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PERMANENT ESTABLISHMENT. THE CRISIS OF THE ARTICLE 5 OECD MC IN THE DIGITAL ECONOMY (*)

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ABSTRACT

The rise of the digital economy, breaking with business models that require a physical presence to develop their activities, has dislodged the traditional concept of permanent establishment set out in Article 5 OECD MC. In the light of the precept's loopholes, large multinationals have engaged in abusive practices to relocate their profits, thus avoiding contributing in the States where the income is generated in accordance with their economic capacity. In this paper, we examine the concept of permanent establishment included in art. 5 OECD MC, its typology following the BEPS Project's modifications and the different scenarios that do not constitute a permanent establishment. We also explore whether its legal regime continues to be useful in today's context or whether, on the contrary, the moment has come to abandon the concept of permanent establishment entirely due to the problems generated by today's article 5 OECD MC, unable to respond to the challenges posed by the digital economy.

Keywords: permanent establishment, digital economy, The Organisation for Economic Co-operation and Development (OECD), Base Erosion and Profit Shifting (BEPS), significant digital presence.

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EL ESTABLECIMIENTO PERMANENTE. LA CRISIS DEL ARTÍCULO 5 MC OCDE EN LA ECONOMÍA DIGITAL

Montserrat Hermosín Álvarez

RESUMEN

El auge de la economía digital desvinculada de los modelos de negocios que requieren de presencia física para el desarrollo de la actividad empresarial, ha desbancado el tradicional concepto de establecimiento permanente contenido en el artículo 5 OECD MC. Ante los vacíos que plantea el mencionado precepto, las grandes multinacionales han incurrido en prácticas abusivas para la deslocalización de beneficios sin contribuir en consonancia con su capacidad económica en los Estados donde las rentas se generan.

En el presente trabajo se analiza la institución del establecimiento permanente, contenida en el art. 5 OECD MC y su tipología tras las modificaciones realizadas por el Proyecto BEPS, así como los diferentes supuestos que no constituyen un establecimiento permanente. Nos planteamos si su régimen jurídico sigue teniendo virtualidad práctica en el contexto actual o, por el contrario, habría llegado el momento de su absoluta superación debido a la problemática generada por el actual artículo 5 OECD MC incapaz de dar respuesta a los retos que plantea la economía digital.

Palabras clave: establecimiento permanente, economía digital, Organización para la Cooperación y el Desarrollo Económicos (OCDE), Erosión de la Base Imponible y Traslado de Beneficios (BEPS), presencia digital significativa.

SUMMARY

1. The digital economy and problems regarding its international taxation. 2. The concept of digital economy: necessary specification and e-commerce background. 3. The concept of permanent establishment in the OECD MC. 3.1. Fixed place of business. 3.2. The authorised dependent agent. 3.3. Excluded scenarios: preparatory or auxiliary activities. 4. Identifying the main challenges of the permanent establishment status. 5. New alternatives to the traditional concept of permanent establishment. 5.1. Significant digital presence. 5.2. Source taxation of received income. 5.3. The website as a new permanent establishment. 5.4. The creation of a tax on digital services. 6. Final reflections. Bibliography and resources.

1. THE DIGITAL ECONOMY AND PROBLEMS REGARDING ITS INTERNATIONAL TAXATION

Globalisation has led to the internationalisation of business activities and their development across different States. It is therefore paramount to determine the provenance of the income generated in each territory for its subsequent taxation in the competent State.

The concept of permanent establishment has long been a fundamental pillar (1) of international tax law to determine which State has the authority to exercise taxation (2).

Until now, the concept of permanent establishment has allowed taxing the income generated by economic activities of a company residing in another country in the source State. In essence, permanent establishment has embodied the critical connection factor to define tax authority over this income. But the traditional economy has given way to a new model of digital economy (3) that has no geographical barriers: profits can be relocated, bypassing today's tax scenarios which are based on physical permanence and linkage with the territory (4).

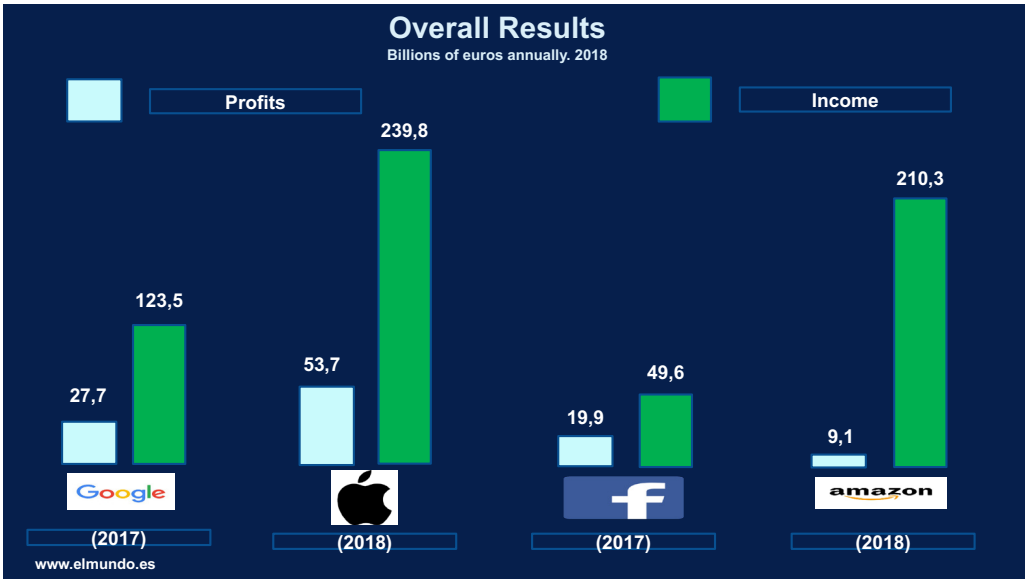
In recent years, large technology companies have been exposed for not contributing to the public treasury in accordance with their financial capacity. In the case of Spain, four of the biggest digital companies have contributed a total of only 23.9 million euros compared to a turnover of over hundreds of billions of euros.

(1) Skaar, A. A (1991): *Permanent establishment. Erosion of a tax treaty principle*, Kluwer Law and Taxation, Deventer: 71.

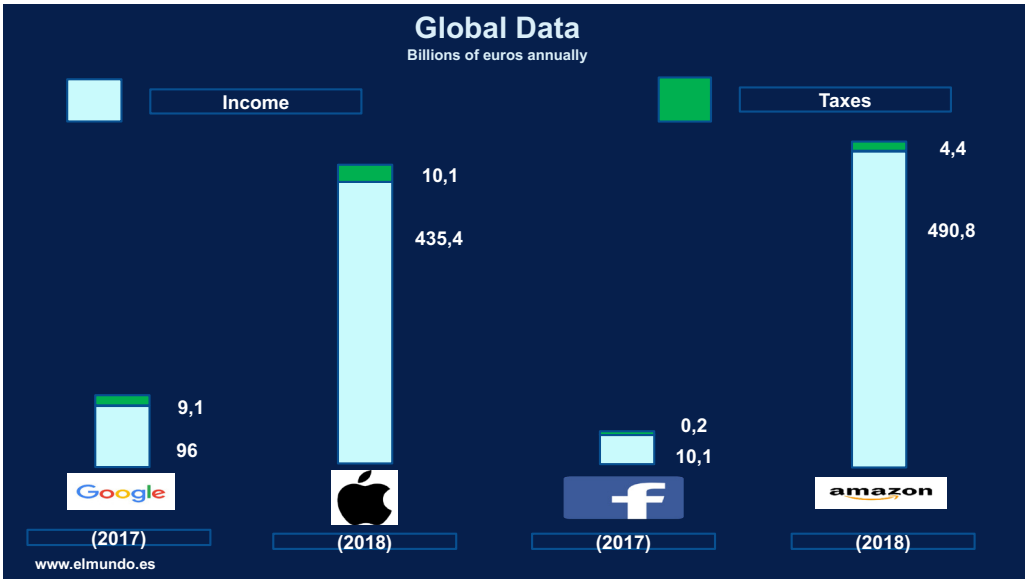
(2) García Prats, F. A. (2008): "La figura del establecimiento permanente en el orden tributario mundial", en *El tributo y su aplicación: perspectivas para el siglo XXI*, Tomo I, Buenos Aires: 1253; Melis, G. (2014): "Le interrelazioni tra le nozioni di residenza fiscale e stabile organizzazione: problemi ancora aperti e possibili soluzioni", *Diritto Pratica Tributaria*, n.º 1: 10029; Fransoni, G. (2015): "La stabile organizzazione: nihil sub sole novi?", *Rivista di Diritto Tributario*, n.º 2: 123.

(3) *OECD* (2015a): "Adressing the Tax Challenges of the Digital Economy: Final Report Action 1", *OECD Publishing*: 50 y ss.

(4) Cockfield, A. (2003).



The problem is increasingly publicised and has no easy solution. The numbers speak for themselves. Google has contributed only 9.1 million euros, Apple 10.1 million euros, Facebook 0.2 million euros and Amazon 4.4 million, as shown in the following tables taken from one of many publications on the subject (5).



(5) https://www.elmundo.es/economia/empresas/2019/09/15/5d7be3c6fdddff34208b45ad.html

The same conclusions can be drawn from the data provided by the subsidiaries of these multinationals operating in our country.

