Bearing of Human Presence on constitution of a Fixed Place Permanent Establishment in Digital Economy

In the era of digital economy, remotely operated computerized equipment and robots are moderately taking over the work sites. Given this, in the near future, a 'fixed place of business', which is a prerequisite for existence of a permanent establishment (PE), may be entirely operated without involvement of any human intervention at the workplace. For example, an enterprise may produce goods in a foreign country in a fully automated factory, which requires no human presence on-site.

The question that arises for consideration is whether a foreign enterprise's fully-automated fixed place of business in a source state, without the presence of human beings, would constitute a fixed place PE?

The question is no longer academic. To mention a few examples, Philips in the Netherlands is operating a fully-automated manufacturing unit to produce electric razors with the use of robots. FANUC, a Japanese robotics company is operating a fully-automated factory since 2001, where robots are building other robots and the factory can run unsupervised for as long as 30 days at a time.

It is pertinent to note that Article 5(1) of the Model Convention and various bilateral tax treaties defines a fixed place PE as – "a fixed place of business through which the business of an enterprise is wholly or partly carried on". The definition has no mention of the fact that the enterprise must carry on business at such a place through its employees or other personnel. Given this, one view on the matter that exists is that the presence of human element is not a requirement for existence of a fixed place PE under Article 5(1) of a tax treaty.

In a decision of the *German Bundesfinanzhof (Federal Tax Court) in the Pipeline Case (No. IIR 12/92 dated 30 October 1996)*, a Netherlands Company owned an underground pipeline for transporting third-party customers' crude oil and petroleum products. That pipeline was situated in the Netherlands and Germany. The pipeline was operated by the Netherlands Company remotely from the Netherlands, without having any personnel in Germany. The Court concluded that since transportation of crude oil and petroleum products was the core business of the Netherlands Company, the said transportation activity could not be regarded as an auxiliary activity for the purposes of determining the Netherlands Company's PE in Germany.

In the *Swiss Server decision [Case No. II 1224/97 dated 6 September 2001, Finanzgericht of Schleswig-Holstein (Tax Court of First Instance)]*, D Co – tax resident company of Germany – owned an Internet server installed at a rented place in Switzerland. The company stored programs and dealt with its Swiss client's files in the server. The server functioned without involvement of D Co's employees in Switzerland. A second company, S Co, which was D CO's affiliate and a Swiss tax resident, managed the server (i.e. computer programs and information about D Co's clients in Switzerland). D Co argued before the German Tax Authorities that its Swiss server amounted to PE and its income attributable to it was exempt from German tax. The German tax authorities rejected this argument. In D Co's appeal, the German Tax Court of First Instance held that the server constituted D Co's fixed place of business and a fixed place PE in Switzerland. The Court's view was that for a fixed place PE to exist, it was unnecessary that the server had to be operated by human beings (i.e. employees of D Co, a contractor or any other enterprise). The Court pointed out that any equipment could amount to a fixed place PE even if it functioned fully automatically without human intervention. In so holding, the Court also took into account Article 5(3)(a) of the Germany-Switzerland tax treaty (which was similar to Article 5(4)(a) of the OECD Model Convention). As per that provision, the term PE did not include facilities used solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise. In that respect, the Court expressed that only the assets that could be itemized on

the enterprise's balance sheet could be regarded as goods and merchandise. Therefore, in the Court's view, Article 5(3)(a) of the tax treaty did not apply to the server used for storing the information that was supplied by D Co to its customers in Switzerland. The Court also examined Article 5(3)(e) of the Germany-Switzerland tax treaty. That provision negated existence of a fixed place PE if a fixed place of business was maintained solely for the purpose of (i) advertising, (ii) for the supply of information, (iii) for scientific research, or (iv) for similar activities that were of preparatory or auxiliary character. In this respect, the Court observed that the decisive criterion was whether the activity carried on in the said place of business formed an essential and significant part of the core business of the enterprise as a whole. In that context, the Court observed that D Co's activities through the server were not preparatory or auxiliary, since the transfer of information formed part of D Co's core business. Accordingly, the Court concluded that Article 5(3)(e) of the Germany-Switzerland tax treaty did not apply in the present case. The German Court took note of Paragraphs 42.1 to 42.10 of the OECD Commentary on Article 5, which distinguished between server hardware and server software. As per the said commentary, a server hardware constituted a PE if the content provider owned the server and he exercised his business through the server. In such a situation, it was not relevant whether the foreign enterprise used personnel in the host country where the server was situated. Therefore, the Tax Court of First Instance concluded that the above-mentioned computer server amounted to D. Co's fixed place PE in Switzerland.

The Italian Tax Authorities have adopted a similar position to the approach in the above-mentioned Swiss Server case. *Italy's Tax Administration in Resolution 119 of May 28, 2007* has ruled that under some circumstances, a foreign company's internet server located in Italy constitutes a PE of the foreign company in Italy and that the foreign enterprise is taxable in Italy on a net income basis on the profits attributable to the business activity carried out through that server. In the instant case, a French company offered online video game services to Italian customers. The customer must subscribe to the service, open an account, and install a player, which is licensed free of charge with no right to copy, modify, or commercially use the games. At that point, the customer can download or use the games offered on the company's online list. To facilitate the online connection and reduce connection costs, the French company installed two servers with an Italian Internet Service Provider. The French company owned the servers and their configuration and operation, as well as the installation of the software applications and the delivery of the games to the customers, which were carried out directly from France. Apparently, the French company had no personnel in Italy involved in the operation of the server. The video games were offered partly directly through the servers and partly through the Italian service provider. The tax administration observed that a server, which is a tangible, physical property, can constitute a PE under specific circumstances, namely when: (i) it is permanently available to the foreign enterprise (whether owned, leased, or otherwise); (ii) it is located in the same place for a significant period; and (iii) it is actually and directly used to carry out the foreign enterprise's trade or business. According to the tax administration, when the server is used to conduct electronic commerce aimed at the sale of goods and services downloadable directly from the company's web site, the server is an integral and essential part of the business and constitutes a PE. The tax administration cited the commentary to the OECD Model Convention (specifically regarding Article 5, Paragraph 42) as additional support for its conclusion. First, the commentary points out that a server is a piece of equipment with a physical location and that the location may therefore constitute a fixed place of business of the enterprise that operates that server. The commentary then clarifies that a server at a particular location may constitute a PE if it is 'fixed', meaning that it is located at a particular place for a sufficient period. Finally, according to the commentary, to obtain PE status, the business of the enterprises must be carried out through the server so that it can be said that because of the use of such equipment, the enterprise has facilities at its disposal where business functions are performed. Most importantly, the commentary clarifies that the presence of the foreign enterprise's personnel at the location where the server is placed is not required.

The conclusions reached by Switzerland's Tax Court of First Instance and the Italian Tax Administration in the above rulings and the arguments offered in support of the conclusion, appear to be in line with the explanation provided in the OECD commentary and consistent with the position taken on the same issue at the OECD level. Given this, in author's view, for existence of a fixed place PE under Article 5(1) of a relevant tax treaty, the presence of human beings at a foreign enterprise's fixed place of business in the source state is not a prerequisite. In a case where the various essentials for a fixed place PE (including but not limited to stability, productivity and dependence) are satisfied, then a fixed place PE may exist even in case of a fully-automated place of business.

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