Head in the Cloud: Applying Permanent Establishment, Nexus and Treaty Principles to Electronic Commerce Transactions
AKA: Dodgeball!
Introducing the Teams

Multinational Corporations

Versus

International, Federal & State Tax Authorities
Overview

• Multinational corporations that operate in multiple jurisdictions are required to navigate overlapping and sometimes inconsistent tax residency requirements.
  ▪ In the international context, the “permanent establishment” principles found in income tax treaties (and sometimes incorporated in the local tax residence requirements) are significant.
  ▪ In the U.S. state analysis, the question is whether the corporation has sufficient nexus in the state so as to subject it to that state’s tax laws.

• The interplay of these rules can lead to odd results.
  ▪ Because treaties do not affect state law, income that is exempt from federal taxation because it is not attributable to a permanent establishment may nonetheless be subject to U.S. state taxation.

• We will review the relevant rules below and then use some examples to illustrate how they work in practice.
The Rules: Tax Residence

• Permanent establishment is a treaty concept.
  ▪ Although the permanent establishment concept is sometimes used to denote tax residence, it is a treaty concept.
  ▪ Under income tax treaties, the “business profits” of a corporation that are resident in one treaty jurisdiction generally are not subject to tax in the other treaty jurisdiction unless they are attributable to a permanent establishment maintained in that jurisdiction.

• Before you get to the permanent establishment question, you must first determine if there is a tax residence in the local jurisdiction.
  ▪ Under U.S. principles, for example, a corporation that is engaged in a U.S. trade or business is subject to tax on its income that is effectively connected with that trade or business.
  ▪ The determination of whether a corporation is engaged in a U.S. trade or business is made based on facts and circumstances, which are similar but not identical to the permanent establishment factors discussed below.
The Rules: Permanent Establishment

• Once it has been determined that there is a tax residence under local law, the question under the treaty is whether the corporation has a “permanent establishment” in the taxing jurisdiction.
  ▪ Under most tax treaties, the business income of a foreign corporation is taxable only if that corporation has a “permanent establishment” in the taxing jurisdiction.

• The permanent establishment provision in most international tax treaties (including most U.S. treaties) is derived from the OECD Model Treaty and its commentary.
  ▪ The UN Model Treaty permanent establishment provision is similar, except that it expands the range of activities to include assembly projects and certain supervisory activities.
The Rules: Permanent Establishment

• Under the OECD Model (Article 5), there are two types of permanent establishments:
  - *Fixed Place PE* – Article 5(1)
  - *Agency PE* – Article 5(5)

• A corporate subsidiary is not per se a fixed place permanent establishment under the OECD model (Article 5(7)).
  - Note, however, that activities of a subsidiary may give rise to an agency permanent establishment, discussed below.

• Commentary to the OECD Model Treaty provides helpful guidance on the interpretation of the permanent establishment rules.
  - Of particular relevance here is commentary regarding electronic commerce, discussed below.
The Rules: Fixed Place PE
The Rules: Fixed Place PE

• Under the OECD Model Treaty, there are three basic requirements to the finding of a fixed place permanent establishment (Article 5(1)):
  ▪ Premises owned, rented or otherwise at disposal of the foreign corporation or its employees;
  ▪ Permanency; and
  ▪ Conduct of meaningful business activity by employees, local agents or other personnel.
The Rules: Fixed Place PE

• Physical presence requirement
  ▪ Ownership and rental of property is clear, but the “at the disposal of” language can lead to some close calls.
  ▪ According to the OECD Commentary:
    ▪ Mere presence of the corporation or its employees at a location in the jurisdiction is not sufficient.
    ▪ Similarly, regular visits by sales personnel to customer premises in the jurisdiction alone are not sufficient to constitute a PE.
  ▪ But,
    ▪ The continuous use of office space of another company for an extended period is considered to give rise to a permanent establishment.
    ▪ Incidental contacts with a jurisdiction, such as the use of cable or pipeline or entering into a roaming agreement, are not sufficient contact to result in a permanent establishment.
The Rules: Fixed Place PE

- **Easy calls:**
  - Branch
  - Office
  - Factory
  - Workshop
  - Mine, oil or gas well, quarry or any other place of extraction of natural resources.

