

Taxable Presence and Highly Digitalized Business Models

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In this article, the authors discuss how the digitalization of the economy is affecting nexus rules and analyze international tax treaty law on permanent establishment and the taxable presence of digital businesses.

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I. Introduction and Scope

As the economy moves from the physical world to the online space, it has become clear that international tax rules continue to focus primarily

on physicality.¹ Accordingly, much of the debate about the tax challenges of digitalization has revolved around the perception that the tax rules are outdated for highly digitalized business models, which to some extent no longer require physical presence in a given market (sometimes referred to as the ability to obtain scale without mass).² That development has been said to affect the distribution of taxing rights by reducing the number of jurisdictions that can assert those rights over business profits from cross-border activities.³

Based on that understanding, it is commonly argued that the concept of permanent establishment in the era of digitalization appears less relevant, or even obsolete,⁴ and that a new threshold is therefore needed to source taxation.⁵

Hence, when policymakers — be it supranational or unilateral — suggest a new threshold for taxable nexus, the proposals are often based on the belief that the rules currently applicable cannot capture the value creation of digitalized business models and thus generate tax revenue in market jurisdictions. An example of that is the policy rationale behind the OECD's

¹ See, e.g., Marcel Olbert and Christoph Spengel, "International Taxation in the Digital Economy: Challenge Accepted?" 9(1) *World Tax J.* (2017); Daniel W. Blum, "Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative — The Nexus Criterion Redefined?" 69(6/7) *Bull. Int'l Tax'n* (2015); Georg Kofler, Gunter Mayr, and Christoph Schlager, "Taxation of the Digital Economy: 'Quick Fixes' or Long-Term Solution?" 57(12) *Euro. Tax'n* (2017); and Yariv Brauner and Pasquale Pistone, "Adapting Current International Taxation to New Business Models: Two Proposals for the European Union," 71(12) *Bull. Int'l Tax'n* 681 (2017).

² OECD, "Tax Challenges Arising From Digitalisation — Interim Report 2018," at 24 (Mar. 16, 2018).

³ OECD, "Addressing the Tax Challenges of the Digitalization of the Economy — Public Consultation Document," at 8 (Feb. 2019).

⁴ Vishesh Dhuldhoya, "The Future of the Permanent Establishment Concept," 72(4a) *Bull. Int'l Tax'n* 12 (2018).

⁵ Peter Hongler and Pistone, "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy," Working Paper, at 14 (2015); and Michael P. Devereux and John Vella, "Implications of Digitalization for International Corporate Tax Reform," WP 17/07, at 25 (July 2017).

February 2019 consultation document to address the taxation of a digitalized economy:

These proposals would require fundamental changes to both the profit allocation and nexus rules and expand the taxing rights of user and market jurisdictions. . . . These proposals have the same over-arching objective, which is to recognize, from different perspectives, value created by a business's activity or participation in user/market jurisdictions that is not recognized in the current framework for allocating profits.⁶

The OECD argues that specific characteristics — primarily observed in highly digitalized businesses — enable value creation by activities closely linked with a jurisdiction without needing to establish a physical presence there.⁷ Further, it says that kind of remote participation in a domestic economy is the key issue in the digital tax debate, despite different views on the scale and nature of those challenges, as well as whether and to what extent the international tax rules should be changed.⁸

It seems, however, that a thorough analysis across digitalized business models has not been carried out.⁹ That also seems to be somewhat

recognized by the OECD inclusive framework in the consultation document, given that the second question for public comments was: “To what extent do you think that businesses are able, as a result of the digitalisation of the economy, to have an active presence or participation in that jurisdiction that is not recognised by the current profit allocation and nexus rules?”

Despite the numerous responses, none seems to provide thorough answers to that question.¹⁰ Hence, digitalized business models might not qualify as PEs under the current rules. Further, not all states share that simplified view and are therefore trying to determine if a right to tax can be established under current tax legislation.¹¹ Many tax disputes are pending, so it could take years before we fully understand the limitations to the PE concept when applied to digitalized business models.¹²

This article is meant to shed further light on the topic by systematically confronting the notion of a PE as defined in the 2017 OECD model tax convention¹³ by analyzing several business models that have arisen in connection with the digitalization of the economy¹⁴ (typically referred to as “highly digitalized business

⁶ OECD, *supra* note 3, at 23. The February 2019 consultation document supports the digitalization work by the inclusive framework under its mandate from the G-20 finance ministers and working through its Task Force on the Digital Economy. Similar thinking is presented in OECD, “Secretariat Proposal for a ‘Unified Approach’ Under Pillar One — Public Consultation Document,” at 7 (Oct. 2019); and OECD, “Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy — January 2020,” at 8 (Jan. 2020).

⁷ The three emphasized characteristics are scale without mass, a heavy reliance on intangible assets, and intensive use of data and user participation.

⁸ OECD February 2019 consultation document, *supra* note 3, at 8.

⁹ Olbert and Spengel, “Taxation in the Digital Economy — Recent Policy Developments and the Question of Value Creation,” 3 *Int'l Tax Stud.* (2019). They state that “there is no in-depth analysis of what the current tax challenges are and that no scientific evidence exists for the asserted flaws in the existing tax system.” They identify several presumptions made by the European Commission in two draft Council Directives issued in March 2018 (COM(2018) 147 and COM(2018) 148 final), including that the corporate tax rules are outdated. The authors state that “[U]ndoubtedly, the current framework of international and domestic tax law that is in place dates back to a time when the use of information technologies by most businesses was far from intense or sophisticated, if even existent. Since then, entirely new business models (and companies) have emerged and are still emerging. One can thus conclude that tax rules are outdated and that the time is right to rethink the current framework and existing rules.” Devereux and Vella have also touched on the question, although without systematically analyzing highly digitalized business models. See *supra* note 5.

¹⁰ See also the comprehensive study conducted by Pistone, João Félix Pinto Nogueira, and Betty Andrade, “The 2019 OECD Proposals for Addressing the Tax Challenges of the Digitalization of the Economy: An Assessment,” 2 *Int'l Tax Stud.* 9-11 (2019), only briefly touches on the question before moving on to assess the OECD's proposals.

¹¹ The Spanish Supreme Court (Tribunal Supremo), “Spanish Dell Case,” 2555/2015 (2016). That notion is also mentioned by Jose Luis Migoya Vargas (Spain) in “Withholding Tax in the Era of BEPS, CIVs and the Digital Economy,” 103(B) *IFA Cahiers* 645 (2018). For an analysis of the case, see Adolfo J. Martín Jiménez, “The Spanish Position on the Concept of a Permanent Establishment: Anticipating BEPS, Beyond BEPS or Simply a Wrong Interpretation of Article 5 of the OECD Model?” 70(8) *Bull. Int'l Tax'n* 458 (2016).

¹² Further, as recognized by the OECD and pointed out in several responses to the consultation document, the consequences of the final BEPS implementation remain to be seen in full effect. See OECD 2018 interim report, *supra* note 2, at 91. See also, e.g., the Digital Economy Group's response to the OECD (2019), at 4.

¹³ Jacques Sasseville and Arvid Skaar, “Is There a Permanent Establishment?” 94a *IFA Cahiers* 23 (2009); and Philip Baker, *Double Taxation Agreements and International Tax Law* 2 (1991). Further, it is too early to assess with certainty the impact of the PE provisions in individual tax treaties as implemented by the OECD multilateral instrument. Moreover, the MLI overlaps with the 2017 OECD model and commentary and therefore serves as a credible proxy for tax treaties updated by it.

¹⁴ This article does not use “digital economy,” a term the OECD has rightfully abandoned. See OECD, “Addressing the Tax Challenges of the Digital Economy, Action 1 — 2015 Final Report,” at 54 (2015), which notes that the digital economy is simply embedded in the economy and that it is difficult, if not impossible, to ring-fence it from the rest of the economy.

models”).¹⁵ Until now this has been assumed widely (and repeated eagerly) without any further analysis and solely based on the obvious finding that some digital business models enable the conduct of business without any physical presence in the market state. It also examines the actual impact of recent base erosion and profit-shifting initiatives, which lowered the threshold for nexus in some digital business models.

Because of the scale and complexity of the challenges of the topic analyzed in this article, some demarcations are necessary. First, while an analysis of the profit allocation to PEs created in highly digitalized business models is inherently linked to answering whether the current rules can capture value creation of those models and thus generate acceptable tax revenues in market jurisdictions, that analysis is outside the scope of this article. Moreover, an analysis of whether the activities of highly digitalized business models create service PEs, as known from the U.N. model tax convention and implemented as an option in the OECD model, also falls outside the scope of this article. Finally, this article does not contribute to pending discussions on the tax policy design of a new digital or significant economic presence.¹⁶

This article does not claim to provide a final answer to the tax challenges imposed by the digitalization of the economy. Instead, it presents details on various digital business models under the current international tax order and offers input for the ongoing policy discussion.

II. The Tax Challenges of Digitalization

The digitalization of the economy is the result of a transformative process by information and communications technology that has made technologies cheaper, more powerful, and widely standardized, thereby improving business processes and fostering innovation across all economic sectors.¹⁷ That all sectors are affected implies that it is generally impossible to define

and ring-fence the digital economy for tax purposes.¹⁸ Instead, as a part of the BEPS project, the OECD has identified key features of business models in the digital space, as well as their associated tax challenges. The most important features are use of multisided business models, heavy reliance on intangible assets, extensive collection of user data and user participation, and an ability to scale without mass.¹⁹ This article analyzes to what extent digitalized businesses can carry out their business without physical presence and thereby create a taxable presence.

The use of multisided business models refers to businesses through which several distinct groups of users and customers interact. Those business models typically enjoy indirect network externalities, meaning an increase in users on one side of the market increases the utility of users in another market at little or no cost to the business. Further, those businesses may adopt nonneutral pricing strategies, implying that optimal prices can be below the marginal cost of providing services on one market side (for example, free services provided to end-users), while being above marginal cost on the other side (for example, selling ad spaces targeted at the end-users sold to third-party customers).²⁰ However, capturing value from the externalities generated by free products (or barter transactions²¹) and the difficulty of determining the jurisdiction where value creation occurs have been the subject of great concern and debate.²²

Reliance on intangible assets, particularly intellectual property such as software and websites, is typically an important driver of business value. Because where a company's intangible assets are controlled and managed has a material impact on where that company's profits

¹⁸ *Id.* at 142.

¹⁹ OECD, 2018 interim report, *supra* note 2, at 24; and Tsutomu Endo, “Modification of a Taxable Nexus to Address the Tax Challenges of the Digital Economy,” *Taxation in a Global Digital Economy* 107-108 (2017).

²⁰ OECD 2018 interim report, *supra* note 2, at 23.

²¹ *Id.* at 29. In “Allocation of the Right to Tax Income From Digital Intermediary Platforms — Challenges and Possibilities for Taxation in the Jurisdiction of the User,” 1 *Nordic J. Comm'l L.* 153-161 (2018), Louise Fjord Kjærsgaard and Peter Koerver Schmidt discuss whether the users' provision of personal data in exchange for access to an intermediary platform can be considered a barter transaction for tax purposes in the user jurisdiction.

²² OECD action 1 final report, *supra* note 14, at 16.

¹⁵ OECD 2018 interim report, *supra* note 2, at Chapter 2.

¹⁶ *E.g.*, European Commission, “Recommendation Relating to the Corporate Taxation of a Significant Digital Presence,” C(2018) 1650 final (Mar. 21, 2018); Hongler and Pistone, *supra* note 5; and Blum, *supra* note 1, at 314. *See also* OECD action 1 final report, *supra* note 14, at 107; and February 2019 consultation document, *supra* note 3, at 16.

¹⁷ OECD action 1 final report, *supra* note 14, at Chapter 3.

are subject to tax, and because those assets are highly mobile, the OECD has argued that they can be used to shift income into low- or no-tax environments.²³

User data and user participation may be collected to develop products and services, provide content for other users of the product or services provided by the business, and for advertising targeting users. The OECD has noted that companies are making increasing and more intensive use of data.²⁴ It has argued that the value created from the changing nature of customer and user interaction is not sufficiently captured in user jurisdictions under an international framework that focuses on the physical activities of the business itself, which because of the ability to scale without mass, may be outside the user jurisdiction.²⁵

Scale without mass refers to the ability to locate parts of the production function across jurisdictions while accessing customers worldwide. The OECD has said that advances in digital technology have not changed the fundamental nature of the core business, which in simplified terms should still just add value to input and allow businesses to sell to customers at a better price than competitors.²⁶ However, digitalization enables businesses to carry out the value-adding activities remotely, automatically, and faster. Further, the OECD has argued that this dematerialization is most significant — although not unique — to digitalized business models, and because of cost-efficient cloud-based solutions, could be applicable to not only large multinationals but also to small enterprises.²⁷ That limited need for physical presence when doing business has been argued to reduce the number of jurisdictions where a taxing right to business income can be allocated. However, as also recognized by the OECD, in many cases, large multinational enterprises will indeed have taxable presence in the countries where their

customers are located — for example, to ensure high-quality service, have a direct relationship with key clients, or minimize latency.²⁸

Some members of the inclusive framework have said that the key features described above work together to particularly enable highly digitalized businesses to create value by activities closely linked with a jurisdiction without needing to establish a sufficiently physical and thereby taxable presence either in the form of a subsidiary or a PE.²⁹

Commonly known examples of digital business models include cloud computing, social networking, online retailers, intermediary platforms, and search engines. The rise of businesses that primarily transact with customers via the internet undoubtedly tests many traditional tax principles. An increase in remote activities will create problems for tax authorities, which may encounter difficulties in taxing economic activities that take place outside their geographic jurisdictions. Therefore, those types of business models are analyzed to understand which activities could create taxable presence in the form of PE.

III. The PE Concept in a Nutshell

The PE concept is in most tax treaties³⁰ and is one of the most analyzed international tax concepts. Even so, its applicability in the digital context has been questioned because of its inherent physical presence requirement.³¹ However, the amendments to article 5 of the OECD model tax convention and its commentaries over time have lowered the threshold for required physical presence. For instance, the commentary additions of the painter example and provisions on e-commerce and optional service PEs, as well as the implementation of BEPS action 7 on preventing the artificial avoidance of PE status, all seem to lower the threshold for when source taxation can be established through a PE.

²³ OECD 2018 interim report, *supra* note 2, at 24, 52-53; and OECD action 1 final report, *supra* note 14, at 65-68.

²⁴ OECD 2018 interim report, *supra* note 2, at 24, 53-59; and OECD action 1 final report, *supra* note 14, at 68-70.

²⁵ OECD, *supra* note 3, at 10.

²⁶ OECD 2018 interim report, *supra* note 2, at 167.

²⁷ OECD 2018 interim report, *supra* note 2, at 52-53; and OECD action 1 final report, *supra* note 14, at 100-102.

²⁸ OECD action 1 final report, *supra* note 14, at 100-102.

²⁹ OECD February 2019 consultation document, *supra* note 3, at 9.

³⁰ Sasseville and Skaar, *supra* note 13; and Baker, *supra* note 13.

³¹ Hongler and Pistone, *supra* note 5; and Devereux and Vella, *supra* note 5.

The PE concept acts as the main allocator of taxing rights for cross-border activities. Business income from cross-border activities is taxable only in the country of residence, unless the business has a PE in the market state (assuming that payments received are not subject to withholding tax). The concept as commonly applied in tax treaties is largely based on the concept as stated in article 5 of the OECD model tax convention³² that a PE can be created based on the main rule (a basic PE) or the secondary rule (an agency PE).

According to article 5(1) of the 2017 OECD model, a basic PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Regarding the challenges presumed to be driven by the digitalization of the economy, specific provisions on e-commerce were included in the commentary to article 5 of the OECD model tax convention in 2003. In the 2017 version, the comments are in paragraphs 122-131 and primarily focus on when a server may create a PE.³³ They may thus be of limited use for newer, highly digitized business models based on various cloud solutions. The main conclusions from the 2003 commentary (also found in the 2017 version) are argued to be, on the one hand, that a website does not in itself constitute tangible property and consequently is not a location that is a place of business as far as the software and data constituting that website are concerned.³⁴ On the

other hand, the server — where the website is stored and through which it is accessible — is a piece of equipment having a physical location that could constitute a place of business of the enterprise operating it. Hence, the distinction between the website and the server is important when the enterprise operating the server is different from the enterprise that carries on business through the website.³⁵

When the three cumulative conditions are all met, the following exceptions may apply under article 5(4) of the 2017 OECD model if the activities are preparatory or auxiliary to the specific business model analyzed:

- using facilities solely for the storage, display, or delivery of goods belonging to the enterprise;
- maintaining a stock of goods belonging to the enterprise solely for the storage, display, delivery, or processing by another enterprise;
- maintaining a fixed place of business solely for purchasing goods or merchandise or collecting information for the enterprise; or
- carrying on any other activity for the enterprise.

For e-commerce, the commentaries list several activities as generally being of a preparatory or auxiliary character:

- providing a communications link between suppliers and customers;
- advertising goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise; and
- supplying information.³⁶

Further, the maintenance of a fixed place of business solely for any combination of activities mentioned above will not create a PE if the overall activity of the fixed place of business is preparatory or auxiliary. Consequently, whether each individual activity is indeed preparatory or auxiliary, as well as whether all the activities in

³² Sasseville and Skaar, *supra* note 13. Further, even the amendments in article 5 of the 2017 OECD model implementing the BEPS action 7 recommendations are of practical relevance in older tax treaties because MLI articles 12 (artificial avoidance of PE status through commissionaire arrangements and similar strategies) and 13 (artificial avoidance of PE status through the specific activity exemption) give countries the opportunity to implement them in existing tax treaties.

³³ For criticism, see Hazal İşınsu Türker, "The Concept of a Server PE in the Digital Economy," *Taxation in a Global Digital Economy* 130 (2017), stating that focusing on the server just because it fulfills the physical presence criterion cannot solve the presumed problems of taxing the digitalized economy.

³⁴ Para. 123 of the OECD model commentary to article 5. In accordance with that interpretation, see the Danish Tax Assessment Board in SKM2011.828.SR (2011) and SKM2014.268.SR (2014), stating that a non-Danish tax-resident company intending to offer online games via Danish websites from servers located outside Denmark would not create a PE in Denmark because there would be no fixed place of business there. See Türker, *supra* note 33, at 132, critiquing the position on websites and urging lawmakers to design a new PE definition including them. Some countries have taken that position in case law. See, e.g., A.S. Özgenç, "Recent Turkish Decision Finds that a Website Can Constitute a Permanent Establishment," (59)2/3 *Eur. Tax'n* 135-137 (2019), discussing a Turkish Supreme Administrative Court decision that found that a website can constitute a PE.

³⁵ Para. 124 of the OECD commentary to article 5.

³⁶ Para. 128 of the OECD commentary to article 5.

their synergy are effectively preparatory or auxiliary, should be analyzed.³⁷

Before the implementation of BEPS action 7, it was debatable whether the activities explicitly mentioned were also subject to a preparatory or auxiliary requirement or whether they per se could not create a PE.³⁸ However, in practice, many enterprises and national courts adopted a strict literal interpretation of the provision and were of the view that the preparatory or auxiliary requirement was referred to only in the catch-all provisions in article 5(4)(e) and (f) of the 2014 OECD model and therefore did not apply to the other activities listed in article 5(4)(a)-(d).³⁹ As a consequence of the digitalization of the economy, that interpretation resulted in BEPS concerns, because it arguably allowed some companies to undertake their core business in the market jurisdictions without creating a taxable presence there.⁴⁰ The amendments to article 5(4) of the 2017 OECD model mean that even the listed activities must be subject to the preparatory or auxiliary requirement, which should be assessed based on the business of the individual enterprise. Hence, an economic substance test is now included.⁴¹

Moreover, under article 4(1) of the 2017 OECD model, the exemptions do not apply when activities between closely related parties have been fragmented. In simplified terms, the exemptions do not apply to a fixed place of business that is used or maintained by an enterprise if the same, or a closely related, enterprise carries on complementary functions

that are part of a cohesive business operation in the same jurisdiction. Unfortunately, the commentaries do not provide much guidance on what should be considered complementary functions or cohesive business operations.⁴² The article 5 commentaries include two examples from which it can be concluded that: (1) in a bank, the verification of information provided by clients is a complementary function to a decision on a loan application and part of a cohesive business operation of providing loans to clients;⁴³ and (2) a store selling appliances is a complementary function to a small warehouse when identical items are stored and part of a cohesive business operation of storing goods in one place for delivering those goods in accordance with the obligations from their sale.⁴⁴

Finally, if an enterprise's activities do not constitute a basic PE, an agency PE may be created if a person is acting on behalf of the enterprise and in doing so, habitually concludes contracts or plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification. Before the implementation of the BEPS action 7 recommendations, only a dependent agent who habitually exercised the authority to conclude contracts in the name of, or binding on, the principal was deemed to constitute an agency PE.⁴⁵ Both MNEs and many national courts adopted a strict literal interpretation of those two requirements. That enabled MNEs to either limit the authority given to the agent, such that the agent would do all the pre-sales activities in the market jurisdiction, yet the contract would ultimately be concluded by the principal, or deploy commissionaire arrangements so that the agent concluded contracts with customers in its own name and

³⁷ Paras. 73, 129, and 130 of the OECD commentary to article 5.

³⁸ OECD, "OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)," at 24-26 (Oct. 19, 2012). The OECD's opinion was that model article 5(4)(e) stipulated that those activities had to be of a preparatory or auxiliary nature (para. 21 of the 2014 OECD model commentary on article 5). A similar opinion can be found in international tax literature. See, e.g., Rahul Batheja, "Treaty Abuse and Permanent Establishments: Proposed Changes to Article 5(3) and (4) of the OECD MC," *Series on International Tax Law: Preventing Treaty Abuse* 386-387 (2016).

³⁹ Dhuldhoya, *supra* note 4; and Batheja, *supra* note 38.

⁴⁰ OECD, "Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015: Final Report," at 10 (2015).

⁴¹ That may be illustrated by the example in para. 62 in the 2017 OECD model commentary on article 5 regarding a fixed place of business constituted by important facilities used by an enterprise for storing, displaying, or delivering its own goods or merchandise — that is, the local storing is an essential part of the enterprise's sale and distribution business and would therefore not have a preparatory or auxiliary character.

⁴² Sonia Watson, Nick Palazzo-Corner, and Stefan Haemmerle, "UK View on Revised PE Standards in the Multilateral Instrument," 24(3) *Int'l Transfer Pricing J.* 182 (2017), point out that the lack of clarity in the test has caused concern among companies, which they say they expect will inevitably lead to disputes between taxpayers and tax authorities.

⁴³ Para. 81 of the OECD commentary to article 5.

⁴⁴ Para. 82 of the OECD commentary to article 5.

⁴⁵ Article 5(5) of the 2014 OECD model. Further, paragraphs 21, 32.1, and 33 of the 2014 OECD model commentary on article 5 clarified that the authority to conclude should be viewed in the context of contracts that constituted the enterprise's business proper and that only persons who, in view of that authority or the nature of their activity, involved the enterprise to a particular extent in business activities in the market jurisdiction would be deemed a PE.

thereby avoided creating a deemed agency PE of the MNE in the market jurisdiction.⁴⁶ However, the amendments in article 5(5) of the 2017 OECD model imply that those limitations to agent authority and the use of dependent commissionaire arrangements constitute a deemed agency PE for the principal.⁴⁷

What seems apparent is that neither a basic nor an agency PE can exist in the absence of some degree of physical presence. As already noted, that basic finding has been said to cause frustrations in determining the taxable presence of highly digitalized business models if they are in fact able to operate without physical presence in the market jurisdictions.

IV. PEs and Highly Digitalized Models

The objective with this study is to gain an increased understanding of the international standards regarding taxable presence, as well as the ability of those standards to effectively capture business income generated through digitalized business models. To test that, some basic knowledge is needed of the models deemed to cause frustration in the international tax community among lawmakers and tax administrations.

Although our examples are much simplified relative to actual practice, they still serve to illustrate the main points and can be used to determine whether the various models will create a PE in the market jurisdictions where server farms are located, sales-related activities are performed, and marketing and customer support services are provided.

A. Cloud Computing Model

1. Overview

A cloud computing business⁴⁸ creates value and earns revenue by providing a broad set of on-demand, standardized, and highly automated computing services to customers.⁴⁹ Hence, cloud customers do not have to make large upfront investments in hardware because their business activities take place on a network of remote servers through the internet rather than on local servers. Because cloud devices are continually updated, customers can access the most recent technology, and because they involve both virtual and physical servers, they allow customer flexibility and scalability in server capacity.

Depending on the form of cloud computing, the cloud services are typically provided on a pay-as-you-go or subscription basis. They may also be provided as a freemium model that generates revenue through advertising, sale of customer data, or sale of expanded services requiring payment. The cloud computing market is known to obtain economies of scale⁵⁰ and may be characterized as a high-volume, low-margin business. Finally, according to the OECD, cloud computing business models are hardly comparable to more traditional counterparts because they appear truly new. Figure 1 illustrates a generic business model for the provision of cloud computing services.

A cloud computing service provider (CCSP) such as Amazon Web Services and Google Cloud Platform is typically the group principal. It

⁴⁸The description provided in the overview is based on the OECD action 1 final report, *supra* note 14, at 59-61, 175-179; and 2018 interim report, *supra* note 2, at 73-79. See also Pistone, Nogueira, and Andrade, *supra* note 10, at 11; and Kjærsgaard, "Allocation of the Taxing Right to Payments for Cloud Computing-as-a-Service," 11(3) *World Tax J.* (Aug. 2019).

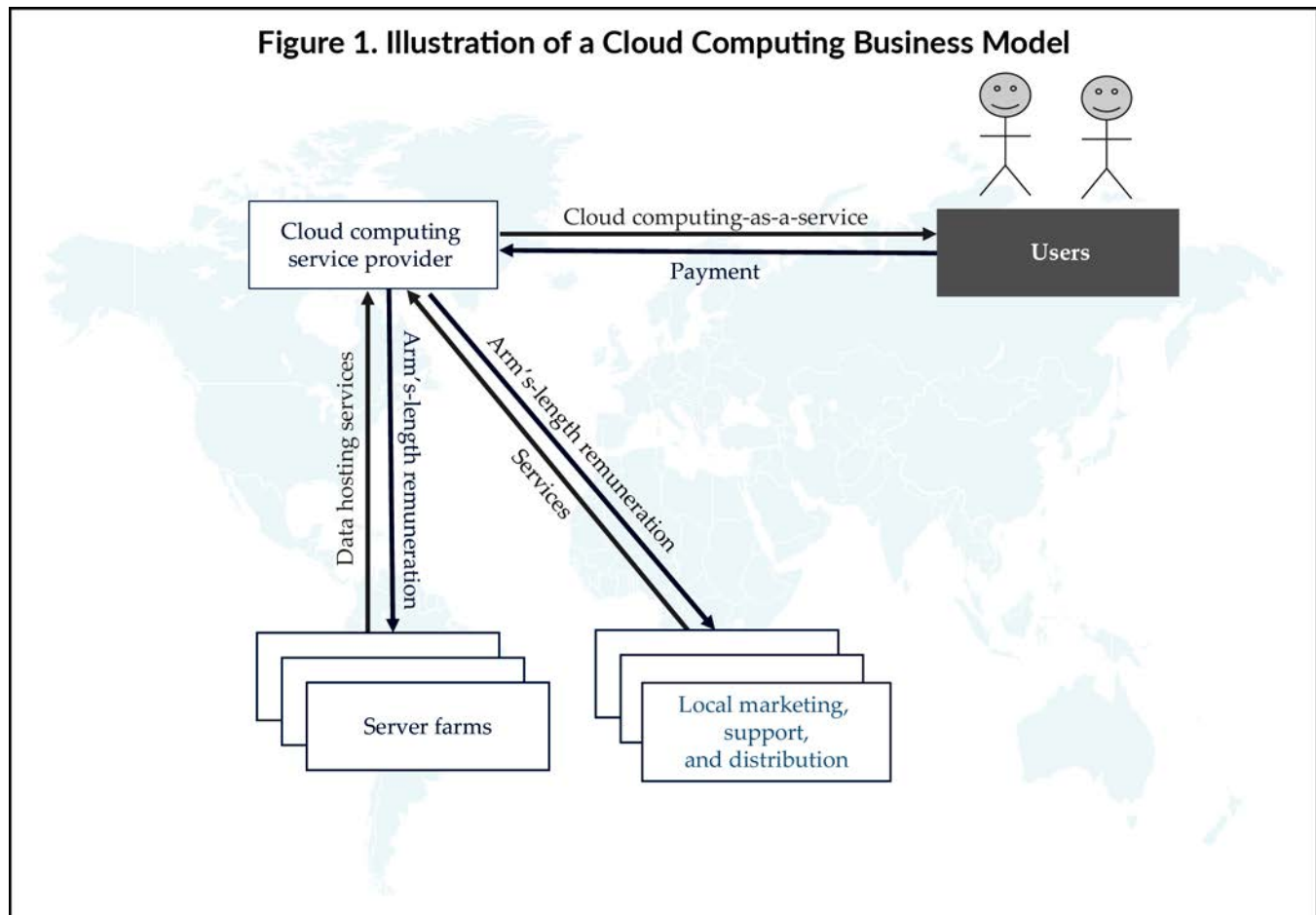
⁴⁹Cloud computing is not defined for tax purposes specifically. Peter Mell and Tim Grance, *The NIST Definition of Cloud Computing* (2011), provide a general definition:

A model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computer resources (for example, network, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interactions.

⁵⁰OECD 2018 interim report, *supra* note 2, at 73. Economies of scale occur when the long-run average costs are decreasing given when the quantity produced is increasing, and the input prices are fixed. See, e.g., Robert H. Frank, *Microeconomics and Behavior* 374 (2010). See also OECD action 1 final report, *supra* note 14, at 60.

⁴⁶Dhuldhoya, *supra* note 4; and Philip Baker, "Dependent Agent Permanent Establishments: Recent OECD Trends," *Series on International Tax Law: Dependent Agents as Permanent Establishments* 24-28 (2014). The authors argue that the controversy surrounding the interpretation of the phrase "the authority to conclude contracts in the name of" originates in the differences of interpretation between civil and common law. See also David Feuerstein, "The Agency Permanent Establishment," *Series on International Tax Law: Permanent Establishments in International and EU Tax Law* 107 (2011).

⁴⁷Dhuldhoya, *supra* note 4; and Carlo Garbarino, "Permanent Establishments and BEPS Action 7: Perspectives in Evolution," 47(4) *Intertax* 376-378 (2019).



develops and owns intangible assets, including IP such as software and algorithms that it operates on servers worldwide and makes available to customers through various client interfaces. The CCSP also remotely coordinates marketing and selling activities to regional operating lower-tier representatives to minimize costs, maintain consistency, and improve efficiency. That representative might conduct some of the following activities:

- ownership and operation of server farms;
- sales activities, although contracts with customers are typically concluded electronically through websites based on more or less standard agreements whose terms are set by the principal; and
- marketing and customer support services.

2. When Is a PE Created?

a. Server Farms

The first scenario to be analyzed is whether the server farms will create a PE of the CCSP if the

servers are owned and operated by the CCSP itself.⁵¹

Because physical servers are equipment with physical locations that may constitute a fixed place of business of the enterprise that operates them (assuming they are not moved for a sufficient period⁵²), they might fulfill the requirement of being a fixed place of business. Further, if the CCSP is operating its own servers to provide cloud computing as a service to customers, it is most likely carrying out business through that fixed location while also taking into

⁵¹This analysis is somewhat based on the analysis in Kjærsgaard, *supra* note 48.

⁵²According to paragraph 28 of the 2017 OECD model commentary on article 5, a PE is often created when the place of business is maintained longer than six months.

account that a PE may exist even though it has no or few employees at the server farms.⁵³

However, even if the three cumulative conditions for creating a PE are met, activities considered preparatory and auxiliary based on a case-by-case assessment will not constitute a PE. The OECD provides no exhaustive list, but as a general rule, auxiliary activities are of a supporting nature, typically without the need for significant assets or employees, and preparatory activities are those that are carried on for a relatively short period in contemplation of the essential and significant part of the CCSP.⁵⁴ Article 5(4) of the 2017 OECD model and the commentaries list some activities that typically are preparatory or auxiliary:

- using facilities solely to store, display, or deliver goods belonging to the enterprise;
- providing a communications link;
- relaying information through a mirror server for security and efficiency purposes; and
- supplying information.⁵⁵

As also recognized by the OECD, it may often be difficult to distinguish between activities that are of a preparatory or auxiliary character and those that are not.⁵⁶ In other words, it may be difficult to determine whether the activities form an essential and significant part of the CCSP as a whole. The challenges are argued to be even greater for digitalized business models such as that used by the CCSP, because the activities performed are typically a range of integrated services traditionally thought to be preparatory or auxiliary — not directly sales-related — but now

inherently belonging to the core of the business.⁵⁷ Hence — and although to some extent dependent on the functionality of the servers — it is argued that even though some of the functions performed on the servers are covered by the listed activities, they are not of a preparatory or auxiliary character in a typical cloud computing business model.⁵⁸ More specifically, because it is not only the software and data belonging to the CCSP that are stored on the servers, the first listed exemptions should not apply to the provision of cloud computing as a service, which in simple terms may be described as storage of the cloud customers' software and data on physical and virtual servers.

Further, an advantage of cloud computing is its functional overlap — that is, data and software are for security and efficiency purposes generally not stored on one specific server but rather on multiple servers. That feature is argued to be part of the core business of the CCSP, although those activities in other business models may be considered preparatory or auxiliary.⁵⁹ Thus, in general it seems fair to conclude that even though servers as machines cannot make decisions or take risks on their own, they are — independent of the type of cloud computing provided — an essential and significant part of the services provided to customers and thereby the core business of the CCSP, even if the hosting service is provided only to the CCSP.⁶⁰

Therefore, if the CCSP owns and operates the servers through which cloud computing services are provided to customers, its activities will typically create a PE in the jurisdictions where the servers are located.⁶¹

⁵³ Para. 127 of the 2017 OECD model commentary on article 5. Further, Grégory Abate (France), "Withholding Tax in the Era of BEPS, CIVs and the Digital Economy," 103(B) *IFA Cahiers* 253 (2018), notes that even though the French tax authorities have endorsed the OECD principles, they issued a stricter interpretation of server PE (Ministerial Reply No. 56961 (July 30, 2001)), according to which the absence of operating staff at the server site generally implies that nothing more than preparatory or auxiliary activities take place, so a PE cannot be created. The condition regarding the presence of operating staff could be disregarded only in specific exceptional circumstances in which the sales functions are run automatically by the server where it is located. However, because that stricter interpretation was not included in the September 2012 recast of the official doctrine of the French tax authorities, it is doubtful that it is still the prevailing interpretation.

⁵⁴ Para. 60 of the 2017 OECD model commentary on article 5.

⁵⁵ *Supra* note 36.

⁵⁶ Para. 59 of the 2017 OECD model commentary on article 5.

⁵⁷ OECD action 7 final report, *supra* note 40, at 10; and Garbarino, *supra* note 47, at 371.

⁵⁸ John Walker and Tom Roth, "The Cloud, E-Commerce and Taxable Presence," 21 *Asia-Pac. Tax Bull.* 2 (2015).

⁵⁹ Ekkehart Reimer, "Royalties," in *Klaus Vogel on Double Taxation Convention* 312 (2015).

⁶⁰ Para. 130 of the 2017 OECD model commentary on article 5. Many countries have made observations to paragraphs 122-131 of that commentary on the interpretation of PE in e-commerce. The United Kingdom says a server used by an e-tailer, either alone or together with websites, cannot as such constitute a PE (para. 176); Chile and Greece do not adhere to all the interpretations (para. 177); Mexico and Portugal want to reserve their rights not to follow the position (para. 182); and Turkey reserves its position on whether and when the activities constitute a PE (para. 183).

⁶¹ Aleksandra Bal, "The Sky's the Limit — Cloud-Based Services in an International Perspective," 68(9) *Bull. Int'l Tax'n* 515, at 519 (2014).

However, CCSPs have seemingly structured their server farm activities in a way that avoids creating PEs: locating server ownership and operation in a local subsidiary and allowing the CCSP to use the server capacity against an arm's-length remuneration (see Figure 1). As a consequence of the separate-entity approach implemented in article 5(7) of the 2017 OECD model, the mere presence of a subsidiary does not create a PE of the parent; a PE will be created only if the parent's activities create a PE, which requires a fixed place of business to be at the parent's disposal. In that respect, even if the arm's-length remuneration is based on the amount of storage capacity used, and the CCSP has been able to select the specific servers the software should be hosted on, the servers should not be at the CCSP's disposal. However, that changes if the CCSP can be said to de facto operate the servers — potentially even remotely.⁶²

That distinction, although not straightforward, might be illustrated in case involving an advance binding ruling from the Danish Tax Assessment Board.⁶³ A Danish subsidiary of a foreign parent owned a Danish-located data center that included servers and other equipment. Employees of the Danish subsidiary ran, operated, and maintained the server farm and according to an intragroup agreement, delivered on arm's-length terms server capacity to host the parent's webpage. All work on the webpages and applications would be performed so that all software, ad content, and data would be stored on servers located at different addresses. The parent company did not have country-specific webpages; all customers had access to one common webpage, but ad content was directed toward customers based on their demographics.

The Danish subsidiary did not have permission to use or handle the data stored on the servers unless it acted as a service provider on behalf of or under instructions from the parent.

The subsidiary would not take part in any agreement to allow it to provide services directly to customers, advertisers, or developers or legally oblige or create obligations for the parent. Personnel employed by, or working under contract for, the Danish subsidiary were primarily responsible for the daily management of the equipment in the data center, including installation, operations, maintenance, and repairs. The employees working in the data center were to follow the instructions received by the relevant management teams for daily operations and maintenance of the datacenter. Access to the datacenter was restricted to the employees of the Danish subsidiary and to specific service providers.

The parent company and a small group of its employees had permission to visit the data center if accompanied by employees of the Danish subsidiary. The parent's employees — located outside Denmark — handled the webpage remotely. They had the ability to monitor the efficiency of the hardware and software installed in the data center, install and uninstall applications, maintain the hosted applications, and handle the software and data stored on the servers. If a server was not working correctly (or in other emergencies), it could be shut down remotely, which also enabled the redirecting of data to other servers. Finally, that remote access was not to differ from the standard terms in any cloud computing arrangement.

The Danish Tax Assessment Board ruled that the Danish subsidiary did not constitute a PE of the parent because the parent could not be considered to own, lease, or operate the servers but instead to pay an arm's-length service fee for the hosting services provided by the subsidiary. The board referred to paragraph 42.2 of the commentary to article 5 of the 2014 OECD model, saying an agreement with an internet service provider under which a website is stored on a server belonging to the provider typically does not result in the server and its location being at the company's disposal, even if the company has been able to determine that its website should be stored on a specific server at a specific location. The board concluded that the parent could be considered to have a server PE in Denmark only if it could exercise control over a server as if it in fact owned or operated the subsidiary's servers. Based

⁶² *Supra* note 35.

⁶³ SKM2016.188.SR. For commentary (in Danish), see also Erik Werlauff in RR 2017 SM.03, pointing out that the decision shows that a PE can be avoided for a foreign company if a Danish subsidiary is established and owns and operates the servers the foreign company's website (data and software) runs on. Further, the concept of a PE in Danish domestic tax law is based on that in the 2014 OECD model.

on the facts, there was no such access because the parent did not have the right to instruct or control the work of the subsidiary's employees. Moreover, the parent company generally did not have physical access to the servers, and remote access could not be regarded as the right to control the servers. Thus, there was no de facto control over the servers, so no PE was created. The board made the reservation in their decision it was assumed that all agreements between the companies should be concluded on arm's-length terms.⁶⁴

The decision is arguably correct: As long as the parent company cannot be regarded as de facto operating the servers — either remotely or via control over the subsidiary's employees — a PE of the CCSP should not be created. Consequently, hosting agreements under typical cloud computing contracts should generally not create PEs — even if between related parties — as long as the structure is well prepared, particularly regarding the CCSP's remote and physical access to the servers, authority to instruct the subsidiary's employees, and compliance with the arm's-length principle.

Somewhat similar interpretations of the PE concept can be seen in case law from other jurisdictions. In CRA Doc. 2012-0432141R3-E, a data center owned and operated by a Canadian affiliate of a U.S. parent company did not constitute a PE of the parent. The subsidiary employees were in principal responsible for the installation, operation, maintenance, and repair of equipment and servers in the data center. The website activities were managed remotely by parent employees who had the ability to monitor the performance of the hardware and software, install and uninstall applications, perform maintenance on the hosted applications, and otherwise manage the software and data. However, employees of the U.S. parent company

would have access to the data center for inspection and maintenance only if accompanied by employees of the Canadian subsidiary. The Canada Revenue Agency concluded that the servers owned and operated by the Canadian subsidiary could not be considered at the disposal of the U.S. parent.⁶⁵

Swedish tax authorities have issued guidelines regarding when servers may create a PE.⁶⁶ A server in Sweden may create a PE of a foreign company that owns, rents, or otherwise disposes of the server, even if the foreign company has no other business or personnel in Sweden. Moreover, and in line with the commentaries to the OECD model, if a foreign company's business consists of hosting websites or other applications for other companies, the operation of the server to provide services to customers is an essential component of the company's commercial activity and cannot be considered preparatory or auxiliary. Further, a PE could arise even if the business activity consists solely of storing and processing information on a server in Sweden, and even if the server is not used in direct contact with customers.

In summary, the general understanding of a fixed place of business at disposal implies that a cloud computing business model may be structured so that basic PEs of the CCSP can be avoided in the jurisdictions where the servers are located if they are owned and operated by local subsidiaries that are entitled to an arm's-length remuneration. The changes to 2017 model article 5(4) as part of the implementation of BEPS action 7 should not affect that result, because they relate to whether the activities carried out at a fixed place of business at disposal should be considered preparatory and ancillary.