Subsidiary Companies in the country	Income	Taxes
1. Apple Marketing Iberia	48,8	5,4
2. Apple Retail Spain	394,5	4,6
3. Amazon Online Spain	55,3	0,2
4. Amazon Spain Fulfillment	364,9	3,2
5. Amazon Spain Services	70,3	0,9
6. Amazon Web Services Spain	0,2	0,07

www.elmundo.es

The rapid expansion of the digital economy is visible through all kinds of commercial operations taking place via the Internet, not only regarding traditional goods and services but also intangibles. Yet this growth has not been accompanied by the development of an international tax system that covers all its elements (6). The concept of permanent establishment is a good example since it has not been adapted to this new economy (7). States are witnessing a gradual loss of taxation sovereignty over income generated in their territory (8) as profits escape to tax havens or low-tax jurisdictions (9). In the midst of this uncertainty and in the face of the staggering rise of an economy that escapes legal bounds, the efforts of the G20/OECD have played a crucial role. The OECD's BEPS project has transformed the notion

(6) Miller, J. E. (1978): "The Nominee Conundrum: The Live Dummy Is Dead, but the Dead Dummy Should Live!", *Tax Law Review*, vol. 34; Hellerstein, W. (1993): "State Taxation of Corporate Income From Intangibles: Allied-Signal and Beyond", *Tax Law Review*, vol. 48; Rottschaefer, H. (1931): "The power of the States to tax Intangibles", *North Carolina Law Review*, vol. 9, 4.

(7) In situation where value is created «by a business activity through (possibly remote) participation in that jurisdiction that is not recognized in the current framework for allocating profits» [OECD (2019): *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, OECD/G20 Inclusive Framework on BEPS:* 11,12].

(8) Duardo Sánchez, A. (2017): "Crisis de los puntos de conexión en la fiscalidad internacional. La residencia fiscal y el Establecimiento Permanente a la luz del Plan BEPS", *Quincena Fiscal*, n.º 12 (BIB 2017, 12001).

(9) OECD (2015b): *Base Erosion and Profit Shifting Project*, Explanatory Statement, OECD Publishing, Paris: 5 [http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf].

of permanent establishment. The BEPS action plan launched in 2013 focused on multinational companies who had benefitted from low taxation thanks to aggressive tax planning. The BEPS Project's main idea is that of preventing profits from being taxed in a different place from where they are generated (10). These objectives, however, started to be pursued years ago by the OECD Committee on Fiscal Affairs, as evidenced by the sheer number of reports, working documents and amendments made to the Model Convention (11).

In point of fact, Action 7 of the BEPS Plan aims at combating the actions and/or tax planning of companies that avoid having a permanent establishment in the country that is the source of their generated income. These widespread conducts have inspired the tax planning of multinationals that operate internationally. They originate in the basic idea underlying Article 7.1 of the OECD MC i.e. in the absence of permanent establishment, corporate income is not taxed in the source State. The legal loopholes posed by the concept of permanent establishment have simply led aggressive tax planning to proliferate further (12).

Nevertheless, it appears that BEPS Plan –following the final BEPS report of 5 October 2015– did not offer a definitive update of the concept of permanent establishment: it failed to take virtual permanent establishments, which were incipient, sufficiently into account. The analysis of these issues requires a joint study of Actions 1 "Tax Challenges Arising from Digitalisation" and 7 "Preventing artificial avoidance of permanent establishment status". Both actions seek to change the definition of permanent establishment included in Article 5 OECD MC since it has proved to be insufficient to combat multinationals' tax planning, as they attempt to avoid at all costs that their presence in the source country be classified as permanent establishment.

(10) Ault, H.; Schön, W; Shay, S. (2014): "Base Erosion and Profit Shifting; A Roadmap for Reform", *Bulletin for International Fiscal Documentation*, vol. 68, 6-7; Boidman, N.; Kandev, M. N. (2013): "BEPS: The OECD Discovers America?", *Tax Notes International*, vol. 72, 11; Brauner, Y. (2014): "What the BEPS", *Florida Tax Review*, vol. 2, 16.

(11) OECD (1986): *Report on Thin Capitalism*, OECD, Paris; OECD (1987): "Double Taxation Conventions and the Use of Base Companies", *International tax avoidance and evasion: four related studies*, OECD, Paris; OECD (1995): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris; OECD (1998a): *Harmful Tax Competition*, OECD, Paris; OECD (1999): *The application of the OECD Model Tax Convention to Partnerships*, OECD Publishing; OECD (2000): *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5*, OECD, Paris; OECD (2002): *Treaty Characterisation Issues arising from E-Commerce*, OECD, Paris; OECD (2003): *2002 Reports Related to the OECD Model Tax Convention*, OECD Publishing; OECD (2005a): *E-Commerce: Transfer Pricing and Business Profits Taxation*, OECD, Paris; OECD (2006): The Tax Treaty Treatment of Services, OECD, Paris; OECD (2010a): *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing; OECD (2010b): *The Granting of Treaty Benefits with respect to the Income of Collective*, OECD, Paris; OECD (2014): *Clarification of the Meaning of "Beneficial Owner" in the OECD Model Tax Convention*, OECD, Paris.

(12) See Pistone, P. (2016): "La planificación fiscal agresiva y las categorías conceptuales del Derecho Tributario Global", *Revista Española de Derecho Financiero*, n.º 170.

The objective of the present study was to analyse the current concept of permanent establishment and the main problems it poses for the taxation of income generated in the new digital economy.

2. THE CONCEPT OF DIGITAL ECONOMY: NECESSARY SPECIFICATION AND E-COMMERCE BACKGROUND

The challenges of the digital economy visible today had already started with the development of e-commerce. In fact, e-commerce is a major manifestation of the digital economy. Its development exposed how the traditional concept of permanent establishment was inadequate to address a new economy led by the rapid progress of new technologies: indeed, entities, through digitised business activities, can operate in the source State without having a physical presence in it. In 1998, the OECD sought to lay down the tax principles applicable to e-commerce (13). The European Union also addressed the legal treatment of a number of these problems through Directive 2000/41/EC of the Parliament and of the Council of 8 June 2000, better known as the E-Commerce Directive (14).

At first, e-commerce proliferation triggered the imminent problem of double taxation scenarios that began to arise among various countries and represented a major obstacle to the development of e-commerce. These situations were resolved through the signing of bilateral conventions between states. Over the years, however, the situation has resulted in opposite outcomes, having to combat situations of international double non-taxation.

It is thus imperative to clarify the meaning of digital economy. To start with, there is no commonly agreed definition of digital economy. The OECD has approached the concept of digital economy, characterising it as one that is «comprised of markets based on digital technologies that facilitate the trade of goods and services through e-commerce» (15). Action 1 of the BEPS Plan also defines the digital economy as the «result of a transformative process brought about by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy» (16).

For its part, the EU pinpointed some essential characteristics in 2014:

– Mobility. Digital goods can travel across the Internet with hardly any obstacles.

(13) *Vid.* OECD (1998b): *Electronic commerce: taxation framework conditions,* Ottawa, [https://www.oecd.org/ctp/consumption/1923256.pdf].

(14) *Vid.* Sprague, G. D. y Boyle, M. P. (2001): "General Report", *IFA, Cahiers de Droit Fiscal International. Taxation of income derived from electronic commerce*, vol. 86a, Kluwer Law International, The Hague, p. 23.

(15) OECD (2012): *The Digital Economy*, Paris: 5 [http://www.oecd.org/daf/competition/The-Digital-Economy-2012.pdf].

(16) OECD (2015a): *Action 1. Addresing the tax challenges of the digital economy*, OECD Publishing, Paris: 11.

– Web effects. Operating over the Internet can reduce companies' production costs, which will have consequences on the prices of goods and services and on the profit margin.

– Data usage. Products and services are additionally customised to consumers thanks to the information provided via new technologies.

Scientific doctrine (17) has also largely expressed itself regarding its characterisation, and we can find some excellent contributions (18).

Following the analysis above, we could conclude that the discipline of the digital economy studies the production and distribution of goods and services adapted to the market, based on data and business models that have no physical presence and that use new technologies.

3. THE CONCEPT OF PERMANENT ESTABLISHMENT IN THE OECD MC

The concept of permanent establishment originates in commercial law and refers to the physical space used to perform business activities (19). In the field of taxation, one of the first references to this concept appears in the first International Agreement for the avoidance of double taxation between the Austro-Hungarian Empire and Prussia (20), which goes back to 1899 (21).

Today, it is essential to specify the concept of permanent establishment within the digital economy as it determines how an income in a given territory is taxed. The concept's inadequacy in the face of the new reality can only lead to a growing number of elusive practices and fraudulent planning that harms society as a whole (22).

(17) Dutriez, J. F. (2018: 188): «Defining the digital economy concept is also not easy. It could be viewed as "a result of transformative process brought by information and communication technology"»

(18) Serrano Antón, F. (2014): "El Informe sobre erosión de bases imponibles y traslación de beneficios de la OCDE: origen e implementación en un marco internacional y globalizado", *Derecho PUCP*, n.º 72: 45-70.

(19) Reimer, E. (2015): "Article 5. Permanent Stablishment", E. Reimer and A. Rust (eds.), *Klaus Vogel on Double Taxation Conventions*, Vol. I, 4ª ed., Kluwer Law International, Alphen aan den Rijn: 336.

(20) Kobestky, M. (2011: 106-151).