- **Potential fouls:**
  - Place of management
    - The most subjective of the types of activities that can give rise to a permanent establishment.
    - Performance of managerial functions in the jurisdiction gives rise to a permanent establishment.
    - Storage of records alone generally is not sufficient to result in a permanent establishment.
  - Seconded employees may give the lending employer a fixed place of business, particularly if they remain on the payroll of the lending employer.
The Rules: Fixed Place PE

• What constitutes permanency?
  ▪ OECD Commentary suggests that activities that are carried on for less than six months cannot constitute a PE, but there is not consistency in practice.
  ▪ Short periods of time at recurring intervals can give rise to a permanent establishment.
  ▪ The duration of business activity is significant.
The Rules: Fixed Place PE

- **Conduct of meaningful business activity**
  - Under the OECD Model, preparatory or auxiliary activities alone do not constitute a permanent establishment (Article 5(4)).
  - Specific exclusions:
    - Storage, display or delivery
    - Purchasing goods
    - Collecting information
• The Rookie – E-Commerce
  - The permanent establishment concept historically is focused on physical presence, but what happens when everything is in the cloud?
  - Given the historic bias toward fixed locations in the taxing jurisdiction, the application of permanent establishment principles to E-commerce has focused on the location of the servers.
The Rules: Fixed Place PE

• The Rookie – E-Commerce
  ▪ The OECD Model Commentary distinguishes between automated equipment and the data and software stored on that equipment (such as a website). (paragraph 42.2)
    ▪ Ownership of automated equipment in a jurisdiction may constitute a permanent establishment; but
    ▪ A website and the server where the website is stored (or the use of an Internet Service Provider) do not generally arise to the level of a permanent establishment since such activities do not constitute a physical presence. (paragraph 42.3)
The Rules: Fixed Place PE

• The Rookie – E-Commerce
  ▪ Under the OECD Model Commentary, even with electronic commerce it is all about the physical presence.
    ▪ Electronic equipment on which the website is accessed and information is stored may constitute a fixed place of business if the server is “at the disposal” of the business (for example, the business owns (or leases) the server). (paragraphs 42.2 and 3)
    ▪ In addition to being at the disposal, the electronic equipment must be fixed and the taxpayer’s business must be carried out through the equipment. (paragraphs 42.3-5)
  ▪ It does not matter if a company has personnel or not at the location of the server. (paragraph 42.6)
    ▪ Is the server the functional equivalent of an employee?
The Rules: Fixed Place PE

- **The Rookie – E-Commerce**
  - And, even if there is physical presence, the electronic equipment must be engaged in something more than “preparatory or auxiliary” activities. (paragraph 42.7)
    - An example of a preparatory or auxiliary activity is where a server hosts a website that is used (i) exclusively for advertising, (ii) for displaying products or (iii) for providing product information to customers. (paragraph 42.9)
    - However, electronic equipment may constitute a PE if such functions form an essential and significant part of a company’s business activity. (paragraph 42.8)
      - For example, if electronic equipment automatically processes (i) payment for the products, (ii) delivery of the products and (iii) the conclusion of customer contracts. (paragraph 42.9)
(Changing) The Rules: You Got Served!
• **Services permanent establishments**
  
  - Traditionally, the performance of services without a fixed place of business does not give rise to a permanent establishment.
  
  - The permanent establishment rules, which focus on having a fixed presence in the taxing jurisdiction, are not easily applied to a services business where a fixed place of business is not required.
  
  - As the ability to provide services across jurisdictions increases, some countries have taken the position that certain services when performed inside the country can give rise to a permanent establishment.
    
    - See, e.g., Canada, Chile, Czech Republic, Slovak Republic, and Turkey.
The Rules: Free (and Not-So-Free) Agents
The Rules: Free (and Not-So-Free) Agents

• As noted above, the activities of a subsidiary or separate corporation generally do not give rise to a permanent establishment, except where that entity is a “dependent agent” in the taxing jurisdiction. (OECD Model Art. 5(5)).

• An agent will be considered to be a dependent agent when it:
  ▪ Is legally or economically dependent on the principal; and
  ▪ Has and habitually exercises the authority to conclude contracts in the name of the principal.
    ▪ Facts and circumstances analysis.
    ▪ “Concluding contracts” is broader than simple execution—can mean negotiation of material terms even if the final execution is in the home jurisdiction.
Okay, I went through the rules and I do not have a permanent establishment. So, no taxes, right?
So wrong
Introduction to Nexus

• Even if you successfully run the permanent establishment hurdles, state tax authorities can still hit you.

