



**DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS  
COMMITTEE ON FISCAL AFFAIRS**

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**Working Party No. 1 on Double Taxation**

**REVISED DRAFT ON THE APPLICATION OF THE PERMANENT  
ESTABLISHMENT DEFINITION IN THE CONTEXT OF ELECTRONIC  
COMMERCE**

**PROPOSED CLARIFICATION OF THE COMMENTARY ON ARTICLE 5 OF THE  
OECD MODEL TAX CONVENTION**

*The attached note is submitted to the Working Party FOR INFORMATION at its meeting on 18-20 September 2000.*

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**SUMMARY / ACTION REQUIRED**

**This note includes the final version of the revised draft on the application of the permanent establishment definition to e-commerce, which was released for comments on 3 March 2000.**

3 March 2000

**THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN THE  
CONTEXT OF ELECTRONIC COMMERCE:**

**PROPOSED CLARIFICATION OF THE COMMENTARY ON ARTICLE 5  
OF THE OECD MODEL TAX CONVENTION**

***REVISED DRAFT FOR COMMENTS***

**Introduction**

1. In October 1999, Working Party No. 1 on Tax Conventions and Related Questions released, for comments, a proposal for clarification of the Commentary on Article 5 dealing with the application of the permanent establishment definition in the context of electronic commerce.<sup>1</sup> Interested parties were invited to send their comments on that proposal before 31 December 1999. The introduction to the proposal indicated that the Working Party intended to review and finalize the proposal in light of these comments at its February 2000 meeting.

2. The Working Party wishes to thank the individuals and organizations who have sent comments on the proposal. At its meeting of 22-25 February 2000, the Working Party has carefully reviewed the proposal in light of these comments and has produced a revised draft (reproduced at the end of this document). It has also decided to follow the suggestion, made by some commentators, to invite comments on this revised draft and to take additional time to deal with this issue. The Working Party intends to finalize its views on the issue at its next meeting, to be held in September 2000.

3. Comments on the attached document should be sent **before 15 June 2000** to:

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4. In presenting this revised draft, the Working Party wishes to stress that, although it has had substantial discussions on the issue, it was felt more useful to present the various positions put forward by delegates, with a view to reaching a compromise solution at a subsequent meeting on the basis of comments received on these various views, than to try to issue another proposal representing majority views.

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1. That draft is available at: [http://www.oecd.org/daf/fa/material/mat\\_07.htm#material](http://www.oecd.org/daf/fa/material/mat_07.htm#material) draft revisions to article 5.

5. The Working Party also wishes to repeat that this revised draft is concerned solely with the issue of the application to electronic commerce of the permanent establishment definition as it currently appears in Article 5 of the OECD Model Tax Convention and does not, therefore, address the broader and ultimately more important issue of whether any changes should be made to that definition or whether the permanent establishment concept should be abandoned. The Committee on Fiscal Affairs has indicated that it “believes that the principles which underlie the OECD Model Tax Convention are capable of being applied to electronic commerce.”<sup>2</sup> It has set up a Technical Advisory Group to monitor the application of existing treaty norms for the taxation of business profits in the context of electronic commerce. The general mandate of that Group is “to examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules.” The work of that group will therefore assist the Working Party in deciding whether changes need to be made to the Model Tax Convention to address this broader issue. Also, as was already mentioned in the previous proposal, the draft below does not address the issue of how much income should be attributed to electronic commerce operations carried on through computer equipment in circumstances where there would be a permanent establishment.

### **The Working Party’s views on some of the comments received**

6. The Working Party felt that, in addition to revising its original draft in light of the comments received, it would be useful to present its conclusions on some of the main points raised in these comments. This is done in the following paragraphs.

#### ***Whether the draft implicitly suggested that the permanent establishment concept should be amended or replaced***

7. A few commentators expressed concerns that the preamble of the draft may be taken to suggest that the Working Party considered that the permanent establishment concept should be amended or replaced.

8. As noted in the preamble of the October draft and in paragraph 5 above, the Committee on Fiscal Affairs has already stated that it “believes that the principles which underlie the OECD Model Tax Convention are capable of being applied to electronic commerce”. At the same time, however, it has mandated the TAG on Monitoring the Application of Existing Norms for the Taxation of Business Profits, among other things,

“...to consider and comment on the following questions:

- a) whether the concept of permanent establishment provides an appropriate threshold for allocating tax revenues between source and residence countries and with respect to the use of tax havens in the context of electronic commerce;
- b) whether there is a need for special rules relating to electronic commerce and whether such rules would be a viable alternative to existing international norms.”