(21) See Huston, J., Williams, L. (1991): *Permanent establishment: a Planning Primer*, Deventer: Kluver Law and Taxation Publishers: 3: «The term "business establishment" shall include branch establishments, factories, depots, offices, places where purchases and sales are effected and others business facilities by which the owner, partner, manager, or other permanent representative carries on his normal business activities».

(22) Carbajo Vasco, D. (2018a): «the OECD has constantly adapted the wording of article 5 to shifts of economic conditions. However, such adjustments have not keep pace with the rapid evolution of MNE strategies, the expansion of new technologies, the appearance and development of the e-commerce and the birth of the digital economy» («BEPS and the concept of permanent establishment, is the end of the story», *Documentos de Trabajo,* Instituto de Estudios Fiscales, n.º 3: 295).

The concept of permanent establishment is defined in Article 5 of the OECD Model Convention and in the commentaries included in the provision. Efforts to adapt the permanent establishment status to the digital economy have resulted in several amendments to the OECD MC and the inclusion of new commentaries. The result is the tenth version of the OECD MC of 21 November 2017, which incorporates some of the proposals included within the BEPS report.

Until now, the concept of permanent establishment established in Article 5 OECD MC represented the traditional nexus whereby income generated through economic activities could be linked to a State's territory and consequently taxed. However, the concept's growing complexity over the years has led some authors to describe it as the unknown element (23).

Admittedly, despite being widespread, Article 5 of the MC does not contain, strictly speaking, a definition of permanent establishment. The norm is casuistic, based on a large number of specific cases. On the one hand, it lists positive examples of permanent establishment and, on the other, it provides a negative list of scenarios that are not regarded as permanent establishments for the purposes of the MC (24).

Thus, the Article starts with a general clause that identifies permanent establishment with a fixed place of business where the economic activity takes place (paragraph 1), provided this activity is not preparatory or auxiliary in nature (paragraph 4). The Article 5 OECD MC develops permanent establishment scenarios in detail giving examples such as: headquarters, branches, offices, factories, workshops, etc.

Second, a special rule is articulated on permanent establishment in the context of construction-related activities. We will not address it here as it is not linked to the digital economy.

Third, the norm describes a permanent establishment concept in the case of economic activities through a dependent agent, who usually operates on behalf of and for the account of the non-resident enterprise (paragraph 5), provided this person is not considered an independent agent (paragraph 6).

Finally, paragraph 4 defines the concept of permanent establishment negatively, excluding certain activities that are merely auxiliary or preparatory.

Paragraph 2 lists a series of scenarios that are specifically considered as a permanent establishment, although the list is not definitive: any other case fitting in the general definition and meeting the requirements can be considered to be a permanent establishment. Whether the scenario is among those listed in Article 5.2 or follows the generic definition of paragraph. 1 of Article 5, it must fulfil the conditions to constitute a permanent establishment included in the commentaries of paragraph 1 of Article 5 of the MC. We examine these latter commentaries below (25).

(23) Ritter, W. (1976/1977): «Grenzüberschereitende Gewinnabgrenzung bei Betriebstätten-Ein systematischer Versuch», *Jahrbuch der Fachanwälte für Steuerrecht*: 288.

(24) See García Prats, A. (1996): *El establecimiento permanente. Análisis jurídico-tributario internacional de la imposición societaria*, Tecnos, Madrid: 99-103.

(25) Burlada Echeveste, J. L. (2018): "La noción de establecimiento permanente a la luz del

3.1. Fixed place of business

It is worth nothing that the current wording of the 2017 version of this general clause has not been modified. Art. 5.1 OECD MC says:

«For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on».

Article 5. 1 presents a general definition in which permanent establishment is identified with the fixed place of business where a company carries out all or part of its activity (26). It seems that Art. 5 chooses not to interpret the expression "fixed place of business" literally (27).

Thus, a "place of business" (28) needs to exist, understood as facilities, premises, machinery, equipment or material means used to carry out the company's activities. The article specifies that the enterprise does not have to possess premises: disposing of some space suffices.

It is sufficient for the company to have this place of business, but no specific formal legal base for the exercise of the business is required. Thus, «It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise» (29). It is not, therefore, necessary to have a "formal legal

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proyecto BEPS", *Revista Quincena Fiscal*, n.º 20, BIB 2018\13660: 6; Mas Hernández, J. (2016): "Acotando el abuso del EP: medidas adoptadas en el marco de BEPS", *Crónica Tributaria,* n.º 158: 191 y ss; Ramos Prieto, J. (2016): "Acción 1. La crisis de la noción de establecimiento permanente: un paradigma de los desafíos que afronta la tributación de los beneficios de las empresas multinacionales en el contexto de la economía digital", en J. Ramos Prieto (dir.), *Erosión de la base imponible y traslado de beneficios: estudios sobre el plan BEPS de la OCDE*, Thomson Reuters Aranzadi, Cizur Menor (Navarra): 42-44.

(26) This seems obvious «when talking about a traditional economic framework, but in the light of the growing "digital economy", structures and the e-commerce potential, localization of PEs becomes more complex» (Dutriez, J. F. 2018: 186).

(27) As in section 2 of Art. 5, it is specified that: «The term "permanent establishment" includes especially:

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

(28) Carbajo Vasco, D. (2018a): «The so-called "place of business" test needs a physical presence of the non-resident taxpayer in the source country territory. Even though the term "place" has been broadly interpreted, it is clear from the start that the digital economy doesn´t need any physical structure to do business abroad» ("BEPS and the concept of permanent establishment, is the end of the story", *Documentos de Trabajo,* Instituto de Estudios Fiscales, n.º 3: 294).

(29) Real estate is not the relevant point: many court rulings have affirmed that mere property ownership does not entail the presence of a permanent establishment: Edwardes-Her, Belgium; Consolidated Premium Iron Ores, Case, USA; Inez de Amodio V. Commisioner Case, USA [Pedro-

right to use that place". In fact, the text specifies that «could exist where an enterprise illegally occupied a certain location where it carried on its business» (30).

The second requirement is that this place of business be considered as "fixed"; that is, it must be at a determined location and present a certain degree of continuity over time. Both elements are closely linked and it is not possible to understand a physical place of business without a minimal and necessary permanence over time (31). In this regard, the text points out that «there has to be a link between the place of business and a specific geographical point» (32), though «this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands», as it suffices that «the equipment remains on a particular site» (paragraph 21) (33). Furthermore, for a permanent establishment to exist, human presence is not required either, deeming the business activity carried out by machines to be sufficient (34). With the digitisation of companies and the adoption of new technologies, the physical fixity of permanent establishment is precisely one of the most outdated requirements due to the digital economy's exponential growth in recent decades (35). Thus, we must ask whether, according to these requirements, a website could be regarded as a place of business linked to a particular geographical point (36), due to its intangibility and because it is a simple document viewable through a browser (37). The server that stores the website is part of a computer with a physical location, and such a location can thus constitute

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sa López, J. C. (2019): "Análisis histórico del concepto de establecimiento permanente en el artículo 5 del Modelo de Convenio OCDE", *Revista Técnica Tributaria,* n.º 125: 66].

(30) See Commentary on paragraph 11, article 5, section 1 Model Tax Convention on Income and on Capital OECD.

(31) Serrano Antón, F. (2015): "Los aspectos fiscales de los establecimientos permanentes", en F. Serrano Antón (dir.), *Fiscalidad Internacional (I)*, CEF, Madrid: 209.

(32) See Commentary on paragraph 21, article 5, section 1 Model Tax Convention on Income and on Capital OECD.

(33) On this matter, the Federal Court of Canada concluded that, «(…) an enterprise has a permanent establishment where it has a "fixed place of business", an identifiable location with a certain degree of permanence in which the business of the enterprise is being carried on. By analogy, a particular location is a "fixed base regularly available" to a person who provides independent personal services only if the business of that person is being carried on there» (*Canada v. Dudney*, 2000 DTC 6169, FCA, paragraph 16).

(34) Sasseville; Skaar, (2009): "General Report: Is there a Permanent Establishment?", *Cahiers de Droit Fiscal International,* IFA, vol. 94: 24.

(35) Burlada Echeveste, J. L., "La noción de establecimiento permanente a la luz del proyecto BEPS", *op. cit.*: 5.

(36) In year 2000, the OECD modified its comments to Art. 5 MC –section 42º– seeking to adapt the concept of permanent establishment to *e-commerce* and to establish criteria that allowed differentiating between a web page and a server.

(37) Rodríguez Ondarza, J. A. (2001): "La fiscalidad del comercio electrónico. Imposición directa", *Documentos de Trabajo,* Instituto de Estudios Fiscales, n.º 6: 8; Cruz Padial, I. (2017): "Economía Digital, establecimiento permanente y presencia digital significativa: tras las conclusiones del informe del GEFED", *Revista Quincena Fiscal*, n.º 18, BIB 2017/13197: 8; Álamo Cerrillo, R. (2018a): "Economía Digital, responsabilidad social tributaria y erosión de las bases imponibles", *Revista Quincena Fiscal*, n.º 13, BIB 2018/10227: 6-7.

the "fixed place of business" of the company operating the server if it complies with the other conditions (38).

The line followed by the OECD was to initially refuse to consider a website as a permanent establishment and then to consider it as a virtual permanent establishment when it was located on a server in the source State (39).