If the local subsidiaries owning and operating the server farms do not constitute basic PEs of the

⁶⁴ Somewhat similar decisions have been made in other binding rulings given by the Danish Tax Assessment Board. In SKM 2015.369 SR, a Danish resident company would contractually receive some services but obtain no further rights. It would be responsible for the operation and maintenance of the content placed on the servers (software and data), while the service provider would be responsible for operating the servers and could change functions after notifying the Danish company. The Danish Tax Assessment Board found that the Danish company could not be considered to have facilities where its business activities were performed and therefore its foreign activities did not constitute a PE.

⁶⁵ Daryl Maduke and Natasha Miklaucic (Canada), "Withholding Tax in the Era of BEPS, CIVs and the Digital Economy," 103(B) *IFA Cahiers* 146 (2018), argue that the concept of a server PE is unlikely to have a meaningful impact on any Canadian tax revenue loss resulting from the digitization of traditional transactions. The primary reason is that the many major U.S. digital companies reduce the need to have servers in Canada. Secondly, even if it is desirable for a U.S. company to set up a data center in Canada, it may be possible to isolate the data center in a Canadian subsidiary and thereby limit the U.S. parent's liability for Canadian taxes.

⁶⁶ *Server som fast driftställe*, Dnr: 202 493137-18/111 (Nov. 23, 2018).

CCSP according to 2017 model article 5(1), the next question is whether they are dependent agents under article 5(5) — that is, whether the server farms habitually play the principal role leading to the conclusion of contracts for the provision of cloud computing as a service by the CCSP. However, that should generally not be the case because the subsidiaries will neither interact, nor be an active part of contracting, with CCSP customers.

Even so, if the negotiation and conclusion of customer contracts are fully automated by the software operated and stored on the servers, a wide and somewhat far-fetched interpretation could be that the subsidiaries' operation of the servers could imply that the servers play the principal role leading to the conclusion of contracts. However, that interpretation cannot be supported because neither the software nor servers can be considered persons under 2017 OECD model article 3, and because the mere storage of software cannot be considered to play the principal role leading to the conclusion of contracts.⁶⁷

Consequently, a local subsidiary owning and operating the servers should constitute neither a basic nor an agency PE of the CCSP.

b. Regional Support, Sales, and Marketing

Another aspect in analyzing whether a CCSP will create PEs as a consequence of providing cloud computing as a service is whether local representatives providing customer support services as well as sales and marketing activities may constitute a basic or agency PE. Although presumably depending on the size of the cloud computing business, the importance of the local market, and the intended permanency of presence there, the CCSP's local representatives will typically be subsidiaries.

For a basic PE, it should initially be determined whether there is a fixed place of business through which the CCSP's business is wholly or partly carried on and whether the activities are of a preparatory or auxiliary character. If, for example, the CCSP carries on its business through subcontractors such as local

subsidiaries, a PE will exist only if the subcontractor's employees perform the work of the CCSP at a fixed place of business that is at the CCSP's disposal.⁶⁸ Given the above analysis of server farms as a fixed place of business, and that the subsidiary's employees are typically at the subsidiary's sole disposal, subcontractors should typically not constitute a PE of the CCSP but instead be service providers entitled to arm's-length remuneration for the provision of those services.

If instead the CCSP has employees in the market jurisdictions, it should be determined whether there is a fixed place of business such as an office, or even a home office, used on a continuous basis to carry on business for the CCSP. A home office may be considered at the disposal of the CCSP if, for instance, the CCSP has not provided an otherwise needed office, taking into account the work performed by the employees.⁶⁹ If the CCSP has a place of business and the activities are carried out by CCSP employees or other persons receiving instructions from the CCSP, that will generally imply that the CCSP's business is carried on through the place of business whether or not those persons have the authority to conclude contracts.⁷⁰ Because all three cumulative conditions could be met, it should be determined whether the activities are preparatory or auxiliary.

There is no exhaustive list of preparatory or auxiliary activities, so the analysis depends on the facts and circumstances of each business model recalling that preparatory and auxiliary activities cannot be part of the essential and significant activities of the CCSP but may well contribute to its productivity.

Assuming that the marketing activities and customer support services provided by the CCSP's local employees are of a general nature — that is, not specially developed for an individual customer and based on strategies developed by the CCSP, which can also instruct and control the

⁶⁸ Article 5(1) and (7) of the 2017 OECD model; and para. 39 of the 2017 OECD model commentary on article 5(1).

⁶⁹ Para. 18 of the 2017 OECD model commentary on article 5(1).

⁷⁰ Para. 39 of the 2017 OECD model commentary on article 5(1).

⁶⁷ Para. 131 of the 2017 OECD model commentary on article 5 regarding websites hosted on servers; and Reimer, *supra* note 59, at 313.

activities performed⁷¹ — they may be considered of an auxiliary character.⁷² On the other hand, the sales-related activities are less likely to be considered auxiliary if the CCSP employees take active part in the negotiation of important parts of cloud computing contracts — for example, by participating in decisions regarding the type or quantity of cloud services provided.⁷³

Further, if there is a place of business in the market jurisdiction and the marketing activities and customer support services should be considered auxiliary but the sales-related activities should not, the anti-fragmentation rule in article 5(4.1) of the 2017 OECD model most likely implies that the CCSP cannot isolate the marketing activities and customer support functions at a separate place of business and to avoid creating a PE from those services. That is because those functions should likely be considered complementary and part of a cohesive business operation — assuming that the local representatives and the CCSP are related parties as defined in article 5(8) of the 2017 OECD model.

Even if there is no basic PE because there is no place of business in the market jurisdiction, a PE may still exist if the sales-related activities are performed by dependent agents provided that the local representatives are acting for the CCSP and in doing so habitually conclude contracts in the name of the CCSP. A PE may also exist if those representatives habitually play the principal role leading to the conclusion of those contracts (beyond mere promotion or advertising) without material modification by the CCSP — for example, through websites using mostly standard agreements formulated by the CCSP.

Whether the representatives should be considered dependent agents depends on the specific facts and circumstances. However, agents should be considered dependent if they are CCSP employees or agents such as local subsidiaries performing activities exclusively or almost

exclusively on behalf of the CCSP and its related parties.⁷⁴ Other indicators of dependency include the level of CCSP instruction and control, and the entrepreneurial risk assumed by the CCSP.⁷⁵

Further, although the subjective nature of whether an agent has played the principal role has been argued to give rise to much uncertainty,⁷⁶ the representatives will most likely be considered to play the principal role leading to the conclusion of contracts if they send emails, make telephone calls, or visit potential customers to discuss the services provided and are remunerated for doing so based on the number of contracts concluded in the jurisdiction.⁷⁷ That result also seems in line with the purpose of deeming a PE based on agents, which is to cover cases in which the activities a person exercises in the market jurisdiction are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise — in other words, when the person acts as the enterprise's sales force.⁷⁸ As a consequence of the amendments in 2017 model article 5(5), commissionaire arrangements under which the dependent agent concludes contracts with customers in its own name will also generally be deemed an agency PE of the CCSP.⁷⁹

Conversely, if the agent's economic risk profile corresponds to that of a reseller's, that is when cloud computing as a service is resold in the name of the agent and for the agent's own account, that should not result in a PE under 2017 model article 5(5).⁸⁰ Likely as a consequence of the actions taken to target commissionaires' remote selling, commissionaires are being converted into resellers, which should result in more functions performed, risks assumed, and assets used by the

⁷¹ That assumption is in line with the generic description of cloud computing business models in the OECD action 1 final report, *supra* note 14, at 175-176; and 2018 interim report, *supra* note 2, at 73-79. See also Pistone, Nogueira, and Andrade, *supra* note 10, at 11.

⁷² Paras. 71 and 128 of the 2017 OECD model commentary on article 5, stating that advertising goods or services may be preparatory or auxiliary.

⁷³ Para. 72 of the 2017 OECD model commentary on article 5.

⁷⁴ Para. 103 of the 2017 OECD model commentary on article 5.

⁷⁵ Para. 104 of the 2017 OECD model commentary on article 5.

⁷⁶ Dhuldhoya, *supra* note 4; and Maria Cecilia Villareal Regalado, "Treaty Abuse and Permanent Establishments: Proposed Changes to Articles 5(5) and 5(6) of the OECD MC," *Series on International Tax Law: Preventing Treaty Abuse* (2016).

⁷⁷ Para. 90 of the 2017 OECD model commentary on article 5.

⁷⁸ Para. 88 of the 2017 OECD model commentary on article 5.

⁷⁹ *Supra* note 47.

⁸⁰ Para. 96 of the 2017 OECD model commentary on article 5.

reseller and thus in more income being allocated to the reseller's state of residence.⁸¹

c. Local Customers

The last aspect to analyze is whether the cloud customers could constitute a PE of the CCSP. A basic PE should not be created because there will hardly be a fixed place of business at the disposal of the CCSP. Further, we would not support a finding that customer activities (enabling the collection of data) should be considered as carrying out the business of the CCSP. However, if customer activities should be considered as such, they should likely be considered of an auxiliary character. Gathering market data for the enterprise and the supply of information are activities typically considered of preparatory or auxiliary character in e-commerce.⁸² Also, cloud computing business models are characterized by relatively low customer participation because the data customers store in the cloud are generally unavailable for detailed analysis by the CCSP and are typically not shared among customers.⁸³ Finally, customers cannot be considered agents of the CCSP because they are not acting on its behalf in any way that could be considered playing the principal role in the conclusion of contracts; hence, an agency PE cannot be created.

d. Summary of Preliminary Findings

Based on the analysis, a CCSP will create PEs only in rare situations. More specifically, server farms will create PEs only if the CCSP owns and operates the server farms. However, in practice, server farms are typically owned and operated by local subsidiaries remunerated for their services in accordance with the arm's-length principle. Those server farms will generally not be at the CCSP's disposal, although that requires a case-by-case assessment, particularly regarding the CCSP's remote and physical access to the servers,

authority to instruct subsidiary employees, and compliance with the arm's-length principle.

Local representatives will generally create a basic PE of the CCSP only if CCSP employees carry out its business and some of the activities are of a non-preparatory or non-auxiliary character. Sales-related activities by a dependent commissionaire will create an agency PE. However, in practice, the representatives may be local subsidiaries not constituting PEs of the CCSP but remunerated for their reseller services in accordance with the arm's-length principle.

Even though PEs of the CCSP are unlikely to be created, that does not mean that no tax revenue is generated in the market jurisdictions — the creation of PEs is primarily avoided by establishing local subsidiaries entitled to arm's-length remuneration. Consequently, only with remote selling — that is, customers are resident in a jurisdiction without server farms, local representatives, resellers, or CCSPs — will taxable revenue not be realized in the market jurisdiction.

B. Social Network Model

1. Overview

A business model based on the provision of a social network to users is a multisided platform that collects user data and provides advertising services.⁸⁴ It has two objectives: (1) provide an often free platform for users to connect and share content; and (2) enable customers who want to advertise on the platform to effectively reach their target audiences (users on the other side of the market), typically for various fees. As a result, those business models typically have two complementary objectives when linking users and providing advertising services: Users of the social network provide geographic, behavioral, and demographic data in the course of interacting with the network, which helps a company create targeted advertising.

From the perspective of the social network provider (SNP), its user communities are valuable because they are the means of attracting the main commercial customers: advertisers. Hence, the

⁸¹ OECD 2018 interim report, *supra* note 2, at 95, stating that some digitalized MNEs have already started reconfiguring their trade structures based on remote sales in some countries, although not all market jurisdictions have experienced or benefited from those restructurings to the same extent. See also Barry Larking, "A Review of Comments on the Tax Challenges of the Digital Economy," 72(4a) *Bull. Int'l Tax'n* (2018).

⁸² *Supra* note 36.

⁸³ OECD 2018 interim report, *supra* note 2, at 57.

⁸⁴ The description provided in the overview is based on the OECD action 1 final report, *supra* note 14, at 62-72; and 2018 interim report, *supra* note 2, at 44-50. See also Pistone, Nogueira, and Andrade, *supra* note 10, at 10-11.

larger the user base, the larger the value — if sufficient user data can be collected and analyzed. From the perspective of participating users, the platform's value is enhanced as new users join (at little or no cost for the SNP, thereby creating positive externalities).

The traditional business equivalent of the user side of the model could be a membership-based social club, whereas the customer side could be seen in the placement of more traditional forms of advertising, such as television or radio commercials. Figure 2 illustrates a generic business model for the provision of social networking.

Typically, the SNP is the group principal and therefore develops and owns IP, including software and algorithms, which it operates on servers worldwide and makes available to users through various client interfaces. It also remotely coordinates marketing and sales activities to regional operating lower-tier representatives to minimize costs, maintain consistency, and improve efficiency. Those representatives typically provide user support services and sales and marketing activities, although contracts with users and customers are concluded electronically through websites using mostly standard agreements whose terms are set by the principal.

2. When Is a PE Created?

a. Server Farms

The first question is whether a CCSP's servers can constitute a basic PE for the SNP when hosting services are acquired to benefit from flexibility and cost efficiency. The commentaries to article 5 of the 2017 OECD model state that data and software hosted on servers do not constitute tangible property and therefore cannot constitute a place of business.⁸⁵ Physical servers will generally not constitute a place of business at the SNP's disposal independent of whether the SNP's payment to the CCSP is based on the amount of storage capacity used, because the server and its location will typically not be at the disposal of the SNP and its users.⁸⁶

Even if the SNP acquires private cloud computing offsite and thereby may be able to decide which specific servers the software and data should be stored on,⁸⁷ that should not create a basic PE because the servers will generally not be considered at the SNP's disposal.⁸⁸ However, when the SNP acquires private cloud computing onsite and carries on business through a website on servers at its own disposal, those servers could constitute a PE if the other PE requirements are met. Those situations should not occur often because one of the main benefits of purchasing cloud computing as a service is that the cloud customer does not in itself need the resources to operate and maintain the servers that would typically be needed for onsite private cloud computing. In sum, the servers should generally not create a basic PE of the SNP when owned and operated by a CCSP.

Some countries have taken a different position, saying a website may constitute a PE under some circumstances and that an enterprise can be said to have a place of business by virtue of hosting its website via private cloud computing.⁸⁹ However, this interpretation of the PE concept is not supported by the wording of article 5 of the OECD model nor in its commentaries.

Finally, it should be considered whether the CCSP could be regarded as a dependent agent of the SNP, which is generally not the case.⁹⁰ The CCSP will not conclude contracts or play the principal role leading to the conclusion of contracts in the name of the SNP. Also, the CCSP will act in the ordinary course of its business of providing storage capacity and infrastructure,

⁸⁷ According to the National Institute of Standards and Technology:

A private cloud is one in which the computing environment is operated exclusively for a single organization. It may be managed by the organization or by a third party, and may be hosted within the organization's data center or outside of it. A private cloud has the potential to give the organization greater control over the infrastructure, computational resources, and cloud consumers than can a public cloud.

Mell and Grance, *supra* note 49.

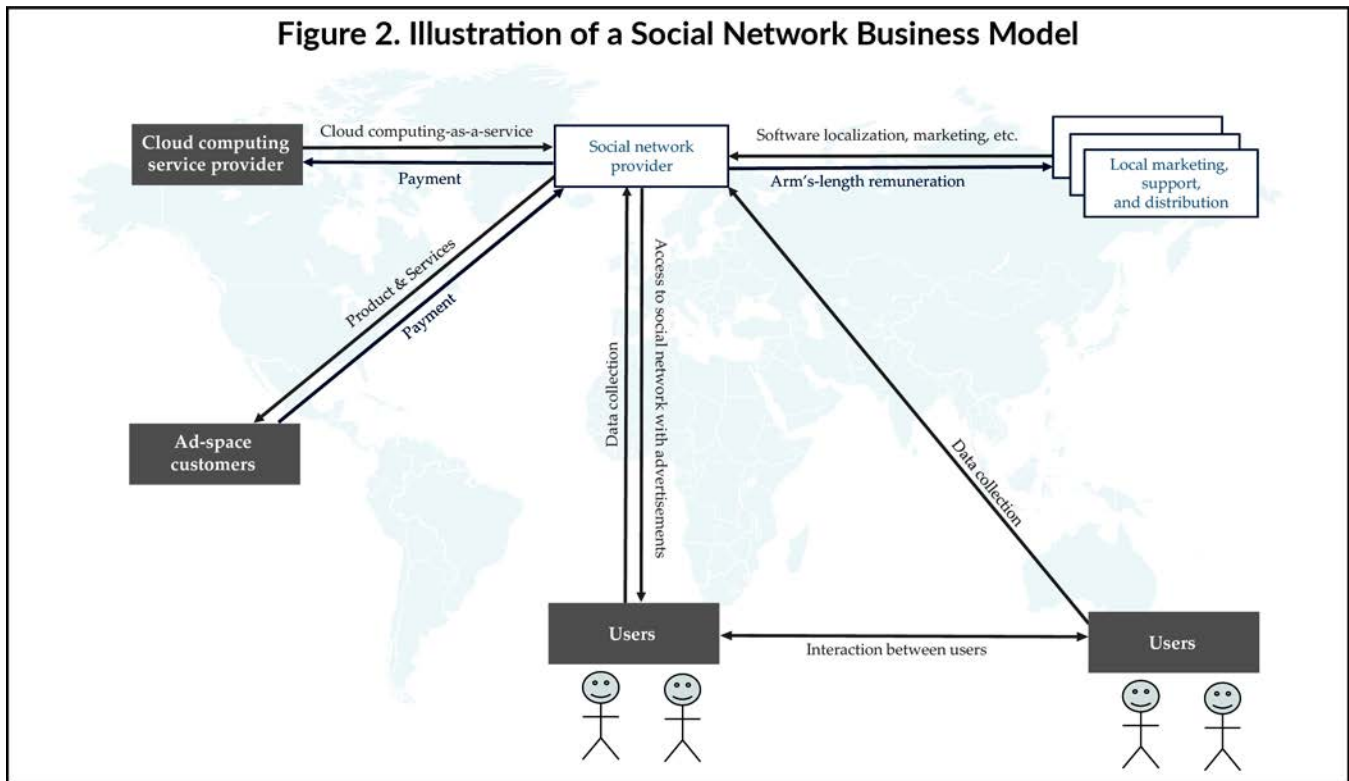
⁸⁸ *Supra* note 35. See also Bal, *supra* note 61, at 519.

⁸⁹ K.K. Chythanya and Rajendra Nayak (India), "Withholding Tax in the Era of BEPS, CIVs and the Digital Economy," 103(B) *IFA Cahiers* at 305 (2018), stating that implications from the position in India's tax treaties is debatable, ranging from treating the point as irrelevant to considering it persuasive, at least for tax treaties negotiated after the position was provided.

⁹⁰ Reimer, *supra* note 59, at 313.

⁸⁵ Para. 123 of the 2017 OECD model commentary on article 5.

⁸⁶ *Supra* note 35.



which is proven by the fact that it typically serves multiple customers and thus acts as an independent agent or service provider.⁹¹

b. Regional Support, Sales, and Marketing

As was the case for cloud computing business models, an SNP will usually have local representatives performing various activities in the local market. However, because of the multisided nature of the business model, the activities may target either users of the social network or ad space customers.

Regardless of which activities are targeted, a basic PE is created only if there is a fixed place of business through which the SNP’s business is wholly or partly carried out and if some of the activities are of a non-preparatory or non-auxiliary character. Based on an analysis similar to the one for cloud computing business models, local subsidiaries of the SNP should generally not constitute a basic PE but instead should be considered service providers of the SNP entitled to an arm’s-length remuneration for the provision

of those services. Further, if the SNP has employees working in the market jurisdictions, it should be determined whether there is a fixed place of business at the SNP’s disposal and, if so, whether the activities carried out are preparatory or auxiliary.

That analysis should be based on a case-by-case assessment of whether the activities performed by the local representatives form an essential and significant part of the SNP as a whole.⁹² That may be challenging regarding the business model deployed by the SNP, because the activities performed typically are a range of integrated services traditionally thought to be preparatory or auxiliary – that is, not directly sales-related – but now inherently belonging to the core of the SNP’s business. For example, it could be necessary to distinguish between marketing activities to increase the number of users and the amount of time they spend on the platform (collecting input for the production

⁹¹ Para. 131 of the 2017 OECD model commentary on article 5.

⁹² *Supra* note 56.

function⁹³) and activities targeting ad space customers (selling the output of the production function).

For activities targeting social network users, 2017 model article 5(4)(d) states that the maintenance of a fixed place of business solely to purchase goods or merchandise or collect information for the enterprise will not create a basic PE if the activity is preparatory or auxiliary to the business. It could be argued that because user data is an important SNP value driver (even when compared with other highly digital business models⁹⁴) and inherently belongs to an SNP's core business, the marketing activities increasing the amount of collected user data should equally be regarded as core business of the SNP. However, the OECD has argued that the fact that local representatives do not conclude contracts for purchasing or collecting user data gives the activities an auxiliary character.⁹⁵

For activities targeting ad space customers, it follows from the commentaries to article 5(4) that employees taking an active part in the negotiation of important parts of contracts for the sale of goods will usually constitute an essential part of the business operations.⁹⁶ Hence, if SNP employees do not negotiate contracts (which are typically concluded electronically through the website using generally standard agreements set by the SNP), those activities should likely be regarded as having a preparatory or auxiliary character.⁹⁷

Similarly, support services provided by local representatives to users and ad space customers on behalf of the SNP will likely be considered auxiliary as long as they are of a general nature. Sales-related activities, however, are less likely to

be considered auxiliary if SNP employees take active part in the negotiation of important parts of ad space contracts.⁹⁸

As with CCSP local representatives, the anti-fragmentation rule in article 5(4.1) of the 2017 OECD model implies that the exemption for activities of a preparatory and auxiliary character does not apply if other activities are performed in the same jurisdiction and result in a PE — if the business activities carried on constitute complementary functions that are part of a cohesive business operation. Hence, the SNP will be unable to isolate the auxiliary marketing and support functions at a separate place of business and thereby avoid creating a PE from those activities.

Even if there is no basic PE, an agency PE of the SNP may be deemed to exist under 2017 model article 5(5). Consequently — as with CCSPs — if SNP employees or other dependent persons send emails, make telephone calls, or visit potential customers to discuss contractual ad spaces and are remunerated for doing so based on the number of contracts concluded in the jurisdiction, those employees should likely be regarded dependent agents of the SNP.⁹⁹ Similarly, dependent commissionnaires of the SNP should generally be deemed agency PEs, although resellers should not create a PE. As mentioned, it seems commissionnaires are thus being converted into resellers, which should result in more functions performed, risks assumed, and assets used in the market jurisdiction and hence in more income being allocated to the reseller's state of residence.¹⁰⁰

c. Local Users and Customers

The last aspect is analyzing whether users or customers could constitute a PE of the SNP. There will hardly be a fixed place of business at the SNP's disposal, so a basic PE cannot be created.

Also, ad space customers will be carrying out their own businesses. However, an interesting yet broad interpretation of the phrase "carrying on the business of the SNP" could find that user

⁹³ That has been referred to as the "phenomenon of free labor," which extends from the theory of the firm formulated by Ronald Coase in *The Nature of the Firm* (1937). According to that theory, companies can choose between subcontracting to suppliers and hiring employees as input in the production function. However, an SNP may be argued to have a third option — that is, user participation generating data, which may be put back into the production function without users' monetary remuneration. See Pierre Collin and Nicolas Colin, *Task Force on Taxation of the Digital Economy* 49 (2013).

⁹⁴ OECD 2018 interim report, *supra* note 2, at 58.

⁹⁵ See examples in para. 68 of the 2017 OECD model commentary on article 5.

⁹⁶ *Supra* note 73.

⁹⁷ *Supra* note 72.

⁹⁸ Paras. 39 and 72 of the 2017 OECD model commentary on article 5(1).

⁹⁹ *Supra* note 77.

¹⁰⁰ *Supra* note 80.

activities (enabling collection of user data) should be considered. With business models based on the provision of social networks having the highest intensity of user participation¹⁰¹ and with reference to the phenomenon of free labor,¹⁰² the argument would be that users become virtual volunteer workers for the SNP by generating data that may be integrated into the production chain — thereby blurring the distinction between production and consumption. In other words, it could be said that data provided by users makes the users SNP production auxiliaries. However, even if user activities should be considered the business of the SNP, they should likely be considered of auxiliary because even though the supply of raw user data contributes to the SNP's productivity,¹⁰³ the generation of that data is so remote from the actual realization of profits that it is difficult to allocate any profit to activities performed by users.¹⁰⁴

Finally, neither users nor ad space customers can be considered agents of the SNP because they are not acting on behalf of the SNP in any way that could play the principal role in the conclusion of contracts selling SNP products, so an agency PE cannot be created.

d. Summary of Preliminary Findings

Based on the analysis, an SNP will create PEs only in limited situations. More specifically, server farms owned and operated by a CCSP will generally not create a PE under 2017 model article 5 because they will not be at the SNP's disposal, and the CCSP will not act as a dependent agent of the SNP.

Local representatives will create a basic PE of the SNP only if SNP employees carry out the business, with some of the activities being of a non-preparatory or non-auxiliary character. Sales-related activities by dependent commissionnaires will create agency PEs. However, the representatives may be local subsidiaries not creating a PE but remunerated for their reseller

services in accordance with the arm's-length principle.

Ad space customers and social network users in general do not constitute a basic PE because there is not a fixed place of business at the SNP's disposal. However, a broad interpretation could find that user activities could be considered as carrying out the business of the SNP, although we believe those activities should most likely be considered of an auxiliary character.

Even though PEs of the SNP are rarely created, that does not mean no tax revenue is generated in the market jurisdictions. PEs are primarily avoided by establishing local subsidiaries entitled to arm's-length remuneration. Given that the functions performed may be of a limited nature, limited remuneration is expected, which market states may perceive as being too low.

Consequently, only with remote selling will taxable revenue not be realized in the market jurisdiction — assuming payments from customers or users are not subject to local withholding tax.

C. Online Retailer Model

1. Overview

An online retailer (OR) creates value by selling goods to customers through an online store.¹⁰⁵ The goods sold may be tangible or intangible, so the retailer's online store can exist with or without accompanying brick-and-mortar locations. Customers typically visit the OR's language-specific website, select items to purchase, and submit the required information. Hence, on the one hand, online retail stores are used to shorten supply chains and eliminate intermediaries; on the other hand, like traditional retailers, they require high investment in advertising, customer care, and logistics (because tangible goods are shipped to customers).

The primary source of an OR's profit is the markup on goods. However, some ORs offer premium services, such as free shipping on eligible items via a subscription model (Amazon

¹⁰¹ OECD 2018 interim report, *supra* note 2, at 58.

¹⁰² Collin and Colin, *supra* note 93, at 49-54.

¹⁰³ OECD 2018 interim report, *supra* note 2, at 58.

¹⁰⁴ Paras. 58, 69, and 128 of the 2017 OECD model commentary on article 5.

¹⁰⁵ The description provided in the overview is based on the OECD action 1 final report, *supra* note 14, at 175-176; and 2018 interim report, *supra* note 2, at 60-66. See also Pistone, Nogueira, and Andrade, *supra* note 10, at 10.

Prime, for example). The OR might also sell customer data it collects or sell ad space targeted to customers purchasing its online products. Figure 3 illustrates a generic business model of an OR providing tangible or intangible products.

Typically, an OR is responsible for infrastructure such as organizational structure and control systems; human resources; research and development, including technological development of the platform and IT infrastructure; global marketing; and sales strategies. An OR's regional operating lower-tier representatives typically provide user support services and sales and marketing activities, although customer contracts are concluded electronically via websites using mostly standard agreements on terms set by the OR.

If an OR sells tangible products through an online store, some logistics activities will also be performed in the local markets. Inbound logistics activities could include sourcing of products and suppliers, receipt and storage of products, and the use of warehouse facilities to store inventory. Further, the logistics require the maintenance of inventory and potentially payment systems. Finally, outbound logistics requires local warehousing facilities and employees or automated processes to fulfill orders. Assembly and shipment activities are typically managed with robotic technology.

2. When Is a PE Created?

a. Server Farms

As with SNPs, the physical servers owned and operated by a CCSP should generally not constitute a basic PE for the OR because they will not constitute a place of business at the OR's disposal, independent of whether the OR's payment to the CCSP is based on the amount of storage capacity used, because they and their location will typically not be at the disposal of the OR and its users. However, if an OR acquires private onsite cloud computing and carries out business through a website on a server at its own disposal, the servers might constitute a PE if the other PE requirements are met.¹⁰⁶ In summary, according to the commentaries to the 2017 OECD

model, the servers should generally not create a basic PE of the OR when they are owned and operated by a CCSP.

Despite that, the Turkish Supreme Administrative Court has adopted a broad legal interpretation that a website can be considered a PE when individuals earn business income by selling goods through a third-party website akin to eBay.¹⁰⁷ The court said a PE could be created by business activities conducted in an electronic environment via a computer or when the taxpayer operates via the internet. However, that interpretation seems to lack support in the commentaries to the 2017 OECD model.

Finally, the CCSP can be regarded as the OR's dependent agent only under unusual circumstances.¹⁰⁸ That is because the CCSP will not conclude contracts or play the principal role leading to the conclusion of contracts in the OR's name. Also, in the ordinary course of its business, the CCSP will provide storage capacity and infrastructure, typically for multiple users, and thus act as an independent agent or service provider.¹⁰⁹

b. Regional Support, Sales, and Marketing

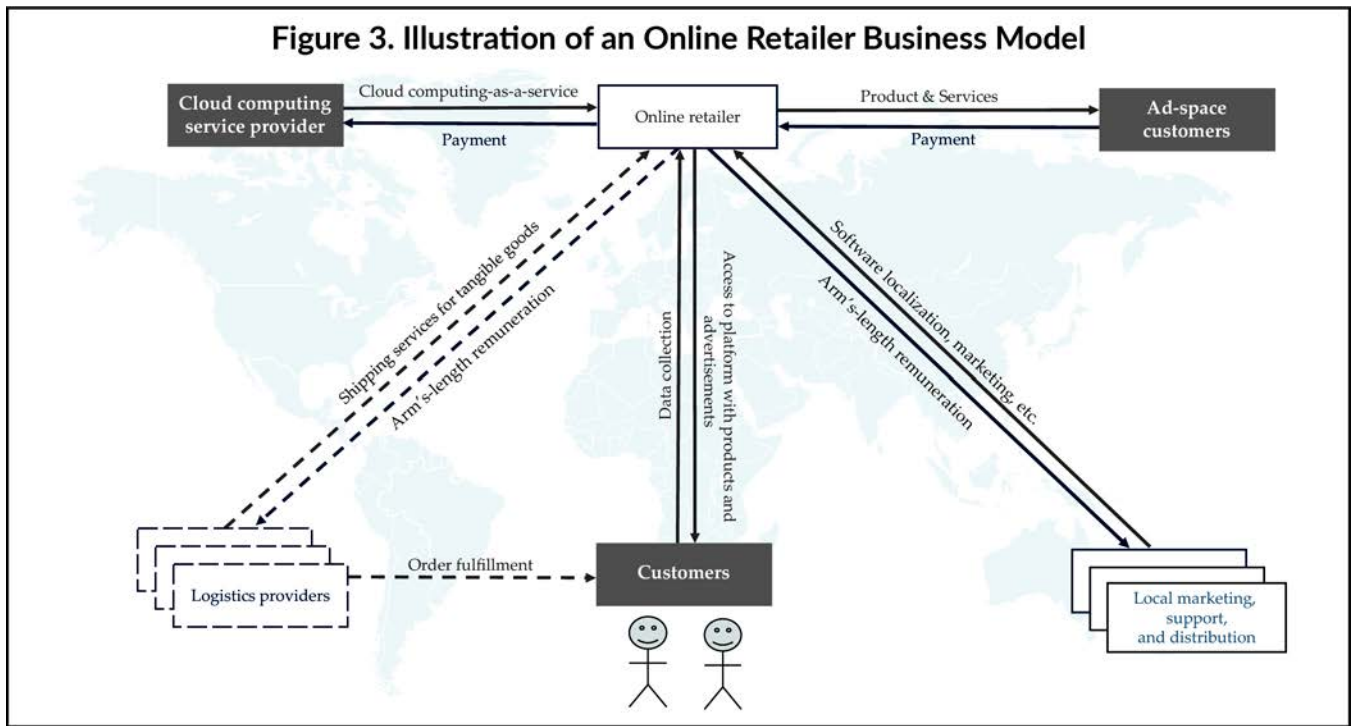
Like the cloud computing and social network models, ORs will usually have local representatives performing customer support, sales, and marketing activities in the market. That could constitute a basic PE if there is a fixed place through which the OR's business is wholly or partly carried out and if the activities are not all of a preparatory or auxiliary character. Based on an analysis similar to that for cloud computing business models, the OR's local subsidiaries generally do not constitute a PE and instead are service providers entitled to arm's-length remuneration. However, if the OR has employees in the market jurisdictions, it should be determined whether there is a fixed place of

¹⁰⁶ *Supra* note 88.

¹⁰⁷ Turkish Supreme Administrative Court, 4th Cir., E.2014/2193, K. 2017/6396 (unpublished). The issue was a matter of domestic law, so the decision's importance is unclear. Tax scholars assume that it could have an impact on the interpretation of a PE from a tax treaty perspective because the domestic concept of PE complies with the treaty definition in the OECD model. *See, e.g.,* Özgenç, *supra* note 34.

¹⁰⁸ Reimer, *supra* note 59, at 313.

¹⁰⁹ *Supra* note 91.



business at the OR’s disposal and, if so, whether the activities are preparatory or auxiliary.

The analysis should be based on a case-by-case assessment of whether the activities performed by the local representatives form an essential and significant part of the OR as a whole.¹¹⁰ However, assuming that the marketing activities and customer support services provided by the local employees are of a general nature and based on strategies developed by the OR, which is able to instruct and control those activities,¹¹¹ the services may be considered of an auxiliary character.¹¹² The sales-related activities are less likely to be considered auxiliary if OR employees take active part in the negotiation of important parts of contracts (for example, type, quality, and quantity of the product or services sold by the OR).

Again, under the anti-fragmentation rule in 2017 OECD model article 5(4.1), the exemption for preparatory and auxiliary activities does not apply if other activities are performed in the same jurisdiction and result in a PE — if the business

activities carried on constitute complementary functions that are part of a cohesive business operation. Hence, the OR should be unable to isolate the auxiliary marketing and support functions at a separate place of business and thereby avoid creating a PE from those activities.

Finally, even if there is no basic PE, an agency PE may be deemed to exist if the local representatives are acting for the OR and habitually conclude contracts in the name of the OR or habitually play the principal role leading to the conclusion of contracts without material modification by the OR. Consequently — as with CCSPs and SNPs — if OR employees or other dependent persons send emails, make telephone calls, or visit potential customers to discuss ad spaces provided under the online standard contracts and are remunerated for doing so based on the amounts of contracts concluded in the jurisdiction, they should be regarded as the OR’s dependent agents.¹¹³ OR commissionnaires will generally create a PE, whereas resellers should not. Likely as a consequence, commissionnaires are being converted into resellers, which should result in more functions performed, risks

¹¹⁰ *Supra* note 56.

¹¹¹ *Supra* note 71.

¹¹² *Supra* note 72.

¹¹³ *Supra* note 77.

assumed, and assets used by the reseller and thus in more income being allocated to the reseller's state of residence.¹¹⁴

c. Local Logistics

In determining whether the activities related to inbound, operational, and outbound logistics will create a PE, there must be an analysis of pre- and post-implementation of the BEPS action 7 recommendations. Based on a strict literal interpretation, the activities were by definition argued to be preparatory or auxiliary before the BEPS project, but post-BEPS that is the case only if they are in fact of a preparatory or auxiliary character in the specific business model.¹¹⁵ That economic substance test is illustrated by the example in the commentaries to the 2017 OECD model regarding a fixed place of business constituted by facilities used by an enterprise for storing, displaying, or delivering its own goods or merchandise. Hence, if a large warehouse where a significant number of employees work for the main purpose of storing and delivering goods owned by an enterprise that sells them online to customers in the local market, the storage and delivery activities represent an important asset that requires employees, thereby constituting an essential part of the enterprise's sale and distribution business. Those activities would therefore not be of a preparatory or auxiliary character.¹¹⁶

Conversely, the commentaries to article 5 state that a fixed place of business maintained by an enterprise solely for delivering spare parts to customers for machinery sold to those customers will be considered preparatory or auxiliary if

there is no machinery maintenance or repair. Thus, what may be in the nature of preparatory or auxiliary for one business may be a core activity for another.¹¹⁷

Therefore, under the new standard, it seems fair to conclude that if the OR itself — whose business model relies on proximity and quick delivery to customers — maintains a large local warehouse to store and deliver products sold online to customers, that would constitute a basic PE for the OR.¹¹⁸ The underlying argument is that ensuring fast delivery to customers by maintaining local warehouses goes beyond mere auxiliary activity because it forms a strategically decisive part of an OR's business model. That outbound logistics increasingly rely on automated processes with an extensive use of robotic technology should not alter that conclusion, because the presence of personnel is unnecessary in considering whether the OR carries out its business at a warehouse.¹¹⁹

On the contrary, if a local subsidiary provides logistics services through a warehouse on behalf of the OR for orders from local customers, that should generally not result in a basic PE because the fixed place of business will typically not be at the OR's disposal. Further, it is not the business of the OR that is carried out, but instead the business of the local subsidiary. Moreover, the activities performed at the warehouse are carried out after the contract with the customers is concluded, so the local subsidiary should not be deemed an agency PE of the OR.¹²⁰

¹¹⁴ *Supra* note 80.

¹¹⁵ Garbarino, *supra* note 47, at 368-373, analyzing the differences between pre- and post-implementation of the BEPS action 7 recommendations.

Some national courts have interpreted the exemption to include a requirement of preparatory or auxiliary character to the exemptions explicitly listed. *See, e.g.,* Tōkyō Chihō Saibansho, Gyou No. 152 (2015) regarding online retail business. The court found that the warehousing, delivery activities stemming from sales through an online store, and receipt of returned products could be said to constitute a PE of a nonresident taxpayer in the jurisdiction where the sales were made because those activities were important elements of an online retail business. The court also held that substantially all of the sales income from the business activity should be attributed to the PE because of the functional significance of the activities in Japan. For discussion, see Sagar Wagh, "The Taxation of Digital Transactions in India: The New Equalization Levy," 70(9) *Bull. Int'l Tax'n* 542 (2016).

¹¹⁶ Para. 62 of the 2017 OECD model commentary on article 5.

¹¹⁷ Para. 63 of the 2017 OECD model commentary on article 5.

¹¹⁸ *See* Kofler et al., *supra* note 1, at 527; and Wolfgang Schön, "Ten Questions About Why and How to Tax the Digitalized Economy," 72(4/5) *Bull. Int'l Tax'n* 281-282 (2018).

¹¹⁹ Para. 127 of the 2017 OECD model commentary on article 5 discusses an enterprise that operates computer equipment at a particular location; however, it also says that conclusion applies to other activities in which equipment operates automatically.

¹²⁰ *See* Kofler et al., *supra* note 1, at 527, stating that if the logistics are organized as local subsidiaries, the core question is shifted away from the presence of a PE to appropriate transfer pricing arrangements.

The OECD argues that because the orders for tangible products are placed by customers via a website managed by the OR, the local subsidiary is allocated minimal taxable income for the routine services provided to the OR. All revenue derived from the online sales of products are treated as OR income in the absence of a PE in the market jurisdiction to which the income is attributable. Action 1 final report, *supra* note 14, at 169.

d. Local Customers

As with the cloud computing and social network models, the final aspect is analyzing whether customers can constitute a PE of the OR. However, like the other highly digitalized business models, the OR will hardly have a fixed place of business at its disposal, so a basic PE cannot be created. Also, customers should not be considered agents of the OR because they are not acting on behalf of the OR in any way that could be considered playing the principal role in the conclusion of contracts to sell OR products or ad space. Thus, a deemed agency PE cannot be created.

e. Summary of Preliminary Findings

Based on the analysis, an OR will create PEs only in limited situations. More specifically, according to 2017 model article 5, server farms owned and operated by a CCSP should generally not create a PE because they will neither be at the OR's disposal nor act as the OR's dependent agent.

Local representatives will generally create a basic PE only if OR employees carry out the business and some of the activities are of a non-preparatory or non-auxiliary character. Sales-related activities by a dependent commissionaire will create an agency PE of the OR. However, in practice, the representatives may be local subsidiaries not creating a PE of the OR but remunerated for their reseller services in accordance with the arm's-length principle.

Local logistics of an OR selling tangible goods will constitute a PE only if OR employees perform the activities, because those activities do not have a preparatory or auxiliary character. A local subsidiary performing the logistics services should not constitute a PE of the OR, but the subsidiary will be entitled to an arm's-length remuneration.

Even though the creation of a PE can be avoided, that does not mean that no tax revenue is generated in the market jurisdictions because the creation of PEs is primarily avoided by establishing local subsidiaries that are entitled to arm's-length remuneration. Given that the functions performed may be of a limited nature, a limited remuneration is expected, which market states may perceive as too low.

Consequently, only with remote selling will taxable revenue not be realized in the market

jurisdiction — assuming the payments from customers are not subject to local withholding tax, because the customers should not create a PE of the OR.