9. The Working Party notes that the draft dealt solely with the interpretation of the definition of permanent establishment as currently found in the OECD Model Tax Convention. While it cannot rule

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2. *Electronic Commerce: A Discussion Paper on Taxation Issues*, page 23.

out that changes could eventually be made to the existing rules, it will await the report of the TAG before considering any such changes as regards e-commerce.

### *Overall policy considerations*

10. Many commentators raised general policy arguments as justification for their conclusions concerning the interpretation of the permanent establishment definition.

11. While the object and purpose of Article 5 is clearly relevant in interpreting its wording, many of the policy considerations put forward in the comments received did not relate to the object and purpose of this Article. Also, the ordinary meaning of the words used in the definition of permanent establishment, taken in their context and in light of the interpretations put forward in the Commentary, cannot be ignored in interpreting that definition.

12. For these reasons, these general policy arguments are more relevant for purposes of the work of the TAG on Monitoring the Application of Existing Norms for the Taxation of Business Profits, which addresses the issue of whether the existing treaty rules are appropriate for e-commerce (see above), than for the interpretation of the current wording of Article 5. The Working Party will therefore ensure that these arguments are communicated to the TAG.

### *The difficulty of allocating profits to a server/permanent establishment*

13. Many commentators have focussed on attribution of income issues, suggesting that it would be extremely difficult to allocate profits to a server/permanent establishment. Some of them have also suggested that there was a need to address that issue before deciding the PE issue.

14. The Working Party acknowledged the importance of that concern. It noted, however, that the Committee on Fiscal Affairs had also stated that it believed "that the principles which underlie the international norms that it has developed in the area of tax treaties and transfer pricing (through the Model Tax Convention and the Transfer Pricing Guidelines) are capable of being applied to electronic commerce." In pursuing this approach, the first question, which is the issue that the revised draft addresses, is whether a server can constitute a permanent establishment. If, in the event it is determined that a permanent establishment exists, it then proves difficult in practice to allocate profits to that permanent establishment, this points toward the question of whether the existing rules in Article 5 should be reviewed. Certainly from a matter of legal interpretation, the logic of Article 7 is that if there is a PE, one must determine what profits are attributable to it. It seems inappropriate to suggest that if attribution proves to be difficult, one should go back and decide there is no permanent establishment.

15. The Working Party also felt that attributing income to functions performed through a server is not exclusively (or even primarily) a permanent establishment problem. The same issue arises even where there is no doubt whatever that a permanent establishment exists (i.e. the web site of a multinational enterprise is stored on a server located in the headquarters or in a store belonging to that enterprise). It may also arise where e-commerce operations are carried on through an associated enterprise (e.g. where the e-commerce operations of a large retailer are carried on by a foreign subsidiary which only owns and operates a web site from a server located in its country of residence, the delivery of goods sold through that site and the after-sale services being done from stores operated worldwide and owned by other subsidiaries).

16. Given the importance of clarifying how income should be attributed when business functions are performed through a server, the Working Party agrees that this issue should be given priority by the Committee on Fiscal Affairs. It was also noted that the TAG on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits had included that issue in its work programme.

***More time should be taken to examine the issue***

17. Some commentators suggested that the Working Party should not finalize the proposals at its February 2000 meeting and should invite new comments on its revised draft.

18. As already noted, the Working Party adopted that suggestion and decided to release a new draft for comments with the aim of finalizing its work at a subsequent meeting.

***The need for clearer distinction between the various forms of doing business***

19. Some commentators have indicated that the different forms of doing business should be more clearly distinguished in the proposed draft, that the reference to the “operation” of a web site or server was unclear and that it should be clarified, in some of the paragraphs, that the statements refer to an enterprise that, for example, owns or rents the server.

20. The Working Party agreed that its proposal could be usefully clarified in that respect and the attached revised draft contains a number of drafting changes that have been made for that purpose.

***Payments based on disk space taken up on a server***

21. One commentator has suggested that "web space is typically rented on the basis of disk space taken up on the server [...]. Looking at paragraph 4 of the commentary to article 5 it could be argued that the enterprise has this space, which forms part of the premises owned by another enterprise, at its constant disposal." The Working Party rejected that view. It concluded that while each case needs to be examined on the basis of its facts and circumstances, web hosting contracts are generally not contracts for renting disk space or servers, even though part of the consideration may be computed by reference to the amount of disk space used for client.