With regard to the requirement of being fix over time, a "certain degree of permanency" of the permanent establishment is required. It cannot be of a "purely temporary nature". The difficulties in complying with this requirement are, however, acknowledged: in some cases, the very nature of the business means that it can only be carried out for a limited period. The commentaries related to this requirement do not establish a minimum time period as such but refer directly to the practices adopted by the different States, noting that a permanent establishment cannot be considered to exist in «situations where a business had been carried on in a country through a place of business that was maintained for less than six months». Although continuity is required, it is specified that temporary interruptions of activity do not imply that a permanent establishment ceases to exist (40).

Third, it is necessary that all or part of the company's activity be carried out through the permanent establishment. However, it is not necessary that these activities contribute to the productivity or profits of the enterprise. Furthermore, it is specified that the fact that a specific establishment is productive within the business organisation does not mean that it should, in any event, be regarded as a permanent establishment (41). What is essential is that business activities be "carried out on a regular basis" via the permanent establishment (paragraph 7). The business activity must be performed mainly by the employer or persons who have an employment relationship with the company (employees, agents acting on behalf of the company or dependent agents, etc.). With regard to this latter requirement, the text specifies that the company's activities can be carried out by means of automatic equipment, the employee activity consisting of installing, managing, controlling and maintaining such equipment. In this sense, gaming machines, vending machines and similar machines may constitute a permanent establishment if the company installing them maintains them and operates them on its own account or through a dependent agent (42).

(38) Carmona Fernández, N. (2012): "La noción de establecimiento permanente en los tribunales: las estructuras operativas mediante filiales comisionistas", *Crónica Tributaria*, n.º 145: 193; Falcón y Tella, R. y Pulido Guerra, E. (2013): *Derecho Fiscal Internacional*, Marcial Pons, 2ª. Edic, Madrid: 75.

(39) *Vid.* OECD (2000): *Clarification on the application of the permanent establishment definition in e-commerce: changes to the commentary on the Model Tax Convention on Article 5*, París, [http://www.oecd.org/tax/treaties/1923380.pdf] y OECD (2005b): *Are the current treaty rules for taxing business profits appropiate for e-commerce?*, París [http://www.oecd.org/ctp/treaties/35869032.pdf].

(40) See Commentary on paragraph 28, article 5, section 1 Model Tax Convention on Income and on Capital OECD.

(41) See Commentary on paragraph 7, article 5, section 1 Model Tax Convention on Income and on Capital OECD.

(42) See Commentary on paragraph 41, article 5, section 1 Model Tax Convention on Income and on Capital OECD.

3.2. The authorised dependent agent

The dependent agent clause is included in sections 5 and 6 of Article 5 of the Model Tax Convention on Income and on Capital OECD (43).

The use of the figure of dependent agent to determine a possible permanent establishment was residual until the complex structures of multinational companies proliferated and began to operate internationally, through subsidiaries and sub-affiliates of commission agents. The use of commission contracts and similar strategies have precisely been one of the most common practices to artificially circumvent the permanent establishment status. The commission agent acts in his or her own name but on behalf of the foreign enterprise. In this way, the foreign company manages to carry out its business activity without having a permanent establishment to which these operations can be attributed for tax purposes. Using the agent clause, companies succeed in reducing their profits in the State where taxes are higher. The commission agents, for their part, cannot be taxed on the income obtained through these business operations, as they would only pay, where applicable, based on the remuneration received from commission services. Until the 2017 OECD MC amendment, if the commission agent was considered an independent agent, no permanent establishment was deemed to exist. On the other hand, if the commission agent was regarded as a dependent agent, a permanent establishment was deemed to exist and the company had to pay taxes in the State that was the source of the generated income.

The dependent agent or subsidiary clause contained in Article 5.5 OECD MC is perhaps the most complex to interpret. Unsurprisingly, relevant changes have been made in paragraphs 5 and 6 of Article 5 of the MC and new comments have been introduced for interpretation purposes (44). The rule contained in Article 5.5 of the MC

(43) Article 5. Model Tax Convention on Income and on Capital OECD: «5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf on an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise».

(44) Avery Jones, J. F. y Lüdicke, J. (2014): "The origins of article 5(5) and 5 (6) of the OECD

establishes an alternative criterion to the general rule (paragraphs 1 and 2 of Article 5). If the person meets the requirements of Article 5.5 MC and of comments 82 to 101 –that we analyse below– a company is considered to have a permanent establishment in the State where that person conducts activities, despite not having a fixed place of business. Thus, when a person usually acts on behalf of a company in a Contracting State, it will be understood that company has a permanent establishment in that State, unless the activities correspond to some of the activities detailed in Article 5.4 and this place cannot be considered a permanent establishment.

a) Dependent agents.

   First, they must be company-dependent agents acting "on behalf of the company". Whether they are natural or legal persons is irrelevant as long as both fit into the definition of the term "person" used in Article 5.5 MC They do not have to be residents either, nor have a place of business in the State in which they operate (paragraphs 82 and 83, comments to Article 5, section 5 MC).

b) Persons with the authority to conclude contracts affecting the represented company.

   However, not any acting person dependent on the enterprise will determine a permanent establishment in the Contracting State. Only persons having the authority to regularly link the enterprise to activities performed in the foreign State may constitute a permanent establishment of the enterprise they depend on (45).

c) Persons with the "authority to conclude contracts in the name of the enterprise".

   In this regard, the comments to Article 5 MC makes a corrective interpretation of what is to be understood as "having the authority to conclude contracts in the name of the enterprise". It is pointed out that in addition to a literal understanding, the expression also includes the enterprise's binding contracts, even if they are not established in the name of the enterprise (46).

d) The contracts signed by the agent must correspond to the enterprise's own activity.

   Paragraph 97 of the comments to Article 5, section 5 MC states that contracts concluded by the dependent agent must concern the business activity of the represented enterprise (47). Having the authority to perform other similar activities or to hire personnel to assist in the performed operations would be irrelevant.

Model", *World Tax Journal*.

(45) See Commentary on paragraph 83, article 5, section 5 Model Tax Convention on Income and on Capital OECD.

(46) See Commentary on paragraph 93, article 5, section 1 Model Tax Convention on Income and on Capital OECD.

(47) See Gorospe Oviedo, J. I. (2018): "El concepto de establecimiento permanente en la imposición directa y su análisis jurisprudencial", *Documentos de Trabajo*, Instituto de Estudios Fiscales, n.º 3: 372.

e) The authority of the dependent agent must be exercised habitually in the source State.

This requirement makes it intrinsically difficult to understand the definition of habitual since Article 5 of the MC requires that in order to consider a permanent establishment in that State, the presence of the enterprise in the Contracting State be more than merely transitory. It is precisely the dependent agent's continued presence in the source State that legitimises the represented enterprise's obligation to pay taxes in that territory. However, paragraph 98 itself acknowledges that "It is not possible to lay down a precise frequency test". However, to clarify this undetermined concept, the comment refers to the factors detailed in paragraph 6 to establish when business activities are habitually carried out.

f) Exceptions to the dependent agent rule.

Article 5.6 MC states that a permanent establishment will not be considered to exist when the business activities are carried out by a broker, a general commission agent or any other agent of an independent status when they act within the ordinary course of their business. Points 102 to 114 of paragraph 6 of the commentaries establish when it is understood that the agent acts independently: in these cases, a permanent establishment would not be considered to exist in the source State. Thus, for example, the following would be taken into account: whether the activities are independent, whether the business risk must be borne by the agent or by the represented enterprise, and whether the activities are subject to detailed instructions or a global control. For these purposes it is also specified that the control exercised by the parent company over its subsidiary as a shareholder is irrelevant when determining the dependence or independence of the subsidiary as the parent agent. Another indication to consider would be if the agent operates exclusively for a single company over a long period of time, even though the latter does not constitute a requirement in itself to determine independence (48).

The final report of Action 7 proposes amendments to paragraphs 5 and 6 of Article 5 MC, in relation to the «Artificial avoidance of PE status through commissionnaire agreements and similar strategies».

With these modifications, even if agents act in their own name and on behalf of others, it is possible to consider a permanent establishment status (49). Therefore, it is no longer necessary to act on behalf of the foreign company to determine whether a permanent establishment exists through the agent figure, nor is it required that the intermediary acquire the ownership of the goods to be delivered (50). As we have seen, Article 5.5. MC refers to a person who has "authority to conclude contracts on behalf of an enterprise". The preliminary version of BEPS Action 7 required the action of a «person acting on behalf of a foreign enterprise to have the

(48) Vázquez del Rey Villanueva, A. (2015): "Poder tributario y establecimiento permanente. Análisis de la reciente jurisprudencia española", *Auctoritas Prudentium*, n.º 12: 27-28.

(49) Pedrosa López, J. C. (2019): *op. cit.*: 71.

(50) Jiménez-Valladolid De L´Hotelleire-Fallois, D. (2016): "La elusión artificiosa del estatuto del establecimiento permanente de «agencia» ¿Son suficientes las modificaciones propuestas en la Acción 7 del Plan de Acción BEPS", *Revista de Fiscalidad Internacional y Negocios Transnacionales*, n.º 3: 143.

authority to conclude contracts in the name of the enterprise». By contrast, the Final Report of Action 7 refers to a person who conclude contracts or who «habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise». Thus, in the comments of the 2017 OECD MC, the dependent agent's ability to conclude contracts and their binding nature are dissociated from the effective signing of the contract. The OECD MC comments seem to embrace a broad and non-literal interpretation: agents are deemed to act on behalf of the main company based on their relevant participation in the contract's negotiation, not based on the formal data of a signature. An opposite interpretation would open the way to easily circumventing the concept of permanent establishment.

