apply to non-resident entities that have annual global revenue of over AU\$ 1 billion in the relevant income year in which they sought to obtain a tax benefit under the scheme or to reduce their tax liability; and
- (ii) it will only apply to non-resident entities that are, or have a related entity (or entities) in their corporate structure that are, subject to no corporate tax or a low corporate tax rate (either under the law of a foreign country or through preferential regimes or where it is not subject to corporate income tax in any country), unless:
 - a. the activities of the entity in that jurisdiction, or of each of those entities if there is more than one entity, in a no or low tax jurisdiction are not related directly or indirectly to the Australian supply; or
 - b. the entity or each of the entities in the no or low tax jurisdiction has substantial economic activity in the no or low tax jurisdiction in relation to those Australian supplies relative to the profits subject to no or low corporate tax in that jurisdiction.

Where a scheme is captured by TIMAL, the Commissioner of Taxation has the power to look through the scheme and apply the tax rules as if the non-resident entity had been making a supply through an Australian PE. This includes raising income tax on the business profits from the supply that would have been attributable to an Australian PE and obligations arising (for the relevant taxpayer or another taxpayer) under royalty and interest withholding tax.⁵⁷ The Commissioner will also have the power to cancel tax benefits obtained by the non-resident or other persons in relation to the non-

⁵⁶ *Id* pp. 5-6.

⁵⁷ *Id* p.5.

resident's artificial avoidance of a PE in Australia.⁵⁸ In addition, penalties of up to 100% of the allegedly avoided tax will be imposed together with interest.⁵⁹

Placing TIMAL in context within the OECD BEPS Project, the Explanatory Material to TIMAL notes from the outset that Australia is committed to the BEPS Project, but while the OECD's work in this regard is essential, immediate action is required to ensure that Australia's tax laws are fit to deal with the most "egregious" tax avoidance arrangements.⁶⁰ In particular, in relation to the introduction of TIMAL the Explanatory Material notes as follows:⁶¹

These amendments will ensure that multinational entities cannot use complex, contrived and artificial schemes to escape paying tax. Entities will no longer be able to have significant sales activity here but book their revenue overseas so they can pay little or no tax worldwide...The multinational anti-avoidance law will target the most egregious tax structuring by multinational entities, while limiting the impact on legitimate international business activities, to protect Australia's tax base.

It is interesting that although the Explanatory Material notes that "immediate action is required" by the Australian government, TIMAL is only due to become effective on 1 January 2016, which is after the due date for the finalisation of the BEPS Project. Notwithstanding this, it is unlikely that the Australian government will amend TIMAL on the basis of the conclusions reached in the OECD BEPS Project as the Australian Government has noted that: "*Australia is not waiting for the rest of the world to agree to all fifteen items of the Action Plan and is now taking the next step, consistent with the directions of the G20 and OECD dialogue*". In this regard, Australia has also commenced with implementing four of the key actions of the BEPS Project before their finalisation.⁶² Rather, it is expected that the Australian Government will introduce additional measures to complement TIMAL in order to counteract BEPS strategies

⁵⁸ See *Id* p. 21-22. Tax outcomes that are labelled "tax benefits" include an amount not being included in assessable income, a deduction being allowed, a capital loss being incurred, a foreign income tax offset being allowed, and a taxpayer not being liable to pay withholding tax on an amount.

⁵⁹ See comments on the Australian Government's website regarding TIMAL, accessible at: <http://budget.gov.au/2015-16/content/glossy/tax/html/tax-05.htm> (last accessed 24 August 2015).

⁶⁰ *Ibid.*

⁶¹ *Ibid.*

⁶² *Ibid.* The four actions are: country-by-country reporting, treaty abuse rules, anti-hybrid rules and harmful tax practices and exchange of rulings.

once the BEPS Project is finalised. Commenting on TIMAL, the Australian government has made the following announcement:⁶³

This is only the beginning. The Government will commence consultations with the community on whether further amendments are required to Australian law, consistent with the work being carried out by the G20 and OECD, to address other profit shifting strategies used by multinationals to avoid paying tax in Australia on economic activities performed in Australia.