***Whether a server at a given place may ever constitute a permanent establishment***

22. Commentators have suggested a number of technical reasons why a server could not constitute a permanent establishment. The following are the views of the Working Party on some of these arguments:

- *one needs to distinguish between the server and the software (web site) that is stored on it. Since the web site cannot itself be a permanent establishment and the server is not automated without the software/web site, the server cannot be a permanent establishment. It is difficult to follow that logic. Once software and data are stored and operated from a server at a given place, they contribute to the functions performed there and one must then determine whether the business of the enterprise is carried on from that place looking at everything that happens there. By analogy, while employees who do not have authority to conclude contracts cannot themselves constitute a permanent establishment, one needs to look at the functions performed by these employees in a particular building to determine*

whether the business of an enterprise is carried on in that building. An empty server, like an empty building, would not itself be a permanent establishment.

- *a server plays only a passive role; if there is a series of back-up servers (often in different countries and which may or may not be owned by the enterprise) it is difficult at any point in time to tell whether the main server is playing any role at all.* This raises the distinct issue of what is preparatory or auxiliary. It does not affect the fact that a particular server at a given place may constitute a permanent establishment if the functions performed there go beyond what is preparatory or auxiliary.
- *a server should not be more a permanent establishment of mere users than are telephone and data lines, call storing or other information recording or disseminating mechanical machines.* This comment avoids the question of why communication equipment does not constitute a permanent establishment for the user. If the communication equipment situated at a given location in another country is owned by the user (who is not in the telecommunication business), the reason why there is no permanent establishment is not because there is no fixed place of business but rather because the activities performed there are preparatory and auxiliary.

23. It has also been suggested that the fact that a server is owned / rented or not should be irrelevant: if the function of the web site is the same, it should be deemed to meet the requirements of the permanent establishment in the Model Convention. This comment seems to suggest that a web site could constitute a permanent establishment regardless of whether or not facilities, or at least a certain space in a country, is at the disposal of the enterprise operating that site. The Working Party does not agree with that suggestion, which is inconsistent with the current definition of permanent establishment.

***Whether human intervention is required for a permanent establishment to exist***

24. Many commentators argued that some human intervention was required for a permanent establishment to exist. As reflected in the revised draft, a number of delegates have adopted that view. There were different views, however, as to exactly what that requirement implied, particularly as regards the issue of whether the required human intervention needs to be that of employees or can be that of any persons, whether or not employees.

***Preparatory or auxiliary activities***

25. Many commentators have offered views as to the scope of the exception concerning preparatory or auxiliary activities in the case of functions performed through computer equipment. The Working Party considered these suggestions. It felt, however, that in many cases, it did not have sufficient information about the scope or purpose of the proposed activities to make accurate judgements about whether the activities generally would be preparatory or auxiliary. For these reasons, even the conclusions regarding those activities that are listed in paragraph 12 of the revised draft should be considered tentative. The Working Party would welcome more detailed information and analysis about the activities noted in previous comments, whether or not those activities have been included in the revised draft.

**THE APPLICATION OF ARTICLE 5 IN THE CONTEXT OF ELECTRONIC COMMERCE:  
REVISED DRAFT**

“1. There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

2. Whilst fixed automated equipment operated by an enterprise may constitute a permanent establishment in the country where the equipment is located (see paragraph 10 [of the existing Commentary]), a distinction needs to be made between computer equipment, which could constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site is a combination of software and electronic data that does not, in itself, involve any tangible property. It therefore cannot itself constitute a “place of business” (“installation d’affaires” in the French version) as there is “no facility such as premises or, in certain circumstances, machinery or equipment” (see paragraph 2 [of the existing Commentary] above) as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and used is a piece of equipment having a physical location and may thus constitute a “fixed place of business” of the enterprise that operates it.

3. The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not give to the enterprise to which the web site belongs any right to particular space or control over the operation of the server (as opposed to the operation of the web site software itself). In such case, the server and its location are not at the disposal of the enterprise (see paragraph 4 [of the existing Commentary]), even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location; in fact, the enterprise does not even have a physical presence at that location since the web site does not involve tangible assets. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site also owns (or leases) and operates the server on which the web site is stored and used, the enterprise could constitute a permanent establishment of the enterprise if the other requirements of the Article [5] are met.

4. Computer equipment may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved around, but whether it is in fact so moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1 [of Article 5].