With regard to the independent agent, changes have also been made to Article 5.6 MC, replacing the term "associated enterprises" by "one or more enterprises to which it is closely related" (51). The Final Report includes entities holding over 50% of the aggregate vote and the value of the company's shares or the beneficial equity interests. It also covers cases in which one person directly or indirectly owns more than 50% of the beneficial interest in another.

3.3. Excluded scenarios: preparatory or auxiliary activities

Article 5 (4) OECD MC establishes an open list of scenarios that do not constitute a permanent establishment, because they are considered to represent auxiliary or preparatory activities (52). In Action 7 of the BEPS Plan, the OECD detailed various initiatives aimed at preventing the bypassing of the permanent establishment status, leading to a modification of the precept. On the one hand, the concept of warehouse was referred to, and on the other, an anti-fragmentation rule was introduced (art. 4.1 OECD MC) in order to also address the activities conducted by closely related companies.

According to Article 5.4 MC a number of structures or activities are not considered to be a permanent establishment because they are merely preparatory or auxiliary in nature. They are as follow:

a) The use of facilities solely for the purpose of storage, display or delivering of goods or merchandise belonging to the enterprise the maintenance of a stock of goods or merchandise belonging to the Enterprise;

b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(51) Font Gorgorió, P. (2019): "La redefinición del establecimiento permanente en el marco de la economía digital: el establecimiento virtual", *Revista Española de Derecho Financiero*, n.º 182, BIB 2019/5993: 6.

(52) The «goal behind paragraph 4 is to ensure that when an enterprise's activities in a source country are not important enough (i.e. not substantially contributing to the activity of the enterprise), they will not give rise to a PE in that country». Dutriez, J. F. (2018: 187).

d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the company;

e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;

f) The maintenance of a fixed place of business solely for any combination of the activities, mentioned in sub-paragraphs a) to e), provided that the overall activity resulting from this combination is of a preparatory or auxiliary character.

An attempt has also been made to circumvent the permanent establishment status through the "fragmentation" of activities and this concern appears in section B of the BEPS report, which makes several amendments. The report insists on the true auxiliary or preparatory nature of the activity.

Action 7 of the BEPS Plan, to prevent activities from being classified as preparatory or auxiliary when they in fact constitute one of the company's main activities, proposed a new wording for paragraph 4 of Article 5 MC (53). Although the provision does not expressly define what an auxiliary or preparatory activity is, the concept is clarified with the incorporation of comments (54).

These changes particularly affect companies engaged in digital economy business activities that try to bypass the permanent establishment status by including their activities within the exceptions of paragraph 4 of Article 5 MC (55).

The BEPS report also adds paragraph 4.1 to Article 5 MC which includes a rule that seeks to avoid the fragmentation of activities. For its part, the new commentary specifies that the new amendment to paragraph 4.1, article 5 MC tries to stop the splitting of a business into different parts, so that each be regarded as an auxiliary or preparatory activity, thus eluding the constitution of a permanent establishment (56).

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(53) The «PE exceptions in article 5(4) will no longer apply if the operation of logistics centres is a core function of the company». Kofler, G.; Mayr, G. and Schlager, C. (2017: 527).

(54) See Commentary on paragraph 60, article 5, section 4 Model Tax Convention on Income and on Capital OECD: «As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole».

(55) Duardo Sánchez, A. (2018): "La exclusión fraudulenta del estatus del establecimiento permanente", *Documentos de Trabajo*, Instituto de Estudios Fiscales, n.º 3: 333; Pedrosa López, J. C. (2019): *op. cit.*: 69.

(56) Following these modifications, Art. 5.4 OECD MC 2017 was drawn up in the following terms:

«4.1. Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and

a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at

4. IDENTIFYING THE MAIN CHALLENGES OF THE PERMANENT ESTABLISHMENT STATUS

We are witnessing a profound transformation of traditional International Tax Law institutions as they adapt to new realities, such as the challenges of the digital economy. The OECD has reformulated the basic principles of the international taxation system to prevent the erosion of tax bases and the artificial transfer of profits through the BEPS Plan. The BEPS project has not substantially changed the traditional situation (57) in which residence and permanent establishment are essential connecting factors; it has failed to lay the foundations for a new international taxation system on profits. The BEPS project continues in the traditional line of a system based on the permanent establishment status.

It is very difficult, nonetheless, to identify all the mechanisms and structures devised to elude the permanent establishment status and which continue to bypass the current concept designed by Article 5 OECD MC. We can highlight the following, among others:

1. Inefficiency of the concept of permanent establishment within the digital economy.

The business activities carried out within the digital economy are characterised by a lack of physical presence in the source State. After analysing the concept of permanent establishment described in Article 5 MC, we found that it does not include virtual activities performed with no physical presence in the State where the income is generated. Consequently, those incomes are necessarily taxed in the company's State of residence. Despite the increasing generalisation of commercial activities through ICT and the Internet, source States lack the power to tax income generated in their territory due to the absence of a permanent establishment under Article 5 MC.

2. Use of the commissionaire figure to bypass the dependent agent clause in Article 5.5 of the OECD MC. Following the rules contained in the MC on permanent establishment, many companies began to replace local subsidiaries that acted as their distributors in different countries with commission contracts. This modus operandi brought about radical changes. Since no permanent establishment existed in the source State, those profits were transferred for taxation purposes to the main company's State of residence.

The comments of the OECD MC 2017 also highlight that it is not possible to regard the server as a dependent agent of the non-resident entity, since it does not conduct negotiations on behalf of the company and does not conclude contracts (58). Therefore,

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the two places, constitute complementary functions that are part of a cohesive business operation».

(57) Carbajo Vasco, D. (2018a): «BEPS is a reaction, as we know, against these strategies, but a very insufficient and lately one» ("BEPS and the concept of permanent establishment, is the end of the story", *Documentos de Trabajo*, Instituto de Estudios Fiscales, n.º 3: 298).

(58) See Commentary on paragraph 131, article 5, section 8 Model Tax Convention on Income and on Capital OECD: «paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the webs sites belong, because they will not conclude contracts or play the principal role leading to the conclusion of contracts in the name of these enterprises, or for the transfer of property belonging to these enterprises or the provision of services by these enterprises, or because they will act in the ordinary course of a business as an independent agent, as evidenced by the fact that they host the web sites of many different enterprises».

despite the implemented modifications, it does not seem possible to incorporate the operations carried out within the digital economy's framework into today's agent clause.

3. Artificial fragmentation to benefit from the exceptions of the Permanent Establishment condition of Article 5.4 of the OECD MC.

Large multinational companies have attempted to split their business activities so they be regarded as exceptions included in art. 5.4 MC. Thus, they elude the permanent establishment status because these activities are characterised as auxiliary or preparatory (59). Companies that perform digital transactions attempt to abide by the list of activities in order to conduct their business without constituting a permanent establishment. The use of new technologies and the proliferation of new business models make it easier to take advantage of any of these exceptions (60). The fiscal consequences are huge, since these activities are not taxed in the source State because they escape the permanent establishment status based on Article 5.4 MC. The modifications made to the precept represent a step forward, since they seek to rectify an operation's fragmentation into multiple activities so as not to exceed the threshold of auxiliary or preparatory activity. Nevertheless, most operations related to the digital economy continue to be outside the cases of permanent establishment provided for in art. 5 OECD MC.

4. Reconsidering a server as a permanent establishment has aggravated the double non-taxation problem.

As analysed above, the server has been considered a permanent establishment since the 2003 reform of the OECD MC commentaries, because it meets the requirement of being fixed, both in physical terms and over time. Conversely, though it can be used to develop an economic activity, a website cannot be considered a permanent establishment due to its intangibility. But despite the 2003 modification that allows considering a server as a permanent establishment (61), the problem has not been solved: servers are mobile and companies can easily move them to territories with low or nil taxation where websites, supporting all types of *online* (62) business operations, will be hosted. The problem has been aggravated even further, because in this case, the source State, where the recipient of the good or service contracted through the web is located, is unable to exercise its tax authority over the generated income. Not only will the exercise of this tax authority be impossible, but also that of the State of residence of the company that produces the goods or services: it will not be able to tax the income generated through the server or permanent establishment located in a territory of low or no taxation.

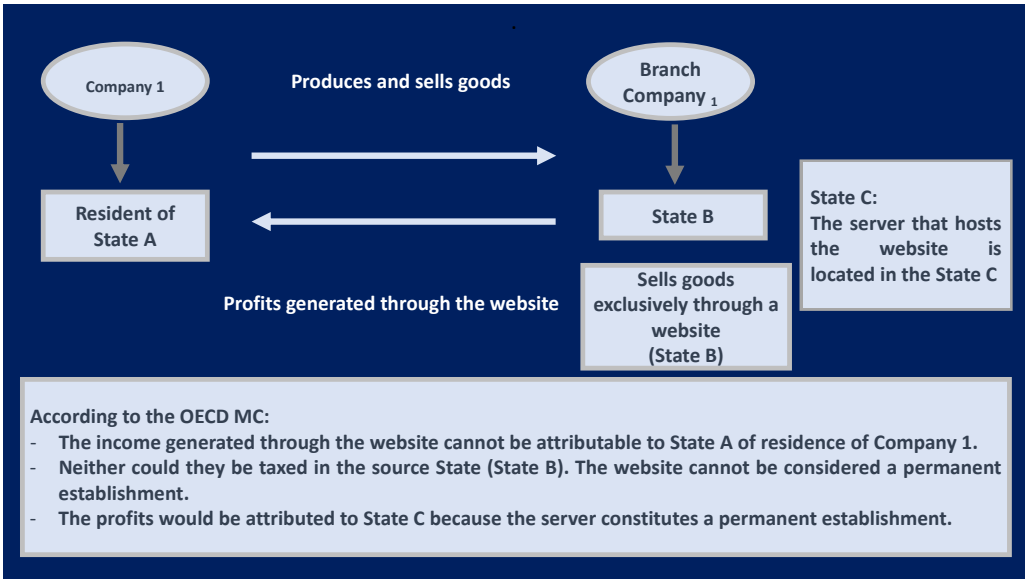
(59) Cruz Padial, I. (2016): "La economía Digital en BEPS: una síntesis", *Nueva Fiscalidad*, n.º 2: 34.

(60) Álamo Cerrillo, R. (2018b): "La economía digital, el concepto de establecimiento permanente y la realización de actividades auxiliares o preparatorias", *Documentos de Trabajo*, Instituto de Estudios Fiscales, n.º 3: 277.

(61) It is necessary to specify, however, that while the comments do not specifically mention servers as a possible permanent establishment until 2003, this does not mean that servers couldn't be regarded as a permanent establishment retrospectively if they met the requirements established in article 5 OECD MC.

(62) OECD (2005b): *Are the current treaty rules for taxing business profits appropriate for e-commerce?*, Paris.

The following table describes the operation pattern in which Company 1, resident of State A, produces and sells goods. This entity has a branch in State B through its website marketing in that State. However, the server that hosts the website is not in State B but located in a third State –State C– which offers a much more beneficial tax regime. The income generated by sales made through the website cannot be attributed to State A of residence of Company 1 since they are attributable to a permanent establishment. But neither could they be taxed in source State –State B– since according to the OECD MC, the website cannot be considered a permanent establishment. In the scenario where Company 1 has a branch in State B, it would attempt to include any of its activities within the exceptions of Article 5.4 OECD MC (stock, storage, etc.). If not, Company 1 could also sell its goods exclusively through a website. Based on this configuration, the server would constitute the permanent establishment to which the profits –generated through the website hosted in a third country, State C, with a much more beneficial taxation regime– would be attributed.



5. Progress has been made through the BEPS Plan but it is insufficient.

The main reaction to the problems created by the traditional concept of permanent establishment was BEPS Action 7. Its two main objectives can be summarised as: a) adapting the OECD's international taxation system to the expansion of the digital economy (action 1); b) correct the lack of connection between the State where business generates value and the place where that economic capacity is ultimately taxed. The BEPS can be regarded as an important step forward in trying to adapt the international taxation system to the increasingly widespread practices of aggressive tax planning. However, BEPS' action recognises that it is virtually impossible to separate the digital economy from other economies for fiscal purposes. Therefore, only minor changes have been made to Article 5 MC. In fact, only two changes were accepted: 1. Modifying the list

of exceptions to the definition of permanent establishment with respect to "preparatory or auxiliary activities" to introduce a new anti-fragmentation rule. This new adaptation is known as Amazon's "permanent establishment example". 2. Modifying the definition of permanent establishment to cover situations created by groups of companies (63). We can conclude that the final changes introduced by BEPS Action 7 have been less significant than the advance of the new digital economy.

The fundamental consequence of BEPS Action 7 and the changes to Article 5 MC is that the number of permanent establishments has increased. Everything points to political motives underlying the OECD's substantial change of position in the Final Reports. Had the initial proposals been accepted, the source States would have recovered their collection capacity with respect to the income generated in their territory. However, the attraction of virtual rents for the main States of residence of large digital companies has had a greater weight in the BEPS Project's final result. The concept of permanent establishment has not been able to evolve in line with the changes implemented by the digital economy, due to the tax collection interests at stake (64).

5. NEW ALTERNATIVES TO THE TRADITIONAL CONCEPT OF PERMANENT ESTABLISHMENT

An enterprise's necessary physical presence in a territory is today combined with its commercial activity, also carried out through the internet. These two scenarios can and must coexist in the new digital age without undermining national tax systems from the viewpoint of just taxation.

But an initial premise is that any solution to the problems posed by the permanent status in the digital economy must be as consensual and global as possible (65).

Many proposals have been made to overcome the problems arising from the traditional concept of permanent establishment (66). Unsurprisingly, some authors are inclined

(63) OECD (2014): «BEPS concerns around the PE rules (outside the digital economy issues) relate primarily to situations where one member of a group (e.g. a commissionnaire) clearly has a physical presence and tax nexus with the jurisdiction but is allocated limited profits because of low risk, whilst another member of the MNE group is shielded from tax by the technical operation of the PE rules and is allocated a large share of the relevant group income (e.g. by virtue of assuming or being allocated business risk, of holding valuable assets, etc.)» (p. 43).

(64) Barreno, M. (2015): "El proyecto BEPS de la OCDE/G20: resultados finales", *Crónica Tributaria*, n.º 155: 8.

(65) One of the greatest and most ambitious proposals would be the creation of a single tax, as advanced long ago by the American doctrine on the implementation of the *single tax principle.* The creation of this global tax would avoid situations of non-taxation and double taxation since the income obtained would always be liable to taxation in a single State [Avi-Yonah, D. (2015): "Who Invented the Single Tax Principle"*, University of Michigan Law School Scholarship Repository*. Shaviro, D. (2015): "The Two Faces of the Single Tax Principle"*, New York University Law and Economic Working Papers*, n.º 12].

(66) See Macarro Osuna, J. M. (2016): "Acción 1. El futuro de la tributación internacional: BEPS y economía digital", en J. Ramos Prieto, (dir.), *Erosión de la base imponible y traslado de*

to completely restructure the permanent establishment status adapted to the new economy of the twenty-first century (67). Some of the most relevant alternatives are summarised in the points below.

5.1. Significant digital presence

It seems legitimate that the source State try to tax income generated in its territory, but online marketing and digital transactions mean that companies hardly need to dispose of any physical elements in the source State (68). To operate with end recipients, companies use other digital means such as tablet or smartphone applications or webpages. The concept of virtual permanent establishment based on a significant economic presence seems to be among the most viable alternatives to introduce a new nexus that could tax operations linked to the digital economy.

With the launching of the BEPS Plan, the Expert Group on the Taxation of the Digital Economy (EGTDE) proposed, in the 2014 preliminary version of Action 1 significant virtual presence as a criterion to solve the problems raised by the traditional concept of permanent establishment, thus seeking a new tax nexus (69). It was suggested that the traditional concept of permanent establishment be fully replaced by that of significant digital presence (70).

However, this option is not without difficulties either. The first issue is that of clearly defining the notion of significant economic presence. Does it need to refer to a certain number of sales? Or to obtaining a given amount of income? In the latter case, would it be calculated based on gross or net income? Many elements would require delimitations. To implement this new nexus, which is an undefined legal concept, three types of factors that make up the so-called "test of significant economic presence" must be taken into account. Its components are as follow: income level, use of digital elements and relationships with users.

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beneficios: estudios sobre el plan BEPS de la OCDE, Thomson Reuters Aranzadi, Cizur Menor (Navarra): 92.

(67) Carbajo Vasco, D. (2018a): «we strongly demand a whole reconsideration of the PE concept to adapt the taxation of international business profits to the new enterprise organizations of the XXI Century» ("BEPS and the concept of permanent establishment, is the end of the story", *Documentos de Trabajo*, Instituto de Estudios Fiscales, n.º 3: 301).

(68) Blum, D. W. (2015).

(69) OECD (2015a): *Action 1. Addressing the tax challenges of the digital economy*, OECD Publishing, Paris: 157.

(70) OECD, *Action Plan on Base Erosion and Profit Shifting*, *op. cit.*, p. 14: «Action 1 Address the tax challenges of the digital economy. Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are no limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services…».

A major factor when appreciating the existence of a non-resident company's significant economic presence is the returns generated in a given country. For this indicator to be truly representative, it should include all the returns derived from remotely concluded operations, not only those generated from transactions made via a company's digital platform. In addition, in the case of business groups, to avoid activity fragmentation, a company's generated income should not be addressed individually. This quantification rule would function as a *iuris tantum* presumption, as it would be possible to prove that the operations were not artificially fragmented. Another main challenge posed by this factor would be the ability of tax administrations to identify and quantify the operations conducted by non-resident companies. To solve this problem, a mandatory registration system for non-established companies could be established in order to obtain the relevant information.

The second factor included in the significant economic presence test is the use of digital elements. Companies operating online need to massively use digital instruments in order to carry out their business activity. The use of these elements would come into play when applying the significant economic presence test. Notable among these digital elements is the use of a domain name or digital platform, as well as local payment mechanisms. In contrast to generic domain names, usually ".com", the non-resident company, in order to attract a relevant number of customers, uses each country's specific domains. In the case of Spain for example, it would be the ".es" domain. In addition, a local digital platform is usually created and adapted to the market country, adjusted to its product and service preferences and using the local language. Another major sign of a company's continuous activity in a jurisdiction is that it tends to integrate the country's existing payment mechanisms in its legal currency and included taxes. Although this data is not highly relevant among EU countries, it is indicative in the rest of cases: indeed, it entails additional costs that companies are willing to face when they seek to operate in a country on an ongoing basis.