IV CONCLUSION

From the onset of the BEPS Project, the OECD has called on governments to refrain from taking unilateral measures until the BEPS Project is finalised as one of the purposes of the BEPS Action Plan is to provide governments with internationally agreed co-ordinated solutions to address BEPS. For the most part at least it seems that countries, including South Africa, have adopted a wait-and-see approach in relation to the outcomes of the BEPS Project before introducing measures to address BEPS. It is clear, however, that the UK and Australia is attempting to position themselves as the leaders in the battle against BEPS by introducing anti-BEPS legislation in the midst of the BEPS Project.⁶⁴

The timing of the UK and Australia's introduction of unilateral measures seems premature, however, as Action 7 of the BEPS Actions deals specifically with measures to prevent the artificial avoidance of a PE, which is ultimately the aim of TIMAL and partly DPT. The other aim of DPT is to align transfer pricing outcomes with value creation which is to be addressed in Actions 8-10 of the BEPS Actions.

Both DPT (partly) and TIMAL is directed at targeting the artificial avoidance of a PE through commissionaire and similar arrangements.⁶⁵ As illustrated in the previous chapter, the revised discussion draft on Action 7⁶⁶ *inter alia* also specifically addresses the artificial avoidance of a PE through commissionaire arrangements and similar strategies and proposes widening the scope of the Agency PE to target these

⁶³ *Ibid.*

⁶⁴ Although the UK and Australia is seen as the leaders, other countries have or are also in the process of introducing unilateral BEPS-related measures such as France, Spain and China.

⁶⁵ Refer to Chapter 5 for the definition of a commissionaire arrangement.

⁶⁶ OECD 2015, *Preventing the artificial avoidance of PE Status*, Revised Discussion Draft, available at: <http://www.oecd.org/tax/treaties/revised-discussion-draft-action-7-prevent-artificial-avoidance-pe-status.htm> (last accessed 30 August 2015).

arrangements. As opined in the previous chapter, it is submitted that the widening of the scope of the Agency PE in Action 7 is akin to an anti-avoidance measure for purposes of circumventing the artificial avoidance of the Agency PE. It is submitted that neither DPT nor TIMAL is attempting to change the scope of the existing Agency PE concept, but similarly acts as anti-avoidance measures aimed at commissionaire arrangements designed to circumvent the existing scope of the Agency PE.

Accordingly, it is submitted that it is unlikely that the introduction by the UK and Australia of DPT and TIMAL respectively will undermine the work on Action 7 as it does not modify the existing Agency PE concept or contradict the current proposals in relation to commissionaire arrangements, but simply adds an additional anti-avoidance measure to the existing Agency PE concept. These unilateral measures may, however, undermine the OECD's idealistic goal of global consistency and internationally coordinated and harmonised standards. In addition, it will be interesting to see if DPT/ TIMAL will be challenged by taxpayers and the UK/ Australia's treaty partners, especially in circumstances where the provisions of a treaty determine that a PE is not established in the UK/ Australia, but nevertheless the UK/Australia seeks to impose DPT/ TIMAL due to the PE having been artificially avoided in their view.

CHAPTER 7

CONCLUSION

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I SUMMARY OF FINDINGS

(a) Chapter 2: Meeting the PE threshold

In considering the history behind the PE concept it was illustrated in this chapter that the PE concept was formulated during an era when business models were relatively immobile, and where tangible economic activities had to be carried on in a state via a regular physical presence in order to engage in significant business activities in that state. Due to the immobile and tangible environment in which businesses operated when the PE concept was formulated, the decisive criterion to meet the PE threshold was set at whether a non-resident maintained a sufficient level of physical presence in a source state.

In considering the requirements to meet the existing PE threshold, in the form of a Fixed Place PE and Agency PE, it was found that the criterion of physical presence is still at the core of the existing PE concept today. In terms of the Fixed Place PE, the non-resident is required to have a place of business in the source state at a specific geographical location with a certain degree of permanence. In terms of the Agency PE, the non-resident enterprise must have a dependent agent in the source state who habitually concludes contracts in the source state which are legally binding on the enterprise.

(b) Chapter 3: Application of the existing PE concept in the digitalised economy

It was illustrated in this chapter that ICT developments in recent years have fundamentally changed the way in which businesses operate today than when the PE concept was developed in the 19th and 20th century. In particular, due to the flexible, mobile and intangible nature of the modern business environment, a non-resident no longer necessarily needs to maintain the level of regular physical presence in a source country which it had to maintain traditionally in order to engage in significant business activities in that country. Consequently, enterprises are increasingly able to reduce their existing source country business activities whilst still actively participating in the economic life of that source country.

This is challenging the application of the existing PE concept to tax business profits derived in a source country, due to the fact that the concept still strongly relies on a

physical presence of the non-resident in the source country in order to establish a tax nexus. It was illustrated in this chapter, however, that technology advances have been challenging tax laws based on physical nexus requirements, similar to that embodied in the PE concept, even before the advent of the digital era and that these challenges were dealt with by applying the relevant existing tax framework. This led to the question whether the digitalisation of the economy is merely a natural evolution of business with which the existing PE concept can cope, or if it is in fact so revolutionary that amendments to the existing PE concept are warranted.

In this regard it was noted that prior to launching the BEPS Project, the OECD maintained the view that the existing PE concept remained adequate to tax business profits derived in the digital economy. Consequently, the OECD merely extended the Commentary on Article 5 to provide for the digital economy, and it was shown that this has been the approach taken by the OECD in relation to other technological advances over the years as well. Consequently, the OECD has held the view that the digital economy is simply a consequence of the natural evolution of business and not so revolutionary that it warrants amendments to the existing PE concept embodied in Article 5.

The effectiveness in taxing business profits derived in the digital economy on the basis of the OECD's amendments to the Commentary was also evaluated in this chapter. In this regard it was found that the OECD's approach is highly unsatisfactory as it provides tax planning opportunities and does not necessarily align taxing rights with value creation. Accordingly, it was concluded that the OECD's approach in applying the existing PE concept to the digital economy potentially contributes to the erosion of source countries' income tax bases.

Finally, it was concluded in this chapter that the digitalisation of the economy is not merely the natural evolution of business but in fact revolutionary in the way that it has influenced business models. This submission is made on the basis that, in contrast to technological advances prior to the digital era, advances in the digital economy are enabling businesses across all sectors to design and build their operating models around technological capabilities to such an extent that it has become embedded and central to the business models of enterprises operating across the globe in all sectors.

Accordingly, the view was expressed that the existing PE concept does not have the ability to cope with the scale of ICT developments that is rapidly and continuously

negating physical presence requirements in the business environment, and therefore, changes to Article 5 are not only warranted, but also necessary to preserve the income tax base of source countries.

(c) Chapter 4: The impact of the digital economy and the existing PE concept on BEPS

It was illustrated in this chapter that the digital economy does not generate unique BEPS issues, but that its key features exacerbate BEPS risks.

In the context of this dissertation, the most important key feature of the digital economy was identified as the flexibility and mobility that ICT developments are progressively affording to businesses. Due to this, businesses are increasingly able to interact remotely with customers in multiple jurisdictions through digital means with little, or even no, physical presence in those jurisdictions. As a physical presence in a source country is essential to meet the existing PE threshold, entities are increasingly able to derive substantial business profits from jurisdictions in which their customers are located without being liable to tax on such profits in those jurisdictions as they do not meet the requisite PE threshold. When this is combined with certain strategies (as was discussed in this chapter) so that the business profits derived in the source country go untaxed anywhere or is subjected to unduly low taxation, BEPS occurs on a global scale.

On the basis of this, it was concluded that the application of the existing PE concept in the digitalised economy potentially exacerbates BEPS risks. In addition, it was concluded that the OECD's approach in extending the PE concept to include servers also potentially exacerbates BEPS risks due to the tax planning opportunities it affords to taxpayers. Lastly, it was concluded that these findings support the author's view expressed in the previous chapter that the existing PE concept is no longer coping with increasingly sophisticated ICT developments that are progressively negating physical presence requirements. Accordingly, it was submitted that the existing PE concept no longer appropriately aligns taxing rights with value creation.

(d) Chapter 5: Appropriateness of the PE concept in the digitalised economy: OECD view

As part of the BEPS Project the OECD has acknowledged that the digital economy is challenging the existing PE concept, and in an attempt to address these challenges it has proposed possible solutions in Action 1. In analysing these proposed solutions it was concluded in this chapter that the OECD is proposing both conservative and radical modifications to the existing PE concept, such as modifying the current list of exemptions to the PE concept (conservative) and introducing a new nexus rule specifically for the digital economy (radical). In addition, it is also proposing other alternatives in the place of the existing PE concept, such as imposing a withholding tax on digital goods and services or introducing a bandwidth tax. It was noted that the OECD has, however, refrained from evaluating these options until the finalisation of the BEPS Project.

Notwithstanding this, it was submitted that by virtue of the proposed solutions, it seems that the OECD is no longer convinced of its prior view that the existing PE concept has the ability to adequately tax business profits derived in the digitalised economy. Consequently, the OECD's work on Action 7, which proposes amendments to the existing PE concept, was considered in an attempt to establish the OECD's view in this regard.

In this regard, it was found that the proposed amendments to the existing PE concept set out in the revised discussion draft on Action 7 do not depart fundamentally from the existing PE concept, but merely strengthen the existing PE concept by expanding the concept to cater for strategies that artificially avoid the establishment of a PE under the existing rules. Therefore, the proposed amendments to the existing PE concept do not in any way alter the fundamental underlying principles of the concept (by introducing a new nexus rule for example), but arguably merely introduce anti-avoidance measures when the existing concept is applied.

Based on this, the conclusion was reached that the OECD still deems the existing PE concept appropriate to effectively tax business profits derived in the digitalised economy, provided minor conservative modifications are made. In this regard, it was concluded that if these proposed modifications are adopted (which is expected) the OECD is at least acknowledging that ICT developments are having a significant impact on the way that businesses operate so as to warrant changes to Article 5 itself and not

merely to the Commentary. On this basis it was submitted that the OECD is gradually accepting that technology advances in the digital economy are not merely the natural evolution of business, but is in fact revolutionising the way in which enterprises conduct their businesses. Lastly, it was submitted that the OECD will not at this time readily embrace more far reaching solutions to address the tax policy concerns raised by the digital economy, especially the question whether the existing PE concept remains an appropriate tax nexus rule to allocate taxing rights on business profits derived in the digitalised economy.

(e) Chapter 6: Analysis of unilateral legislative actions taken in the midst of the BEPS Project specifically in relation to the artificial avoidance of PEs

The OECD has from the outset of the BEPS Project called on governments to refrain from taking unilateral measures until the BEPS Project is finalised. Notwithstanding this, certain countries have introduced unilateral BEPS measures in the midst of the BEPS Project. The unilateral measures introduced particularly by the UK and Australia in this regard were considered in Chapter 6 due to the fact that that these measures relate specifically to the artificial avoidance of a PE, which is the behaviour targeted by Action 7.

On analysing these unilateral measures it was concluded that they are not attempting to change the scope of the existing PE concept, but rather introduce anti-avoidance measures aimed at commissionaire arrangements designed to circumvent the existing scope of the Agency PE. Accordingly, as Action 7 also arguably merely introduces anti-avoidance measures for *inter alia* this same purpose, it was concluded that the introduction of these unilateral measures will likely not undermine the work on Action 7. It was submitted, however, that these unilateral measures may undermine the OECD's idealistic goal of global consistency and internationally coordinated and harmonised tax standards. Lastly, it was submitted that these unilateral measures may potentially be challenged by taxpayers and the UK/ Australia's treaty partners, especially in circumstances where the provisions of a treaty determine that a PE is not established in the UK/ Australia, but nevertheless the UK/Australia seeks to impose these unilateral measures due to the PE having been artificially avoided in their view.