5. Another issue is whether the business of an enterprise may be said to be wholly or partly carried on through equipment such as a server that it controls and operates. Some countries believe that the issue is already dealt with in paragraph 10 [of the existing Commentary], which expressly recognizes that the business of an enterprise may be carried on through automatic equipment. Other countries, however, draw a distinction between the example, given in that paragraph, of a gaming or vending machine and the servers used in electronic commerce operations. These countries consider that in the case of a gaming or

vending machine, the machines are in a fixed place and enter into completed transactions with customers to provide goods or services. They note that a vendor who changes locations each week would quickly lose its customers. The location of a server is, however, irrelevant to the customer of an e-commerce operation, since the customer has access to the business' goods or services wherever the customer has an Internet connections. Thus, the e-tailer's business is carried on, not through the server, but through the enterprise's offices, warehouses, research facilities and other locations in which its income-generating activities take place. According to these countries, the requirement that the e-tailer have a "fixed place of business" is therefore not met by the server in these circumstances.

6. A further issue is to what extent human intervention is necessary for automatic equipment to be considered to constitute a permanent establishment of an enterprise.

7. Under one view, automated equipment that does not require human intervention for its operation may constitute a permanent establishment. For these countries, the relevant question is the nature of the business and whether the activities performed through the equipment are the core income-generating activities of that business. In this respect, electronic commerce activities can be compared to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources. It seems illogical to these countries to conclude that personnel are necessary to have a permanent establishment when no personnel are in fact necessary to generate income. These countries cannot find any explicit reference to a requirement of human intervention in the definition of "fixed place of business" and note that paragraph 10 [of the existing Commentary] already recognizes that automatic equipment may constitute a permanent establishment.

8. Another view is that some human intervention is indeed necessary for a permanent establishment to exist. There are different views, however, as to the exact parameters of that requirement. Those differences relate to the following questions:

- \* whether the intervention must necessarily take place in the country or can be done from abroad;
  - whether the intervention needs to be that of employees of the enterprise or of any person, whether or not employed by the enterprise;
- \* what level of human intervention is required.

9. On the first question, some members consider that the intervention must be that of persons who are present for that purpose in the country where the equipment is located. According to that view, it is only under these circumstances that the enterprise can be regarded as participating in the economic life of that country like domestic enterprises that also employ capital and labour there. This requirement can also be inferred from a comparison with income from employment that can also only be taxed in the country of source if the employer is physically present there to exercise his activities. Others believe that this is the case if, as a matter of fact, it would not be possible to operate and maintain the equipment from a remote location.

10. On the second question, some Member countries consider that an enterprise may only be said to carry on, wholly or partly, business activities in a country through equipment located in that country if the equipment is operated by persons, whether or not employed by the enterprise. Others believe that there is a requirement that this input be made by persons who are employees or dependent agents, though not necessarily authorised to conclude contracts, of the enterprise and note the references to "personnel" in paragraph 2 and 10 of the Commentary on Article 5 as support for that view. They conclude that, at least

in the case of automatic equipment, where the operation and control of the equipment is done by non-enterprise personnel, this requirement is not satisfied.

11. On the third question, there are different views as to which activities would require human intervention for a permanent establishment to exist. While some members consider that what matters is whether or not the equipment is operated, and not merely set up and maintained, by persons, others think that it may be difficult to distinguish the operation from the maintenance of computer equipment, especially when databases are updated or software upgraded.

12. Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment located in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4 [of Article 5]. The question of whether particular activities performed through computer equipment fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which, by themselves, would generally be regarded as preparatory or auxiliary include:

- providing a communications link – much like a telephone line – between suppliers and customers;
- advertising of goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.

13. All countries agreed that, where such functions form in themselves an essential and significant part of the commercial activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 2 to 11 above), there would be a permanent establishment.

14. There were, however, different views as to what constitutes core functions of the enterprise. Some countries took the view that where sales functions are performed through the computer equipment, whether the product is delivered on-line or by traditional methods, the equipment would constitute a "place of business" and may be a permanent establishment. Other countries draw a parallel with the use of other communication facilities, such as the use of telephone lines to conclude a transaction. These countries are of the opinion that the essential business activity of an enterprise that sells certain products - physical or in the form of software - is the selling of the product itself. The communication tools used in the selling process should make no difference, whether the transaction is concluded by mail order, by telephone or through a server connecting the computer (web site) of the selling enterprise with the computer of the customer. They see this view as in line with the recently adopted changes to the part of the Commentary on Article 12 dealing with software payments, which put forward the view that the form in which a product is delivered (physically or electronically) should make no difference for the way in which it is taxed. Thus, only in exceptional cases do these countries see a possible permanent establishment for this category, for example if the relevant transaction (the conclusion of a contract, the payment and the delivery of the goods) is handled fully (automatically) by the server itself.

15. A last issue is whether paragraph 5 [of Article 5] may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 [of Article 5] may apply to deem such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISP. While this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the web sites belong, because they will not have 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 web sites of many different enterprises. It is also clear that since the web site through which an enterprise carries on its business is not itself a "person" as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph."