TAXING TECH:

BRINGING PERMANENT ESTABLISHMENT INTO THE 21ST CENTURY

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INTRODUCTION

Technology is famous for its fast-paced rate of change. A pocket calculator is more powerful than the computer that led NASA's first trip to the moon.[1] Perhaps more strikingly, the 2017 iPhone has 23 times more processing power than the 2007 model[2] and up to 32 times more storage.[3] This has caused an explosion in the software market with firms racing to sell new ways to leverage the computers that can be found in everyone's pocket.[4] The resultant shift – the idea that the most lucrative product is now intangible software that can be distributed across the planet at the speed of light[5] – has exposed a major lacuna in the international tax system. That is because, for almost a century, international tax has been predicated on the idea that a country's right to tax a non-resident corporation depends on physical presence.[6] This notion is now hopelessly out of date in a world where one the world's largest accommodation providers does not own a single hotel, the world's biggest taxi company does not own a single car, and the world's biggest publisher does not own a single printing press. Tax legislation must shift away from physical factors and move into the digital age.

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[1] Kerry Kolbe, 'Man Versus Machine: How Computers Replaced Humans in the Space Race' (The Telegraph, 3 February 2017) <https://www.telegraph.co.uk/films/hidden-figures/space-race-man-versus-machine/> accessed 28 September 2018.
[2] The 2007 iPhone had 128mb of RAM while the iPhone X has 3gb of RAM.
[3] The 2007 iPhone had up to 8gb of storage while the iPhone X offers up to 256gb.
[4] It is reported that four out of five UK adults now own a smart phone: Katie Hope, 'UK "Has Never Been More Addicted to Smartphones"' (BBC, 26 September 2016) <https://www.bbc.co.uk/news/business-37468560> accessed 28 September 2018.
[5] Danny Crichton, 'With Software Eating Hardware, Silicon Valley Enters "Hard" Times' (TechCrunch, 30 June 2014) <https://techcrunch.com/2014/06/30/with-software-eating-hardware-silicon-valley-enters-hard-times> accessed 28 September 2018.
[6] Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (CUP 2011) 106-151. See also: Huston & Williams, *Permanent Establishment: A Planning Primer* (Kluwer, 1993).

THE CURRENT LAW

Under section 5(2)(b) of the Corporation Tax Act 2009, *"A non-UK resident company is within the charge to corporation tax only if … it carries on a trade in the United Kingdom (other than a trade of dealing in or developing UK land) through a permanent establishment in the United Kingdom (emphasis added)"*. Residency is determined in two steps. Firstly, a company incorporated in the UK is automatically treated as resident in the UK unless it can show that for the purposes of a Double Tax Treaty it is regarded as resident elsewhere.[7] Secondly, a company incorporated outside the UK will be treated as a UK resident company if its central management and control is in the UK.[8] Therefore, for those companies that are not resident in the UK – either through incorporation or the central management and control test – the UK's jurisdiction to tax depends on showing that the foreign resident company has a permanent establishment ("PE") in the UK. This can be thought of as a threshold question;[9] without showing PE status, questions as to the relevant tax charges simply do not arise.

PE is defined by section 1141 of the Corporation Tax Act 2010. This statutory provision provides two limbs under which the test for PE will be satisfied. A company will have PE in the UK where:

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[7] Corporation Tax Act 2009, s 14.

[8] Ibid; *De Beers Consolidated Mines v Howe* [1906] AC 455; *New Zealand Shipping Co Ltd v Stephens* (1907) 5 TC 553; *Untelrab Ltd v McGregor* [1996] STC (SCD) 1; *New Zealand Shipping Co Ltd v Thew* (1922) 8 TC 208; Inland Revenue Statement of Practice 1/90; Glen Loutzenhiser, *Tiley's Revenue Law* (Hart Publishing, 2016) 1295-1305.

[9] Michael P. Devereux & John Vella, 'Implications of Digitalization for International Corporate Tax Reform' Oxford University Centre for Business Taxation, Working Paper 17/07, 6; Glen Loutzenhiser, *Tiley's Revenue Law* (Hart Publishing, 2016) 1434.

a. it has fixed place of business there through which the business of the company is wholly or partly carried on; or
b. an agent acting on behalf of the company has and habitually exercises their authority to do business on behalf of the company.[10]

Limb (b) is usually excluded under Double Tax Treaties and so the focus must be on limb (a).[11] Subsection 2 goes on to give a list of non-exhaustive indicators of when limb (a) will be satisfied:

a. a place of management,
b. a branch,
c. an office,
d. a factory,
e. a workshop,
f. an installation or structure for the exploration of natural resources,
g. a mine, an oil or gas well, a quarry or any other place of extraction of natural resources, and
h. a building site or construction or installation project.[12]

This definition of PE is imposed by Article 5 of the OECD Model Tax Convention and can also be found in most of the UK's Double Tax Treaties.[13] For example, Article 7(1) of the US-UK Treaty provides:

> *"The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carried on business*

[10] Corporation Tax Act 2010, s 1141(1).
[11] Glen Loutzenhiser, *Tiley's Revenue Law* (Hart Publishing, 2016) 1449
[12] Corporation Tax Act 2010, s 1141(2).
[13] Glen Loutzenhiser, *Tiley's Revenue Law* (Hart Publishing, 2016) 1449.

> *in the other Contracting State through a permanent establishment situated therein."*[14]

Article 5(1) defines a permanent establishment in the same terms as under limb (a) above and Article 5(2) gives the familiar list of illustrative examples. Where there is an inconsistency between a Double Tax Treaty and domestic law, the treaty is to take priority unless a treaty override[15] was intended and it is accepted law that Double Tax Treaties are to be interpreted in light of the OECD commentaries.[16]

The 2010 OECD Commentary spells out the need for a physical link to a jurisdiction before PE status can be established: *"According to the definition, the place of business has to be a 'fixed' one. Thus in the normal way there has to be a link between the place of business and a specific geographical point."*[17] Concretely, the commentary suggests that:

> *"…an Internet website, which is a combination of software and electronic data, does not in itself constitute* <u>*tangible*</u> *property. It therefore does not have a location that can constitute a 'place of business' as there is no 'facility such as premises or, in certain instances, machinery or equipment' (see paragraph 6 2 above) as far*

[14] UK/USA Double Taxation Convention, incorporated into domestic law by the Double Taxation Relief (Taxes on Income)(The United States of America) Order 2002 (SI 2002/2848).
[15] See further: Craig Elliffe, 'The Lesser of Two Evils: Double Tax Treaty Override or Treaty Abuse?' [2016] BTR 62.
[16] International and Other Provisions Act 2010, s 6; *Bloomberg Inc. (UK Permanent Establishment) and others v The Commissioners for Her Majesty's Revenue & Customs* [2018] UKFTT 205 (TC), [2018] SFTD 1079.
[17] OECD, *Commentaries on the Articles of the Model Tax Convention* (2010) 94.

> *as the software and data constituting that web site is concerned (emphasis added).”*[18]

The 2010 OCED Commentary also states that in some cases the location of a server may be sufficient to create a PE.[19] For example, where *“the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there”* a PE will arise.[20] In practice, however, this can be circumvented by creating three-party contracts whereby the consumer contracts with a server in another jurisdiction and that server in turn contracts with the service or goods provider.[21] Furthermore, there is no technological reason why a server has to be located in the jurisdiction of the users that it seeks to connect with.[22] For example, Facebook has recently built new servers within the Arctic Circle in order to reduce the cost of cooling. [23]

Finally, the commentary goes on to note that for most businesses which *use* the internet to provide goods or services, rather than those that are in the business of providing the internet – in other words Internet Service Providers – the provision of a server will be no more than an activity of preparatory and auxiliary

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[18] Ibid 110.
[19] Ibid 110-111.
[20] Ibid 112.
[21] OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report* (OECD/G20 Base Erosion and Profit Shifting Project 2015) 42.
[22] Brad Litwin, ‘How to Pick the Perfect Location for your Dedicated Server’ (A2 Hosting, 1 June 2017) < https://www.a2hosting.com/blog/dedicated-server-location/> accessed 28 September 2018.
[23] Josh Constine, ‘Zuck’s Photo’s from Facebook’s Futuristic Arctic Data Centre’ (TechCrunch, 28 September 2018) < https://techcrunch.com/gallery/facebook-lulea/> accessed 28 September 2018.

character.[24] An activity which is preparatory or auxiliary falls under Article 5(4) of the OECD Model Treaty as being insufficient to create a PE.[25] An e-retailer is therefore unlikely to attract PE status by having a server located in the UK because they use that server merely as an auxiliary feature of selling goods. The main activities of the typical technology company, including mining user data using machine learning algorithms, negotiating advertising contracts, and research and development, may well take place in another jurisdiction, avoiding PE status in the UK.

THE NEW LANDSCAPE

The notion of PE outlined above first emerged in the 19th century.[26] The concept was then adopted by the League of Nations in the 1920s, with the first Model Treaty for the Avoidance of Double Taxation being singed in 1928.[27] There are a number of points of note from the historical origins of PE. Firstly, PE was introduced as an attempt to avoid double taxation.[28] It was conceived at a time when both the resident and source state could claim complete taxing rights and there was recognition of the need to help grow links between different nations.[29] By contrast, in recent decades a lack of PE has more regularly been used to avoid the payment of tax in a jurisdiction.[30] The lack of PE status in the countries in which technology companies, and particularly software companies, sell their

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[24] OECD, *Commentaries on the Articles of the Model Tax Convention* (2010) 130.
[25] See also Corporation Tax Act 2010, s 1143.
[26] Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (CUP 2011) 106-151.
[27] Ibid. See also: Avery Jones, 'Problems of Categorising Income and Gains for Tax Treaty Purposes' [2001] BTR 382.
[28] Ibid.
[29] Ibid. On the importance of the distinction between source and resident state see: Glen Loutzenhiser, *Tiley's Revenue Law* (Hart Publishing, 2016) 1441.
[30] Heather Self, 'Addressing Base Erosion and Profit Shifting' [2013] BTR 117, 118-119.

products is what makes such a situation possible. One-hundred years ago PE status was seen as a business-friendly exemption to avoid double taxation where a certain transaction clearly took place in the non-resident jurisdiction; now it is seen as a costly blackhole that should be avoided at all costs.[31]

Secondly, the economy of 2018 is fundamentally different to that of 1928. As life has increasingly become digital, PE rules have become an inappropriate way to determine jurisdiction to tax because they are tied to physical factors and do not appropriately consider the value generated in countries with a large number of users interacting on a platform. Take, for example, a large social media platform. Revenue and value is generated on such a platform by the creation of content by users.[32] This creation of content causes other users to logon to the platform and interact with each other and so the cycle continues.[33] The more users that login, the more valuable the website is for potential advertising customers.[34] However, such a platform is able to function in the UK without necessarily creating any physical presence in the jurisdiction. This has been facilitated by the ability to transfer information across the globe at the speed of light. Anyone in the world with an internet connection can be accessed by anyone else, without the need for any physical presence in the jurisdiction. The OECD has termed this concept *"scale without mass"* and it is the reason that permanent establishment is no longer an

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[31] PWC, *Permanent Establishments 2.0: At the Heart of the Matter* (2013); Bruce Militzok, 'Permanent Establishment: How to Know When & Where the Tax Line Has Been Crossed' (Alliott Group, 23 June 2017) <https://www.alliottgroup.net/practice-management-resources-for-owner-managed-firms/permanent-establishment-risk-management-strategy/> accessed 28 September 2018.
[32] OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* (OECD/G20 Base Erosion and Profit Shifting Project 2018) 24-30.
[33] Ibid.
[34] Ibid 38.

appropriate way to establish rights to tax.[35] Devereux and Vella have explained the point as follows:

> *"With modern communications, advertising of all forms, including through social media, may be managed by staff located outside country C. Where this happens, the consumers' country, C, is less likely to be able to tax any part of the profits resulting from the sale because the physical presence necessary to satisfy the threshold is missing."*[36]

Indeed, in the US the physical presence rule has recently been overruled in a federal context. In *South Dakota v Wayfair Inc*, the US Supreme Court had to decide whether South Dakota's right to levy a sales tax on out of state sales depended on some physical presence in South Dakota.[37] Giving the Opinion of the Court, holding that such a link was not necessary, Kennedy J pointed out how arbitrary physical presence has become as a jurisdictional question:

> *"…a business with one salesperson in each State must collect sales taxes in every jurisdiction in which goods are delivered; but a business with 500 salespersons in one central location and a website accessible in every State need not collect sales taxes on otherwise identical nationwide sales."*[38]

[35] Ibid 51.

[36] Michael P. Devereux & John Vella, 'Implications of Digitalization for International Corporate Tax Reform' Oxford University Centre for Business Taxation, Working Paper 17/07, 6.

[37] *South Dakota v Wayfair Inc* 585 US _ (2018).

[38] Ibid 12.

Thirdly, the current system leads to distortion when comparing traditional businesses with their modern counterparts.[39] Take the accommodation sector as an example. Traditionally, setting up a hotel has required bricks and mortar in the jurisdiction in which the accommodation was to be provided, for obvious reasons. Such physical presence would attract PE status and consequent jurisdiction to tax. However, a new business model has now emerged whereby online platforms can link those who wish to monetise spare accommodation capacity with those who are looking for somewhere to stay. From the perspective of the consumer there is no difference between the type of service that is delivered by each of the two models – both can offer a place to stay. However, the online platform's lack of physical presence means that it will not attract a charge to tax in the jurisdiction where the accommodation is provided and can consequently offer cheaper prices. This has the effect of favouring the online platform over the traditional model despite the fact that no policy decision has ever been taken to do so. In the words of Gorsuch J, this *"guarantees a competitive benefit to certain firms simply because of the organizational form they choose".*[40] That criticism holds equal weight on the international tax sphere. If it is felt appropriate to favour online businesses over those with a physical presence, this should be as a consequence of a deliberate decision and carefully designed tax breaks, not the result of technology outstripping the assumptions upon which our tax rules are based.

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[39] Ibid 13.

[40] *Direct Marketing Association v Brohl* 814 F. 3d 1129, 1150–1151.

REFORM: SIGNIFICANT DIGITAL PRESENCE

A number of attempts have been made to counter the issue highlighted in this essay.[41] For example, George Osborne introduced a Diverted Profits Tax (DPT) to catch MNEs who seek artificially to avoid PE status in the UK and book their profits elsewhere.[42] However, measures such as this do not go to the heart of the issue; many modern companies *genuinely* do not have a PE in the UK because of the focus on *physical* attributes in the rule.[43] The DPT seeks to target corporations that have arrangements which are, *"designed so as to ensure that the foreign company does not, as a result of the avoided PE's activity, carry on that trade in the United Kingdom for the purposes of corporation tax (emphasis added)".*[44] This legislation should effectively target the situation, highlighted above, whereby a three-party contract is artificially created or operations are split between different companies.[45] However, the real problem is that the very concept of a physical PE is inept for the digital economy and no amount of anti-abuse legislation will solve that.

The best solution to the issues discussed in this paper would be to abandon the idea of *physical* presence. Instead it should be recognised that in the digital era, many companies are able to operate a substantial presence in the UK without any *physical* nexus. This is an approach that has recently been suggested by the

[41] Australia has also followed this approach with its own Diverted Profits Tax.
[42] Finance Act 2015, Part 3. See further: See further: Criag Elliffe, 'The Lesser of Two Evils: Double Tax Treaty Override or Treaty Abuse?' [2016] BTR 62.
[43] Ben Jones, Susan Seabrook, Sebastiano Sciliberto & Georgina Jones, 'Taxation of the Digital Economy: Unilateral Measures' (2018) 1389 TJ 8, 10.
[44] Finance Act 2015, s 86(1)(e).
[45] See further: OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report* (OECD/G20 Base Erosion and Profit Shifting Project 2015) 42.

European Commission who have made proposals for a Directive laying down rules relating to the corporate taxation of a significant digital presence.[46] Indeed, the EU is not the first body to have suggested widening the concept of PE with Italy, Israel and Taiwan, among others, already having introduced similar reforms.[47] Under Article 4(1) of the proposed Directive, *"a permanent establishment shall be taken to exist if a significant digital presence exists through which a business is wholly or partly carried on"*. Article 4(3) then provides that:

> *"A 'significant digital presence' shall be considered to exist in a Member State in a tax period if the business carried on through it consists wholly or partly of the supply of digital services through a digital interface and one or more of the following conditions is met with respect to the supply of those services by the entity carrying on that business, taken together with the supply of any such services through a digital interface by each of that entity's associated enterprises in aggregate:*
>
> > *(a) the proportion of total revenues obtained in that tax period and resulting from the supply of those digital services to users located in that Member State in that tax period exceeds EUR 7 000 000;*

[46] Proposal for a Council Directive laying down rules to the corporate taxation of a significant digital presence 2018/0072 (CNS).
[47] Ben Jones, Susan Seabrook, Sebastiano Sciliberto & Georgina Jones, 'Taxation of the Digital Economy: Unilateral Measures' (2018) 1389 TJ 8, 11.

> *(b) the number of users of one or more of those digital services who are located in that Member State in that tax period exceeds 100 000;*
>
> *(c) the number of business contracts for the supply of any such digital service that are concluded in that tax period by users located in that Member State exceeds 3 000."*

The location of a user is to be determined by where the users uses the device and the location of the device is to be ascertained by way of Internet Protocol ("IP") address.[48] The method for attributing profits to a significant digital presence is by way of a functional analysis and the following activities would be indicative:

a. The collection, storage, processing, analysis, deployment and sale of user-level data;
b. The collection, storage, processing and display of user-generated content;
c. The sale of online advertising space;
d. The making available of third-party created content on a digital marketplace;
e. The supply of any digital service not listed in points (a) to (d).[49]

There are a number of advantages to the EU's approach.[50] Firstly, it recognises the reality that in the technological age businesses can carry out necessary

[48] Articles 4(4) and 4(6).
[49] Article 5(3).
[50] See also: Eva Escribo, 'A Preliminary Assessment of the EU Proposal on Significant Digital Presence: A Brave Attempt that Requires and Deserves Further Analysis' (SSRN,

functions such as data analytics and marketing from anywhere in the world. Secondly, it shifts control of the taxable nexus from the business to the user. Jurisdiction to tax depends not on the business's location but on that of the user. To this author the criticism that IP address can be manipulated to mask a user's location seems overstated.[51] Why would anyone do that to help MNEs avoid paying tax? Thirdly, it sets a high threshold before the rules on digital presence are engaged. This should protect start-ups in the early stages of development.

Unfortunately, this suggested reform has not received widespread support from EU Member States and it seems unlikely to be implemented in the near future.[52] However, the notion of a digital permanent establishment should be at the forefront of the UK's approach to redefining the international tax system, regardless of the Brexit deal which is eventually arrived at. While the UK government has stated its willingness to act unilaterally,[53] that is likely to lead to arbitrage between different jurisdiction's and increase, rather than decrease, the opportunity for tax planning.[54] It should therefore be seen as a measure of last resort. Reform must be based first on international consensus and then domestic reform.

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31 May 2018) < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3191787> accessed 28 September 2018.

[51] PwC response to European Commission Proposals for Directives regarding fair taxation of the digital economy, 16 May 2018 <https://www.pwc.com/gx/en/about/assets/reponse-ec-proposals-digital-tax-package.pdf> accessed 28 September 2018.

[52] Jim Brunsden & Mehreen Khan, 'France Fights to Keep EU Tech-Tax Plans Alive' *Financial Time* (London, 28 April 2018).

[53] HM Treasury, *Corporate Tax and the Digital Economy: Position Paper Update* (March 2018) 25.

[54] See for example the techniques previously used by Apple: A. Ting, 'iTax – Apple's International Tax Structure and the Double Non-Taxation Issue" [2014] BTR 40.

CONCLUSION

Changing the international tax consensus will not be straightforward. In fact, it is likely to take many years to of painstaking negotiations before the UK will be in a position to re-write its domestic statute book.[55] Furthermore, a change in the rules as to when PE is established should not be seen as a panacea; there are other factors, such as transfer pricing rules and conflicts between domestic residency tests,[56] that allow MNEs to plan their tax affairs in a way that is not available to the average citizen.[57] However, as the digital revolution continues to gather pace and the digital economy quickly becomes the whole economy,[58] it is vital that jurisdiction to tax – the first step in the analysis – is based on principled factors, such as what generates value for a company,[59] rather than on the increasingly arbitrary concept of physical location. Setting the right test for whether a country has jurisdiction to tax is the first step towards a fair and balanced international tax system.

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[55] Heather Self, 'Addressing Base Erosion and Profit Shifting' [2013] BTR 117, 121; OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* (OECD/G20 Base Erosion and Profit Shifting Project 2018) 212.
[56] A. Ting, 'iTax – Apple's International Tax Structure and the Double Non-Taxation Issue" [2014] BTR 40.
[57] A. Ting, 'Old Wine in a New Bottle: Ireland's Revised Definition of Corporate Residence and the War on BEPS' [2014] BTR 237.
[58] Ben Jones, Susan Seabrook, Sebastiano Sciliberto & Georgina Jones, 'Taxation of the Digital Economy: Unilateral Measures' (2018) 1389 TJ 8, 13.
[59] OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* (OECD/G20 Base Erosion and Profit Shifting Project 2018) 212.