II CONCLUSION

In a tax treaty context, if the activities of a non-resident enterprise in a source country do not meet the PE threshold the source country has no taxing rights on business profits derived by that non-resident enterprise within its jurisdiction.

The rationale behind the PE concept is that until a non-resident enterprise establishes a PE in a source country it is not sufficiently participating in the economic life of the source country, and consequently the source country should not have taxing rights on the business profits derived by the non-resident enterprise within its jurisdiction. The PE concept is, therefore, aimed at aligning taxation rights with the country where the economic activities that give rise to business profits are performed, and moreover, where value is created.

The research undertaken in this dissertation has illustrated that in terms of the existing PE concept, a non-resident will only meet the PE threshold if it establishes and maintains a regular physical presence in a source country, in the form of a fixed place of business or a dependent agent. It has also been established that the existing PE concept was formulated on the basis of traditional business models in the pre-digital era where a regular physical presence in a source country was required in order to conduct significant business activities in that country. However, as illustrated in this dissertation, continuing sophisticated ICT developments are increasingly negating the need for businesses to have a physical presence in a source country.

As a result, it is concluded that entities are progressively able to significantly participate in the economic life of a source country without meeting the physical presence thresholds required in order to establish a PE in that country, and hence, the income tax base of source countries is being eroded. In addition, it has been demonstrated in this dissertation that the application of the existing PE concept in the digitalised economy also contributes to BEPS when taxpayers enter into certain co-ordinated strategies so that the business profits derived in the source country go untaxed anywhere or are subjected to unduly low taxation. This not only erodes the source country's income tax base but threatens the global income tax base.

It follows that the research undertaken in this dissertation supports the author's view that the existing PE concept is no longer effectively serving its intended purpose in the

digitalised economy, namely, to align taxing rights with the country where the activities that give rise to business profits are performed and where value is created.

It has also been illustrated in this dissertation that businesses across all sectors are now able to design and build their operating models around technological capabilities to such an extent that it has become embedded and central to the business models of enterprises operating across the globe. Accordingly, ICT developments are increasingly revolutionising the manner in which entities conduct their businesses as it *inter alia* improves flexibility and efficiency, bolsters innovation, reduces operational costs and extends businesses' reach into global markets. As a result, ICT developments are increasingly enabling businesses across all sectors to increase substantially in size and market reach without the need for the level of infrastructure and personnel that was historically required. On this basis, it is the author's view that the digitalisation of the economy is not merely the natural evolution of business, but in fact so revolutionary that changes to the existing PE concept embodied in Article 5 are not only warranted, but also necessary to ensure that the PE concept once again serves its intended purpose.

The research undertaken in this dissertation has illustrated that prior to the BEPS Project the OECD maintained the view that existing international tax rules and principles are sufficient to accommodate emerging issues in relation to the digital economy. As a result, the OECD merely extended the Commentary of Article 5 to provide for components of the digital economy that could meet the requirements of Article 5, which as illustrated, has proved highly ineffective. Consequently, the OECD held the view that the digital economy is simply a consequence of the natural evolution of business and not so revolutionary that it warrants amendments to the existing PE concept embodied in Article 5 of the MTC.

As part of the BEPS Project, however, the OECD has acknowledged that the digital economy is challenging the existing PE concept, and in an attempt to address these challenges the OECD has proposed possible solutions in Action 1. As illustrated, these proposals entail conservative and radical amendments to the existing PE concept (such as a new nexus rule specifically for the digital economy) and even other alternatives such as rather imposing a withholding tax on digital goods and services or introducing a bandwidth tax. Although the OECD has refrained from evaluating these options until the finalisation of the BEPS Project, it is submitted that by putting forward

the proposed solutions, it seems that the OECD is no longer convinced of its prior view that the existing PE concept has the ability to adequately tax business profits derived in the digital economy. However, on the basis of the proposed amendments to the existing PE concept, as set out in Action 7, it is concluded that the OECD still deems the existing PE concept an appropriate nexus rule to effectively tax business profits derived in the digitalised economy, provided minor conservative modifications are made.