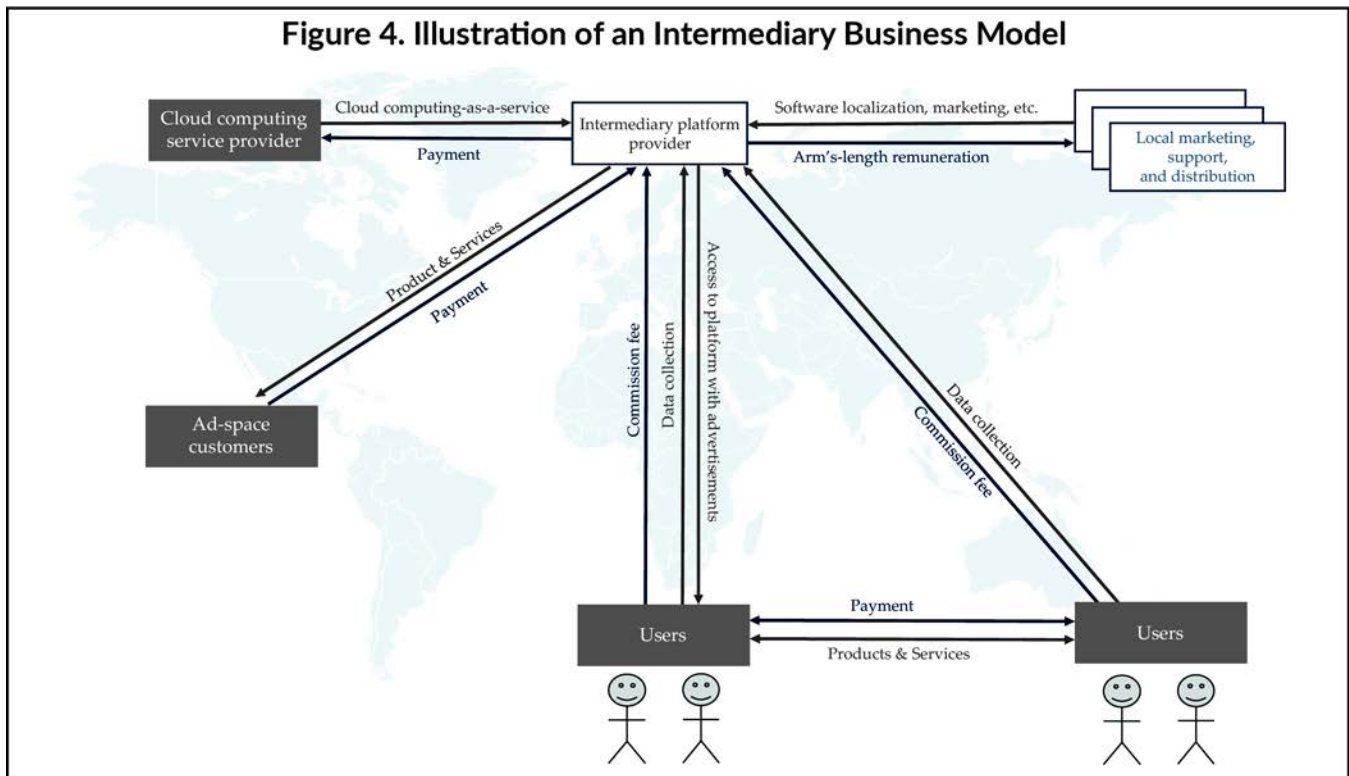
D. Intermediary Platform Model

1. Overview

The business model of digitalized intermediary platforms relies on a three-party relationship among the platform, the providing users, and the buying users.¹²¹ The platform creates value by matching end-users via mediation technology, which links users, organizes and facilitates user exchange, and ensures quality via a review system that allows users to rate the quality of the interaction. The activities performed by the intermediary platform generally include network promotion and contract management activities, such as those to invite potential users to join the network; service provisioning, such as those matching users and facilitating payments and the supply of goods and services; and network infrastructure operation activities to maintain and run a physical and information infrastructure. The main revenue sources for the intermediary platform provider (IPP) are commissions on user transactions, sales of collected user data, and online advertising. Figure 4 illustrates a generic business model for the provision of an online intermediary platform.

An IPP is typically responsible for infrastructure such as organizational structure and control systems, human resources, R&D, global marketing, and sales strategies. An IPP's regional operating lower-tier representatives typically provide user support services and sales and marketing activities, although customer and user contracts are concluded electronically via websites using mostly standard agreements on terms set by the IPP.

¹²¹The description provided in the overview is based on the OECD 2018 interim report, *supra* note 2, at 66-73; Pistone, Nogueira, and Andrade, *supra* note 10, at 10; and Kjærsgaard and Schmidt, *supra* note 21.



2. When Is a PE Created?

a. Server Farms

As with SNPs and ORs, the physical servers owned and operated by the CCSP should generally not constitute a basic PE for the IPP because they will generally not constitute a place of business at the IPP's disposal. Only in the rare situation when an IPP acquires onsite private cloud computing and carries out business through a website on a server at its own disposal will the servers constitute a PE if the other PE requirements are met.¹²² According to the commentaries to the 2017 OECD model, if the CCSP owns and operates the servers, a PE of the IPP will generally not be created.

Further, it is unlikely that the CCSP could be regarded as the IPP's dependent agent¹²³ because the CCSP will typically not conclude contracts or play the principal role leading to the conclusion of contracts in the IPP's name. Further, the CCSP will generally serve multiple users in its ordinary course of business.¹²⁴

¹²² *Supra* note 88.

¹²³ Reimer, *supra* note 59, at 313.

¹²⁴ *Supra* note 91.

b. Regional Support, Sales, and Marketing

An IPP usually has local representatives performing various activities in the local market, and like an SNP, an IPP deploys a multisided business model. The IPP relies on a three-party relationship among the platform, the providing users, and the buying users. The activities performed by local representatives may target selling users, buying users, or ad space customers.

Even so, independent of which segment the activities target, a basic PE is created only if there is a fixed place through which the IPP's business is wholly or partly carried out and if some of those activities are non-preparatory or non-auxiliary. Based on an analysis similar to that for cloud computing business models, local subsidiaries should generally not constitute a basic PE of the IPP. Instead, service providers of the IPP are entitled to arm's-length remuneration for the provision of those services. Further, if the IPP has employees in the market jurisdictions, it should be determined whether there is a fixed place of business at the IPP's disposal and, if so, whether the activities carried out are of a preparatory or auxiliary character.

That analysis should be based on a case-by-case assessment of whether the activities performed by the local representatives form an

essential and significant part of the IPP as a whole.¹²⁵ As with SNPs, it could be necessary to distinguish what segment the marketing activities are targeting: (1) ad-space customers (to sell the output of the production function); (2) buying users (to increase the demand and the amount of transactions through the platform — that is, selling the output of the production function and collecting data for the production function); or (3) selling users (to increase the supply and the amount of transactions through the platform — that is, input for the production function).¹²⁶

As with marketing activities conducted by SNP representatives, it seems likely that activities targeting users of the intermediary platform should be considered auxiliary even though user data are significant drivers of IPP value and therefore inherently part of the core of an IPP's business. The argument is that because local representatives do not conclude contracts for purchasing or collecting user data, the activities have an auxiliary character.¹²⁷ Similarly, it is likely that marketing activities targeting ad-space customers on the intermediary platform should be considered auxiliary if the IPP employees do not take part in negotiating the contracts, which are typically concluded electronically through the website using more or less standard agreements set by the IPP.¹²⁸ Likewise, support services provided by local representatives to users and customers on behalf of the IPP will likely be considered of an auxiliary character as long as they are of a general nature.¹²⁹ Sales-related activities are less likely to be considered auxiliary if IPP employees take active part in negotiating important parts of ad-space contracts.¹³⁰

The article 5(4.1) anti-fragmentation rule again implies that the IPP cannot isolate the marketing activities and customer support functions at a separate place of business and thereby avoid creating a PE from those services if the sales-related activities are considered non-auxiliary and non-preparatory.

Even if there is no basic PE, there may be an agency PE. If IPP employees or other dependent persons send emails, make telephone calls, or visit potential customers to discuss the ad space provided under the online standard contracts and are remunerated for doing so based on the number of contracts concluded in the jurisdiction, those employees should be regarded as dependent agents of the IPP.¹³¹ Similarly, dependent commissionnaires of the IPP should generally create an agency PE, while resellers should not. Likely as a result, commissionnaires are being converted into resellers, which should result in more functions performed, risks assumed, and assets used by the reseller and thus in more income being allocated to the reseller's state of residence.¹³²

c. Local Users and Customers

Again, the last aspect in the analysis is whether users or customers constitute a PE of the IPP. The IPP will hardly have a fixed place of business at its disposal. It could be argued that special consideration should be given to the selling users because, for example, the apartment rented to users through the intermediary platform is a fixed place of business. However, because an IPP is generally only the facilitator of transactions between users,¹³³ it seems unlikely that the fixed place of business is at the IPP's disposal. Further, because the selling users typically cannot be considered IPP employees but instead private or self-employed individuals,¹³⁴ they are generally carrying out not IPP business but instead their own business and not the business of the IPP.¹³⁵

¹³¹ *Supra* note 77.

¹³² *Supra* note 81.

¹³³ *See, e.g.*, the terms and conditions of Airbnb:

Airbnb is not a party to any agreements entered into between hosts and guests, nor is Airbnb a real estate broker, agent or insurer. Airbnb has no control over the conduct of hosts, guests and other users of the Site, Application and Services or any accommodations, and disclaims all liability in this regard to the maximum extent permitted by law.

¹³⁴ Giorgio Beretta, "Taxation of Individuals in the Sharing Economy," 45(1) *Intertax* 5 (2017).

¹³⁵ The OECD has argued that that applies even though the words "through which" should be given a wide meaning so as to apply to any situation in which business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. *See* para. 20 of the 2017 OECD model commentary on article 5.

¹²⁵ *Supra* note 56.

¹²⁶ OECD 2018 interim report, *supra* note 2, at 58.

¹²⁷ *Supra* note 95.

¹²⁸ *Supra* note 72.

¹²⁹ *Supra* note 70.

¹³⁰ *Supra* note 73.

Further, neither users nor customers should be considered agents of the IPP because they are not acting on the IPP's behalf in any way that could be considered playing the principal role leading to the conclusion of contracts in the IPP's name or for the IPP's provision of the intermediary platform or ad spaces. Instead, users and customers pay, respectively, for using the intermediary platform facilitating the transactions and showing targeted advertisement on the platform.

d. Summary of Preliminary Findings

Based on the analysis, an IPP will create PEs only in limited situations. Server farms owned and operated by a CCSP should generally not create a PE because they will neither be at the disposal of the IPP nor act as a dependent agent of the IPP.

Local representatives will generally create a basic PE only if IPP employees carry out the business and some of the activities are of a non-preparatory or non-auxiliary character. Sales-related activities by dependent commissionnaires will create an agency PE. However, in practice, the representatives may be local subsidiaries not creating a PE but who are remunerated for their reseller services in accordance with the arm's-length principle.

Further, selling users should also not constitute a basic PE because there should not be a fixed place of business at the IPP's disposal and because the selling users are neither IPP employees nor other persons carrying out IPP business that facilitates transactions between selling and buying users. Selling users should also not be deemed an agency PE because they are not acting on behalf of the IPP but instead acquiring services provided by the IPP.

Even though the creation of PE may be avoided, that does not mean that no tax revenue is generated in the market jurisdictions because PE creation is primarily avoided by establishing local subsidiaries entitled to arm's-length remuneration. Given that the functions performed are perhaps of a limited nature, limited remuneration is expected, which may be perceived as being too low by market states.

Consequently, only with remote selling will taxable revenue not be realized in the market jurisdiction — assuming the payments from

customers and users are not subject to local withholding tax.

E. Search Engine Models

1. Overview

Search engines are internet-enabled value networks that provide usually free web-based services while generating revenue from targeted advertising and other monetization of user data.¹³⁶ That type of business model has two main objectives: provide a search engine for users (usually free), and enable advertisers to effectively reach their target audiences (typically for a fee). Hence, those models typically have complementary objectives when providing information to users and providing advertising services. In other words, users of the search engine provide geographic and behavioral data, which allow the search engine provider (SEP) to learn about its user base. From the SEP's perspective, its user communities are valuable because they are the means of attracting the main commercial customers. Figure 5 illustrates a generic business model for the provision of a search engine.

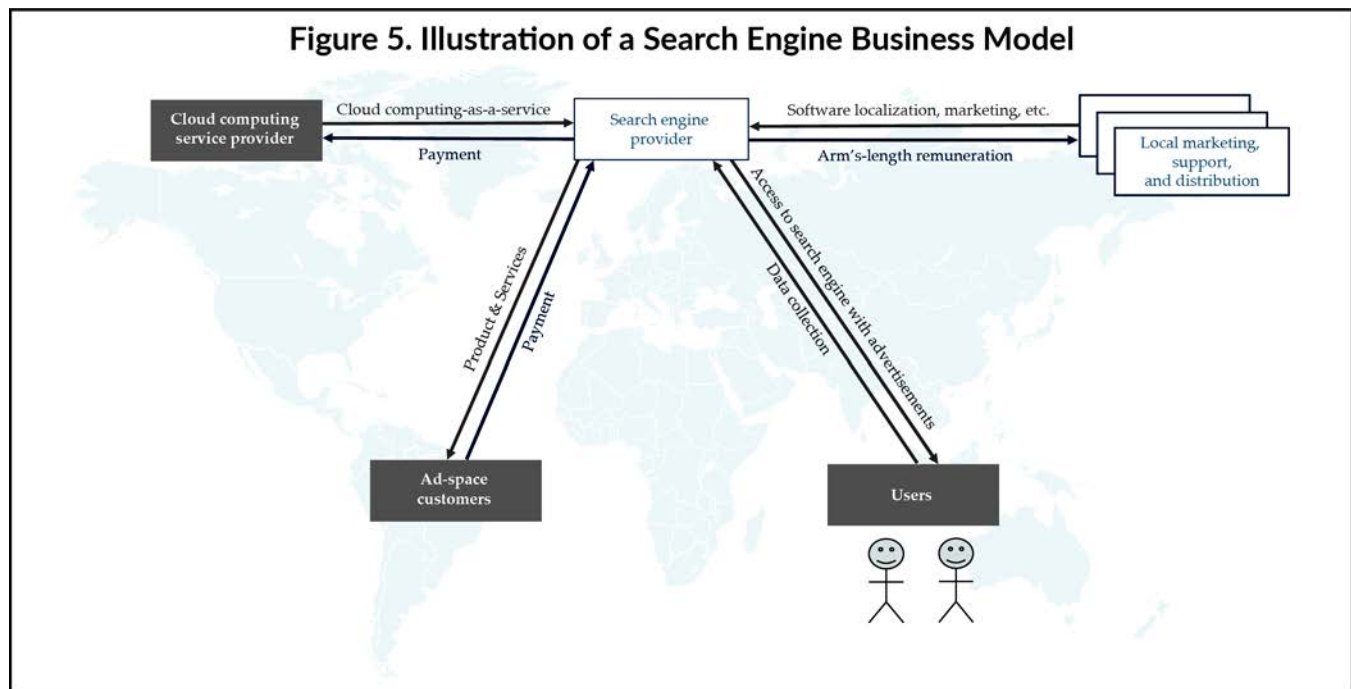
Typically, the SEP is the group's principal and therefore develops and owns IP that it operates on servers worldwide and makes available to users through various client interfaces. It also remotely coordinates marketing and selling activities to regional operating lower-tier representatives to minimize costs, maintain consistency, and improve efficiency. Those representatives typically provide user support services and sales and marketing activities, although contracts with users and customers are concluded electronically via websites using basically standard agreements whose terms are set by the principal.