A third indicator of significant digital economic presence is the series of relationships with a country's users and customers. In this regard, the following can be taken into account: the amount of data obtained via the digital platform on customers and users with a habitual residence within the territory; the conclusion of electronical contracts without the intervention of an independent agent; and the use of the number of monthly active users (MAU) on the digital platform. This parameter is an indicator in business models where users' submitted data constitutes a major means of attracting new users (71).

However, ultimately, the OECD chose not to incorporate the significant fiscal presence nexus into the tenth version of the OECD MC of 21 November 2017 (72). Some

(71) García Pérez, J. A. (2015): "Tributación directa de nuevos modelos de negocio en una economía digital. El establecimiento permanente", *Carta Tributaria*, n.º 2: 15.

(72) OECD (2015a): *Acción 1. Informe Final de 2015. Abordar los retos de la economía digital en la imposición*: 4.

aspects were left pending and subject to debate, such as the technical and legal criteria to attribute profits to permanent establishments (73) (74).

The final report of Action 1, which consisted more of an exposition of the situation than a contribution to specific technical solutions, ruled out this ambitious step forward. The EGTDE's approach is acceptable as an initial proposal to overcome the problems posed by the traditional concept of permanent establishment. Nonetheless, no legal or technical structures are advanced to approach a new nexus regarding a virtual permanent establishment. The main challenge is therefore to define criteria allowing to attribute the profits generated by this new permanent establishment. The configuration of a new virtual establishment adapted to the digital context in which companies operate seemed to be a coherent step as well as a necessary one. However, in addition to the technical problems mentioned, the conceptual evolution of permanent establishment would entail restoring the collection capacity of the source States to the detriment of that of the States of residence. And the latter is the major obstacle to its future development (75).

The new virtual permanent establishment nexus would not fit into the agent clause of Article 5 OECD MC since it requires the agent to be a person (76).

The creation of a new virtual permanent establishment must take into account the activity carried out in the source State, where the end customers of the goods and services reside. The main possible implementation drawbacks are: having to specify what volume of operations would determine the existence of a virtual permanent establishment; and the means of proof of these operations. For this reason, we consider that it is essential to be able to reliably identify the final consumers of goods and services. One solution could be a mandatory registration system implemented by digital platform and web page owners, which different tax administrations could have access to (77). In this sense, the Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, 21.3.2018 COM (2018) 147 final (78) does indeed determine virtual permanent establishment through its definition of three essential parameters: the income obtained from the provision of digital services; the

(73) Bal, A. y Gutiérrez, C. (2015): «before implementing any new nexus standards, it would be worthwhile to consider whether the granting of more extensive taxation rights to the source country will positively affect tax revenue collection in that country. To answer this question, it must be clear how to calculate the amount of profits attributable to a "digital presence", a question that still remains unanswered» ["Taxation of the Digital Economy", en M. Cotrut (ed.), *International Tax structures in the BEPS Era: an analysis of anti-abuse measures*, IBFD Tax Research Series, Amsterdam: 264].

(74) See Dutriez, J. F. (2018: 195): at «this stage, these concepts could potentially move away from the principle of aligning taxation with value creation (as the source state would evaluate taxable income based on the customers' location) and would deviate from the SPF criteria with regard to the attribution of profits to PEs».

(75) Barreno, M. (2015): *op. cit.*:7.

(76) Oliver Cuello, F. (2012): "La fiscalidad directa del comercio electrónico", *Quincena Fiscal*, n.º 21: 11.

(77) Font Gorgorió, P. (2019): *op. cit.*:20.

(78) https://eur-lex.europa.eu/resource.html?uri=cellar:3d33c84c-327b-11e8-b5fe-01aa75ed71a1.0017.02/DOC_1&format=PDF

number of users of digital services; and the number of contracts of a digital service. It also establishes specific thresholds that determine the existence of a virtual permanent establishment as follow: if, over the same tax period, over 7 million euros are generated from the provision of digital services in a Member State; if the number of users exceeds 100,000 or if the number of contracts between companies is above 3,000. Only one of these criteria needs to be met for a significant digital presence to be considered to exist. However, although this initiative includes technical criteria to establish virtual permanent establishment, it is still a unilateral proposal by the EU and it makes it more difficult to agree on coordinated actions within the digital economy framework (79).

The problem of physical presence could be overcome by requiring the website to present direct access and stability over time and attributing the business or commerce activity to the website and not to the server. Although the website does not have a physical presence, it does have a virtual presence, which is fully comparable to the presence of a branch, a workshop, etc. (80)

We believe that it is imperative to modify Article 5 MC to establish a new permanent establishment concept based on significant digital presence, including the website as a linkage that, together with other factors, could also determine a company's presence in the source State.

5.2. Source taxation of received income

International tax law has been granting ever greater rights to States where income is generated in accordance with the benefits principle (81). Benefits obtained through a permanent establishment legitimises taxation by the source State, while the State of residence must arbitrate some exemption or deduction mechanism to avoid these benefits from being taxed twice.

However, the obsolete permanent establishment concept has given rise to enormous difficulties hitherto unsolved. A restructuring of the international tax system has been

(79) See Opinion of the European Economic and Social Committee on 'Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence' [COM(2018) 147 final — 2018/0072 (CNS)] 'Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services' [COM(2018) 148 final — 2018/0073 (CNS)], paragraph, 4.3: «The OECD method of developing the PE definition is a dynamic procedure where the changes in principle have found global acceptance. By deviating from this procedure by proposing a unilateral definition, the complexity of the international tax system increases as does the uncertainty for investors. Even the unlikely event that OECD would adopt the same definition in its expected final report on the digital economy in 2020, it would not be long until the two systems would deviate» [https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52018AE1556].

(80) Gómez Requena, J. A. y Moreno González, S. (2018): "La adaptación del concepto de establecimiento permanente al contexto comercial digital: de la fijeza a la presencia virtual y económica significativa", *Documentos de Trabajo*, Instituto de Estudios Fiscales, n.º 3: 355.

(81) *Vid.* Avi-Yonah, D. (1997): "International Taxation of Electronic Commerce", *Tax Law Review*, n.º 52: 520.

called for ever more insistently through source taxation of received income (82): taxation applied to where the value is created, similar to the current principle of taxing at destination, proper to VAT (83). According to this line of restructuring, the income would be individually considered in the State where it is obtained, foregoing the concept of permanent establishment. This alternative does not seem so far-fetched to the extent that today, income is taxed at a proportional rate, dispensing with any Corporation Tax subjectivity. Therefore, its implementation would not substantially differ from current practices. BEPS Action 1 appears to advance this possibility as a solution to the challenges of the digital economy through the submission of specific digital transactions to source taxation. The possible solutions would be source taxation of all transactions carried out within the territory through tax withholding and, to avoid double taxation, the corresponding elimination of the tax on that same income in the State of residence.

This alternative was already pointed out in 1997 by Avi-Yonah, who proposed to apply a withholding tax equivalent to the corporate tax rate in the source States in which a sales threshold of $1,000,000 was exceeded (84). The withholding could be configured either as a tax retention on account or as a final tax or could be applied to payments received by foreign suppliers from customers, in return for the online purchase of digital goods or services. For this withholding to be effective, two different situations would need to be distinguished. On the one hand, in direct B2C operations with end consumers, the obligation to withhold could be assigned to the financial institutions involved in the service payments since they dispose of relevant information such as the place of realisation and the amount involved in these types of transactions. On the other, in the case of B2B operations between companies, the withholding would be the responsibility of the resident entity that is acquiring the digital goods or services from a non-resident company. The apparent simplicity of this option has its advantages. Collection is made easier for the source State and the non-resident entity would not have to comply with formal tax and settlement obligations in the State where the goods are delivered or where the digital services are provided. In practice, it would be as if a digital tax is being implemented through this retention. This alternative would allow circumventing one of the crucial problems posed by the permanent establishment: defining the criteria for the attribution of profits.

However, the solution presents a number of drawbacks (85), including tax competition between States in the establishment of source taxation. Another key issue to overcome would be that of determining what type of operations the withholding would be

(82) Ribes Ribes, A. (2013): "La residencia de las personas jurídicas en el Derecho Comparado (con especial referencia al ámbito de la Unión Europea)", en P. Chico de la Cámara (dir.), *Residencia fiscal y otros aspectos conflictivos. La armonización de la imposición directa*, Aranzadi-Asociación Española de Asesores Fiscales, Cizur Menor (Navarra): 195.

(83) Cubero Truyo, A. (2018): "Applicability of criteria characteristic of indirect taxation to future regulation of permanent establishments and technical improvements in their current regulation", *Working Papers, Status for Fiscal Studies,* n.º 3: 252.

(84) Avi-Yonah, D. (1997): *op. cit.*: 511.

(85) See Baez y Brauner, Y. (2015): "Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy", *WU International Taxation Research Paper Series*, n.º 2: 168.

applicable to. Such a task would be far from easy, given the breadth of the transactions that are part of the digital economy. Although the proposal presents a great number of technical problems, it could constitute an alternative given the lack of consensus among the States regarding the introduction of a new application nexus based on significant economic presence (86).

5.3. The website as a new permanent establishment

Perhaps the only way to maintain the permanent establishment status would be to introduce a new criterion for the digital economy according to new business models. None of the criteria in Art. 5 OECD MC addresses new digital transactions, therefore, part of the doctrine recommends adding a new section dedicated to the digital economy. Hongler, P. and Pistone, P. (87), support the introduction of a new article 5(8) of the OECD Model with the following wording:

«If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) *per annum*».

To overcome the traditional nexus of physical permanent establishment, one could reconsider classifying the website as a permanent establishment, to the extent that it is accessible to the consumer and has a presence over time. In the current system, business activities are attributed to a server, considered as the permanent establishment because it is physically located in a State's territory. In this sense, we share the view that the server is hardware, since it merely represents a physical support, and the company's real scope of action lies in the website or software with a virtual economic presence comparable to that of a branch or workshop. It is not possible to extend the scope of permanent establishment concept to websites by interpretation. Authors such as Gómez Requena, J. A. and Moreno González, S. suggest including a final clause in paragraph 1 of Article 7 OECD MC attributing business activities to a company website (88). A website could be considered as a place of business and treated that having a permanent establishment. Intangible or digital existence should be enough to determinate a place of

(86) Among the authors who seem to opt for this option is 1987 D. Carbajo Vasco, the latter gives the example of the *equalization tax* established in India in 2016, which is limited to advertising services but which functions as a retention for these types of digital services and can serve as a prior experience to take steps in the future [Carbajo Vasco, D. (2018b): "¿El establecimiento permanente digital, un oxímoron?", *Documentos de Trabajo*, Instituto de Estudios Fiscales, n.º 11: 24].

(87) Hongler, P. and Pistone, P. (2015): "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy", *IBFD*, n.º 20: 25.

(88) Gómez Requena, J. A. y Moreno González, S. (2018): "La adaptación del concepto de establecimiento permanente al contexto comercial digital: de la fijeza a la presencia virtual y económica significativa", *Documentos de Trabajo*, Instituto de Estudios Fiscales, n.º 3: 357.

business (89).This alternative, however, is difficult to implement. Indeed, due to collection interests, two types of countries are clearly divided: on the one hand, the countries who advocate establishing the website as a permanent establishment –because it is the destination of these types of operations–; and on the other, the net-exporter States, who are strongly opposed, as they are home to the headquarters of companies operating in the field of electronic commerce and the digital economy (90).

5.4. The creation of a tax on digital services

No new virtual permanent establishment nexus has been incorporated in art. 5 OECD MC that is adapted to the context in which companies operate today. Moreover, in the absence of a consensus, States have begun to implement unilateral measures that can generate situations of double taxation, non-taxation and tax competition between countries (91). Such unilateral actions, «however, might not be sensible for all states, depending on their legal structure, for example, their tax treaty obligations, or their economic situation. Moreover, from an EU perspective, "[d]ivergent national approaches within the EU can fragment the Single Market, increase tax uncertainty, destabilise the level playing field and open new loopholes for tax abuse"» (Kofler, G.; Mayr, G. and Schlager, C., 2017: 526).

One alternative to address the scant taxation of large digital companies would be the creation of a specific tax on digital services, better known as the Google tax.

Many countries are developing different proposals targeting the companies commonly referred to as GAFA (Google, Apple, Facebook and Amazon) or FAANG –after including Netflix and a play on words– in order to solve a blatantly unfair situation.

France is a pioneer with its approval of a tax on digital services, which levies 3% of the revenues of companies making a turnover of 25 million euros or above in France (92).

(89) Akçaoğlu argued that «is a realistic opinion, which aims to protect the link (nexus) between enterprises and the source countries' taxation authority where physical presence requirement could allow many of enterprises that benefit economically from a country's market through the Internet to avoid paying their fair share of taxes to that country» [Akçaoğlu, E. (2002): *International Taxation of Electronic Commerce: A focus on the permanent establishment concept,* C.51 Sa.1: 139, https://dergipark.org.tr/tr/pub/auhfd/issue/42672/514511].

(90) Calderón Carrero, J. M. (2004): "Artículo 5 OECD MC 2005. Establecimiento permanente", en J. R. Ruiz García y J. M. Calderón Carrero (coords.), *Comentarios a los convenios para evitar la doble imposición y prevenir la evasión fiscal concluidos por España (Análisis a la luz del Modelo de Convenio de la OCDE y de la legislación y jurisprudencia española)*, Fundación Pedro Barrié de la Maza-Instituto de Estudios Económicos de Galicia: 354.

(91) Falcón y Tella, R. (2014): "La tributación de UBER (plataforma de servicios de transporte en vehículos particulares)", *Quincena Fiscal*, n.º 13, (BIB 2014, 2229).

(92) See Szczepański, M. (2020): «The situation moved closer to a trade war between the USA and the EU, which signalled that the latter would support France should tariffs be imposed. Ultimately, a de-escalation seems to have occurred, at least temporarily, during the 2020 World Economic Forum in Davos, where both sides agreed to work on a global solution, with the aim of reaching agreement by the end of 2020» ("Digital Taxation. State of Play and way forward", *European Parliamentary Research Service*: 7).

After it became public that companies such as Netflix only paid 3,146 euros in Spain in 2018, Spain seems to be following in France's footsteps with its proposal of a "Tax on the creation of specific digital services". Thus, Law 4/2020 of 15 October, the Law on the Taxation of Determined Digital Services, has just been approved and has taken effect in January 2021. Its preamble specifies that the measure is transitory and provisional in nature since the Tax on Determined Digital Services shall be applied and claimed only until new internationally adopted legislation comes into force. Meanwhile, the data that continues to surface in the media is alarming. Compared to Google's 10.1 million-euro taxation in Spain, Santander paid 464 million and Inditex 360 million. However, the creation of a state tax on digital services may also come with adverse effects that must be taken into account. First, the tax could be a major obstacle to the country's digital growth and undermine Spain in the international competition that reigns in the sector. In addition, management, collection and inspection costs should be assessed and aligned with expected revenues.

For its part, the European Commission presented the "digital tax package" on 21 March 2018. In the proposal for a Council Directive establishing the taxation rules for companies with a significant digital presence, COM / 2018/0147 final - 2018/072 (CNS), Brussels, 21 March 2018, the EU essentially proposed, to solve the problem, a transition to a tax criterion in the source State, that is, in the State where digital companies have their so-called "significant digital presence". This concept, however, as analysed above, remains unclear and imprecise, based on the progress made to date.

So long as no international consensus is reached on virtual permanent establishment, States will continue to try to reach solutions unilaterally. Double taxation situations will continue to proliferate, intensifying a global problem that requires a joint and coordinated response.

6. FINAL REFLECTIONS

Having examined the permanent establishment status and the problems of legal regime it poses, it seems impossible today to dissociate the digital economy from the economy generally. Today, an increasing amount of companies are following business models based on dematerialised activities.

For this reason, we questioned whether current permanent establishment regulations continue to be viable in practice in the digital economy or whether they have become outdated and the moment has come for a decisive change of course. Some argue that today's permanent establishment regulations are no longer workable, since they were designed in the pre-digital era, when, in order to do business in another State, physical presence was inevitable (93).

(93) Hoffart, B. (2007): "Permanent Establishment in the Digital Age: Improving and Stimulating Debate Through and Access to Markets Proxy Approach", *Nw. J. Tech. & Intell. Prop. 6*: 107.

Having analysed the permanent establishment's legal regime included in art. 5 OECD MC, we concluded that it was not feasible to totally dispense with the traditional concept of permanent establishment based on physical presence. Indeed, the concept continues to have a practical potential of use in the case of companies for which a physical presence is still relevant to run their business.

Both action 1, of a transversal nature, and action 7 of the BEPS Plan sought to remedy the artificial circumvention of the permanent establishment status. Partial adjustments, such as the redefining of the dependent agent clause, or the delimitation of auxiliary or preparatory activities have failed to definitively solve the tax planning strategies designed by large business groups operating in a digital environment.

We do not believe, however, that the concept of permanent establishment contained in art. 5 OECD MC should be entirely replaced. We think, rather, that it is necessary to set out a new application nexus or criterion that takes into account companies' significant economic presence in different States. The idea would consist of including a new section dedicated to the digital economy, addressing the dematerialized activities led by a growing amount of companies. The problem of physical presence stemming from the current concept of permanent establishment could be overcome if the website was considered, along with other factors, as a permanent establishment with sufficient economic presence, comparable, for example, to that of a workshop.

This virtual permanent establishment would attempt to restore the tax authority of the source States where the income is generated. However, it doesn't seem that the international consensus necessary to introduce a new nexus and the required modification of art. 5 OECD MC has been achieved. We must remember that despite the major technical difficulties in establishing a virtual permanent establishment, it is harder still to overcome political issues when there is a clear conflict between the interests of multinational source States and that of States of residence.

Against this backdrop of uncertainty, the OECD published two documents in 2019 exposing the two basic pillars on which to build the future of taxation (94). Based on Pillar 1, multinationals must pay taxes in the territories where their markets are situated, while, based on Pillar 2, a series of mechanisms are established to ensure that multinationals pay a global, minimum tax, deemed reasonable. On the basis of these two very ambitious principles, the OECD has contemplated that a consensus solution be reached by the end of 2020 (95).

Meanwhile, in the light of this complicated and unrealistic scenario, there is an increasing risk that different States create digital taxes that will lead to the proliferation

(94) See: https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

(95) As sharply commented: the «news on the eve of 2021 on taxation of the digital economy or the reform of the international tax system is the lack of political consensus. The aphorism of No news is good news is not applicable to the current situation in international tax law as the latter urgently requires reform». Dourado, A. P. (2021): "The OECD Report on Pillar One Blueprint and Article 12B in the UN Report", *Intertax*, Volume 49, issue 1: 3.

of double taxation and non-taxation situations since, as we have analysed, Article 5 of the OECD MC does still not solve the problem of digital economy taxation.

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