It is submitted that although useful, the OECD's proposed conservative amendments to the existing PE concept as set out in Action 7 (amending the list of exemptions, introducing an anti-fragmentation rule, expanding the scope of the Agency PE) do not effectively align the PE concept with economic realities, being a flexible, mobile, intangible and digital business environment, and further work in this regard is required. Without having analysed the more radical proposed solutions set out in Action 1 in detail, it is the author's view that these proposals may not pass the principle of tax neutrality, which requires that taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation in order to avoid introducing distortions to the market. In other words, the same principles of taxation should apply to all forms of business, while taking into account specific features that may otherwise determine an equal and neutral application of those principles.¹ Notwithstanding this, it is submitted that the OECD will not at this time readily embrace any of the more radical proposals to amend the existing PE concept (such as a new nexus rule), and especially alternative mechanisms to tax business profits derived in the digitalised economy (such as a withholding tax).

By making amendments, albeit conservative amendments, to Article 5 itself and not only to the Commentary to provide for *inter alia* the challenges raised by the digital economy, it is submitted that the OECD is acknowledging that ICT developments are having a significant impact on the way that businesses operate. Accordingly, it is submitted that the OECD is gradually accepting that the digitalised economy is not merely the natural evolution of business, but is in fact revolutionary. Indeed the OECD has acknowledged in the BEPS Project that "*because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-*

¹ OECD 2014, *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, p. 149.

fence the digital economy from the rest of the economy for tax purposes".² It is, therefore, expected that going forward, the OECD will continue its work on the digital economy and closely monitor the appropriateness of the existing PE concept in the modern economy.

In conclusion, it is the author's view that the existing PE concept remains an appropriate nexus rule in the digitalised economy, provided it is modified to rely on a physical presence to a lesser extent. While a physical presence in a source country can be a factor to determine whether the PE threshold is met, it is the author's view that it should not be the principal and decisive factor, as is currently the case. One suggestion to explore in this regard is for the existing requirement of a physical presence in the PE threshold to be replaced with that of an economic presence. Such an approach will look to the substance of the business activities of the non-resident enterprise in the source country and not necessarily the form as is currently the case. In addition, it will ensure that the principle of neutrality is met where certain traditional business models may not yet have been "digitalised". Lastly, it is submitted that this approach will once again ensure that the existing PE concept is appropriately aligning taxing rights with value creation.

III CONTRIBUTION TO TAX LITERATURE

The findings of this dissertation confirms that as a result of the growing digitalisation of the economy the existing PE concept is contributing to the erosion of the income tax base of source countries and is exacerbating BEPS risks. As a result, the findings of this dissertation supports the view that in order to effectively serve its intended purpose of aligning taxing rights with the county where the activities that gave rise to business profits are performed and where value is created, the existing PE concept needs to be modified to rely on the physical presence of a non-resident in a source country to a lesser extent. Accordingly, this dissertation has shown that the PE concept remains an appropriate nexus rule in the digitalised economy, provided it is modified to reflect the flexible, mobile and intangible realities of the modern economy. Lastly, this dissertation has provided a proposal for modification to the existing PE concept that can be explored in future research.

² *Id* p. 12.

IV RECOMMENDATION FOR FUTURE RESEARCH

It is recommended that various proposed modifications to the existing PE concept be considered in an attempt to provide suggestions to best align it with economic realities. In particular, it is recommended that the proposal to replace the physical presence requirement in the existing PE concept with that of an economic presence be examined in order to determine whether it is a viable option. In addition, it is recommended that various proposals be considered in relation to the attribution of profits to a modified PE concept.

V OBSERVATIONS ON FINALISED BEPS REPORTS

As noted in the introductory chapter (Chapter 1), this dissertation has taken into account the available BEPS reports as at **30 September 2015**. Consequently, this dissertation has been drafted on the basis of the interim report on Action 1 which was issued during September 2014, and the revised discussion draft on Action 7 which was issued during May 2015.

Subsequent to the drafting of this dissertation and on 5 October 2015, the OECD released its finalised BEPS reports. Due to time constraints in relation to the submission of this dissertation, the author was not able to consider the finalised reports in relation to Action 1³ and Action 7⁴ in detail and to incorporate the contents thereof in this dissertation. The author did, however, review the finalised reports in relation to Action 1 and Action 7 on a high-level basis, and note the most important observations in this regard below.

The important observations in relation to the finalised report on Action 1 are the following:

- (a) the recommendation in the interim report to modify the list of exemptions to the existing PE rule so that they are only available for activities that are in fact

³ OECD 2015, *Addressing the Tax Challenges of the Digital Economy*, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project

⁴ OECD 2015, *Preventing the Artificial Avoidance of Permanent Establishment Status*, Action 7 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project.

preparatory or auxiliary in nature has been adopted as part of the work on Action 7.⁵ No further amendments to the existing PE concept were proposed;

- (b) the OECD developed the alternative proposals to the existing PE concept set out in the interim report further to provide for revised proposals.⁶ As part of this, the OECD considered a new nexus rule based on a "significant economic presence" which applies where an enterprise leverages digital technology to participate in the economic life of a country on a regular and sustained manner without having a physical presence in that country.⁷ It is noted that the work in this regard could be fundamental to determine whether replacing the physical presence requirement in the existing PE concept with that of an economic presence is a viable option, as proposed above in the recommendations for future research;
- (c) the OECD did not recommend that any of the proposed alternatives to the PE concept be implemented as internationally agreed standards, as in the OECD's view, it is unclear whether such changes are warranted to deal with the changes brought about by advances in ICT;⁸
- (d) the OECD did not express a view as to whether the PE concept remains an appropriate nexus rule in the digitalised economy;
- (e) the OECD noted that the conclusions reached in Action 1 may evolve as the digital economy continues to develop,⁹ and therefore, it is important to continue working on the issues and to monitor developments of the digital economy over time;¹⁰ and
- (f) the OECD should produce a report reflecting the outcome of the continued work in relation to the digital economy by 2020.¹¹

⁵ OECD 2015, *Addressing the Tax Challenges of the Digital Economy*, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, p. 136.

⁶ *Id* refer to Chapter 7 for a discussion on the revised proposals.

⁷ *Id* pp. 106-113.

⁸ *Id* p. 137.

⁹ *Id* p. 138.

¹⁰ *Ibid.*

¹¹ *Ibid.*

Accordingly, from the high-level review of the finalised report on Action 1 it does not appear that the finalised report influences the findings of this dissertation materially. The most important development between the interim and the finalised report for purposes of this dissertation is that the OECD considered a new nexus rule based on an economic presence. This is, however, only material for purposes of future research, as the OECD did not adopt this proposal.

In relation to Action 7, from a high-level review of the finalised report it appears that it mostly mirrors the revised discussion draft. In this regard, the proposals in relation to the modification of the existing PE concept as set out in the revised discussion draft have been adopted in the finalised report, namely modifying the list of exemptions to ensure that only activities of a preparatory or auxiliary nature will qualify for exemption, expanding the scope of the Agency PE and introducing an anti-fragmentation rule. Accordingly, the finalised report on Action 7 does not appear to have any significant impact on the findings of this dissertation. The contents of the revised discussion draft on Action 7 would, however, need to be compared with that of the finalised report to determine whether there are any significant changes to the actual text of the proposed amendments.

End

[NUMBER OF WORDS: 30,905]

The author would like to sincerely thank her family, friends and colleagues at Webber Wetzel Attorneys for their support and encouragement during the dissertation process.

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