2. When Is a PE Created?

a. Server Farms

As with other business models, the physical servers owned and operated by the CCSP should generally not constitute a basic PE because they will typically not constitute a place of business at the SEP's disposal. However, only in the unusual

¹³⁶ The description provided in the overview is based on the OECD action 1 final report, *supra* note 14, at 171-173; and 2018 interim report, *supra* note 2, at 44-51.



situation where the SEP acquires onsite private cloud computing while carrying out business through a website on a server at its own disposal, the server may constitute a PE if the other PE requirements are met.¹³⁷

Further, it is unlikely that the CCSP could be a dependent agent of the SEP because the CCSP generally does not conclude contracts or play the principal role leading to the conclusion of contracts in the name of the SEP and, in its ordinary course of business, the CCSP will serve multiple users.¹³⁸

b. Regional Support, Sales, and Marketing

Like the other highly digitalized business models, a SEP will usually have local representatives performing various activities in the local market. However, because of the multisided nature of the business model, the activities may target either users or customers. Even so, those activities should not create a basic PE. Based on an analysis similar to that for cloud computing business models, local subsidiaries generally constitute service providers of the SEP entitled to arm's-length remuneration for the provision of those services. However, if the SEP

has employees working in the market jurisdictions, it should be determined whether there is a fixed place of business at the SEP's disposal and, if so, whether the activities carried out are preparatory or auxiliary. Similar to SNPs, that analysis may be challenging regarding the business model deployed by SEPs, because the activities performed are typically a range of integrated services traditionally thought to be of a preparatory or auxiliary character that now belong to the core of the SEP's business.

It seems likely, however, that marketing activities targeting search engine users should be considered auxiliary even though user data are a significant SEP value driver (even when compared with other highly digitalized business models¹³⁹) and therefore inherently belong to the core of a SEP's business. The underlying argument is that the fact that the local representatives do not conclude contracts for purchasing or collecting user data gives the activities an auxiliary character.¹⁴⁰

¹³⁷ *Supra* note 88.

¹³⁸ *Supra* notes 90-91.

¹³⁹ OECD 2018 interim report, *supra* note 2, at 38 and 58, considering business models based on search engines internet-enabled value networks similar to social networks.

¹⁴⁰ *Supra* note 95.

Similarly, is it likely that marketing activities targeting ad-space customers should be considered auxiliary if SEP employees do not take part in the negotiation of contracts, which are typically concluded electronically via the website on the basis of mostly standard agreements set by the SEP.¹⁴¹ Likewise, support services provided by local representatives to users and customers on the SEP'S behalf are likely to be considered auxiliary if they are of a general nature. Sales-related activities are less likely to be considered auxiliary if SEP employees take an active part in negotiating important parts of ad-space contracts.¹⁴²

Once again, the anti-fragmentation rule in article 5(4.1) implies that the SEP cannot isolate the marketing activities and customer support functions at a separate place of business and thereby avoid creating a PE from those services. That is because those functions should likely be considered complementary and part of the SEP'S cohesive business operation.

Finally, even if there is no basic PE, an agency PE may be deemed to exist. In that respect, national tax authorities have challenged what has been called the "Google model," which is based on a narrow interpretation of an agency PE that allowed Google to penetrate the market by using commissionaire arrangements without creating a PE. In 2017 the Paris Administrative Court ruled that according to the applicable tax treaty, Google Ireland Ltd. did not have a PE in France between 2005 and 2010.¹⁴³ The Administrative Court of Appeal of Paris affirmed that Google Ireland did not have a PE in France through a subsidiary of Google Inc. and Google International LLC.¹⁴⁴

The French entity performed support and marketing services on behalf of Google Ireland,

for which it received a cost-plus 8 percent markup. The appellate court concluded that Google Ireland did not have a basic PE in France because it did not have a fixed place of business at its disposal there and the employees of the French entity were at that entity'S sole disposal for its own activity and thus did not carry out the business of Google Ireland. The court also found that the French entity was a dependent agent because it provided services for Google Ireland according to instructions from the company. The services benefited only Google Ireland, and the remuneration to the French entity, which was legally and economically dependent on Google Ireland, resulted in no financial risk from its activity. However, the court said the French tax authorities failed to prove that the French entity had the authority to conclude contracts in the name of Google Ireland, even though the company merely added its signature to documents electronically.

The court of appeal based its reasoning on several factors. First, Google Ireland allowed customer advertisements to be posted online only after it reviewed and signed the contracts. Second, while internal documents from the French entity showed that its employees were recruited, trained, and remunerated for selling advertising products, the agreements concluded between the advertising agencies and the advertisers referred to the purchase of those products from the French entity. However, that did not support the assertion that the French entity'S employees were able to commercially engage or commit Google Ireland on their own. Third, post-selling operations (for example, resolution of commercial or technical problems and recovery of unpaid bills) was not proof of an authority to commit Google Ireland to a commercial relationship.

The appellate decision confirms how the definition of a PE in pre-BEPS tax treaties should be interpreted and that it is difficult to apply to digital activities in the market jurisdiction. However, the treaty amendments implementing the BEPS action 7 recommendations include a broader definition of a dependent agent, which could lead to different conclusions in similar cases. If so, the Google case could be obsolete because local subsidiaries will likely be considered to habitually play the principal role leading to the conclusion of contracts without

¹⁴¹ *Supra* note 72.

¹⁴² *Supra* note 73.

¹⁴³ Case No. 15505178/1-1 (2017), *aff'd* Case No. 17PA03065 (2019).

¹⁴⁴ Other courts have reached similar conclusions. See, e.g., French Administrative Supreme Court, *Société Zimmer Ltd. v. Ministre de l'Économie, des Finances et de l'Industrie*, Nos. 304715, 308525 (2010), involving the France-U.K. tax treaty, which has a provision similar to that in the France-Ireland treaty.

material modification by the SEP.¹⁴⁵ Likely as a consequence, commissionnaires are being converted into resellers, which should result in more functions performed, risks assumed, and assets used by the reseller and thus in more income being allocated to the reseller's state of residence.¹⁴⁶

c. Local Users and Customers

The final aspect of the analysis is whether users or customers can constitute a PE of the SEP. Again, because there will hardly be a fixed place of business at the SEP's disposal, a basic PE will not exist. Neither users nor customers can be considered agents of the SEP because they are not acting on the SEP's behalf in any way that could be considered playing the principal role in the conclusion of contracts selling SEP products, so an agency PE is not created.

Moreover, ad-space customers are carrying out their own business, whereas a very broad interpretation of "carrying out the business of the SEP" could find that the user activities could be considered as carrying out SEP business by making users SEP production auxiliaries. However, even if successfully making that argument, the activities should likely be considered of an auxiliary character because even though the supply of raw user data contributes to the SEP's productivity,¹⁴⁷ the generation of those data is so remote from the actual realization of profits that it is difficult to allocate any profit to activities performed by users.¹⁴⁸

Finally, neither users nor customers can be considered SEP agents because they are not acting on behalf of the SEP in any way that could be considered playing the principal role in the conclusion of contracts selling SEP products. Hence, an agency PE is not created, either.

d. Summary of Preliminary Findings

Based on the analysis, a SEP will create PEs only in rare situations. Server farms owned and

operated by a CCSP should generally not create a PE because they will neither be at the SEP's disposal nor act as a dependent agent of the SEP.

Local representatives will generally create a basic PE only if SEP employees carry out the business and some of the activities are of a non-preparatory or non-auxiliary character. Sales-related activities by dependent commissionnaire will create an agency PE, although in practice, the representatives are typically local subsidiaries not creating a PE that are instead remunerated for their reseller services in accordance with the arm's-length principle.

Search engine customers and users should not constitute a basic PE because there will not be a fixed place of business at the SEP's disposal.

Even so, that does not mean that no tax revenue is generated in the market jurisdictions because PEs are primarily avoided by establishing local subsidiaries entitled to arm's-length remuneration. Given that the functions performed may be of a limited nature, limited remuneration is expected, which market states may perceive as too low.

Consequently, only with remote selling will taxable revenue not be realized in the market jurisdiction — assuming that payments from customers or users are not subject to local withholding tax.

V. Conclusions and Perspectives

The widespread assumption that some businesses can perform activities closely linked to a jurisdiction without needing to establish a physical presence there holds true, but it also concluded that it cannot be described in a single sentence covering all business models. The topic is much more complicated and fact-dependent than seems the case when relying on the simplified assumption that highly digitalized business models can operate remotely without creating taxable nexus.

In all the business models analyzed, it is possible to conduct remote sales, although the extent to which the models require physical presence varies. More specifically, we make several findings.

First, all business models seem to rely on local regional representatives, which — depending on the size of the company, the importance of the

¹⁴⁵ This of course requires that the contracting states under the applicable tax treaty both apply the amended definition of agency PE to include commissionnaires and similar arrangements under article 12 in the multilateral instrument.

¹⁴⁶ *Supra* note 81.

¹⁴⁷ OECD 2018 interim report, *supra* note 2, at 58.

¹⁴⁸ *Supra* note 104.

local market, and the intended permanency of presence in the market — may take the form of subsidiaries not constituting PEs. However, if the principal's employees are in the market jurisdictions, a basic PE may be created because there could be a fixed place of business at the principal's disposal and it is unlikely that all the activities performed will be of a preparatory or auxiliary character. That sales-related activities are less likely to be considered auxiliary may trigger the anti-fragmentation rule if the business activities carried on by local representatives constitute complementary functions that are part of a cohesive business operation. Further, the local representatives could be deemed agency PEs if dependent persons conclude contracts in the name of the principal or play the principal role leading to the conclusion of contracts. Similarly, a dependent commissionaire should generally be deemed an agency PE whereas a reseller should not.

Second, CCSPs and ORs selling physical goods both depend on some physical presence in market jurisdictions in the form of either server farms or warehouses. If the CCSPs or ORs themselves own and operate the server farms or warehouses respectively, that should generally create basic PEs in the market jurisdictions. To avoid that, server farms and warehouses are in practice operated by local subsidiaries.

Third, none of the highly digitalized business models analyzed should create PEs through users and customers because there will not be a fixed place of business at the principal's disposal. Further, neither users nor customers should be deemed agency PEs because they are not acting on the principal's behalf.

Consequently, all local activities (other than consumption by users and customers) will generally create a taxable presence in the market jurisdiction, and those representatives will be entitled to arm's-length remuneration. Given that the functions performed may be of a limited nature, limited remuneration should be expected, although market states may perceive that as too low. If that is the case, the discussion involves not so much nexus as profit allocation.

As illustrated, the implementation of the BEPS action 7 recommendations has affected highly digitalized business models by lowering the threshold for creating taxable presence in a

market jurisdiction. More specifically, the amendments prevent a strict literal interpretation of the preparatory or auxiliary requirement for the activities listed in 2017 OECD model article 5(4) and subject the exemptions to an economic substance test based on the business model. Further, the auxiliary or preparatory exemption is limited by the anti-fragmentation rule applicable to complementary functions that are part of a cohesive business operation performed by related parties in the same jurisdiction. Also, the implementation of the action 7 recommendations could prevent a strict literal interpretation of dependent agents who habitually exercise the authority to conclude contracts in the name of, or binding on, the principal, thus limiting the authority of dependent persons who play the principal role leading to the conclusion of contracts. Finally, the use of dependent commissionaire arrangements now constitutes a deemed agency PE.

Even though the implementation of the BEPS action 7 recommendations has extended the taxing rights of market jurisdictions, what seems apparent from the analysis is that neither a basic nor agency PE can exist without some degree of physical presence. However, remote selling does not occur exclusively through the highly digitalized business models analyzed in this article, and — to our knowledge — no empirical studies on the quantity or proportion of jurisdictions exposed to remote selling have been conducted.¹⁴⁹ Even so, the striking consensus in the current debate on the international taxation of the digitalized economy is that the international tax regime needs to be reshaped. As expressed by Wolfgang Schön regarding whether the digitalization of the economy requires an update of the international tax rules:

This is not a self-evident truth. Tax law, like any area of the law, is meant to express long-term value judgments and political agreements that have been transformed into legislative language. These norms show a general character and can be

¹⁴⁹ Olbert and Spengel, *supra* note 9, at 5-6, stating that to the best of their knowledge, empirical evidence regarding the tax challenges of the digitalized economy is scarce, and that anecdotes cannot justify new tax rules for that economy.

applied to new facts irrespective of changes in the real world, whether these are changes in technology or changes in the way business is done. One can refer to the age-old concepts of Roman law on warranties for deficient goods irrespective of whether these are sold in a village market or over the Internet. Legal regimes, unlike consumer software, do not need a regular update per se as technology and business progress. Rather, one needs a specific policy argument to amend the law, including tax law.¹⁵⁰

The specific policy argument regarding why the international tax regime must be reshaped may be simply expressed as “too little business income from cross-border sales or services being taxed in market jurisdictions.”¹⁵¹ However,

because remote selling is not exclusive to highly digitalized business models, the fundamental principle of neutrality¹⁵² seems to be violated if special rules are imposed on companies deploying highly digitalized business models. Further, there is a varying need for physical presence even among those models, so rules targeting them generally could also violate the principle of neutrality. ■

¹⁵⁰ Schön, *supra* note 118, at 278.

¹⁵¹ The three proposals in the OECD February 2019 consultation document would all expand the taxing rights of user or market jurisdictions. See *supra* note 3, at 9; and OECD statement, *supra* note 6, at 8.

¹⁵² The principle of neutrality means that taxation should seek to be neutral and equitable between different forms of digitalized business models, as well as between traditional and digitalized business models. The intention is that business decisions should be motivated by economic rather than tax considerations. Consequently, taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation. This principle forms part of the Ottawa Taxation Framework Conditions as adopted by the OECD, “Implementation of the Ottawa Taxation Framework Conditions,” at 12 (2003).