• As noted above, permanent establishment is a treaty concept.
  - U.S. income tax treaties cover federal tax liability, but do not cover state taxes.
  - Thus, even if business profits that are not attributable to a permanent establishment cannot be taxed by the U.S. federal government under a treaty, those business profits may be subject to tax in the states.
Nexus

• Under U.S. state and federal law, if a taxpayer and its activities have nexus with a given state, that state can impose its income and franchise taxes on the taxpayer.

• Nexus
  ▪ Taxable connection to taxing state
    ▪ Taxpayer to taxing state
    ▪ Taxed activity to taxing state
    ▪ Constitutional concept
  ▪ Jurisdiction
    ▪ Exercise of state’s authority to tax
Nexus

The Rules

• Jurisdiction and Nexus are governed by:
  ▪ Federal Law
    ▪ U.S. Constitution
    ▪ U.S. Supreme Court Decisions
    ▪ Federal Statutes with Preemptive Effect (P.L. 86-272)
  ▪ State Law
    ▪ State Constitutions
    ▪ State Statutes
    ▪ Case Law
    ▪ Other Guidance Issued by State Authorities
Nexus

• Economic Nexus
  ▪ Taxpayer has substantial nexus with a state by virtue of the intentional exploitation of the state’s market without a physical presence in the state.
  ▪ Licensing intangible property for use in a state is sufficient exploitation of the state’s market to satisfy the substantial nexus requirement of *Complete Auto Transit*.
Nexus

- **Bright Line Presence**
  - Bright line presence nexus standards require a set threshold to be exceeded, and once exceeded, substantial nexus exists sufficient for the state to impose its income or franchise tax.
  - **Example:**
    - Ohio’s bright line presence rule provides that taxpayers with any of the following have substantial nexus with the state:
      - Greater than $50,000 of property in Ohio.
      - Greater than $50,000 of payroll in Ohio.
      - Greater than $500,000 of taxable gross receipts in Ohio.
      - 25% of its total property, payroll, or sales in Ohio.
Getting in the Game
• **Scenario 1: E-Commerce Business with U.S. Web Hosting**
  - Canada Co. is a Canadian corporation that runs an e-commerce business.
  - The Canada Co. website is hosted on servers owned by U.S. Co., which is related to Canada Co.
  - Canada Co. pays an arm’s length fee for the web hosting services.
  - Canada Co. has no employees in the U.S. and does not own any property in the U.S.
  - Canada Co. sells to customers in the United States, and targets U.S. customers through its advertising efforts.
  - Sales on Canada Co.’s website are completed on the servers.
• Question 1: Does Canada Co. have a U.S. trade or business?
  ▪ There is a risk that Canada Co. would be considered to be engaged in a U.S. trade or business and therefore potentially subject to U.S. tax on income effectively connected with that business. Some relevant factors include:
    ▪ U.S. customers constitute a material portion of Canada Co.’s business,
    ▪ Canada Co. targets U.S. customers through marketing efforts, and
    ▪ Sales of Canada Co.’s products are completed on servers located in the U.S.
• Question 2: If Canada Co. is engaged in a U.S. trade or business, is its income nonetheless exempt from U.S. tax under the U.S./Canada treaty because it does not have a U.S. permanent establishment?

  ▪ Under the U.S./Canada tax treaty, business profits earned by a Canadian company in the U.S. are taxable in the U.S. only if attributable to a permanent establishment located there.

  ▪ This means that Canada Co. must have:
    ▪ A fixed place of business in the U.S. and
    ▪ Its business can be said to be wholly or partly carried out there.

      ▪ Preparatory or auxiliary activities are excepted from PE treatment.
• (Cont.) Question 2: If Canada Co. is engaged in a U.S. trade or business, is its income nonetheless exempt from U.S. tax under the U.S./Canada treaty because it does not have a U.S. permanent establishment?

  ▪ Considering the OECD Commentary on E-Commerce, provided US Co. is simply providing web hosting services, Canada Co. generally should not be considered to have a permanent establishment in the U.S.

  ▪ **Note that in order to claim the treaty exemption, Canada Co. would be required to file a U.S. income tax return indicating it has a U.S. trade or business, but claiming an exemption from tax under the treaty.**

    ▪ Highlights the significance of making the initial determination on whether there is a U.S. trade or business.
• **Question 3:** Even though it is exempt from U.S. federal income tax, does Canada Co. have any potential state tax exposure?
  - Economic nexus? Canada Co. is targeting customers in the United States.
  - Physical presence?
  - Attributional nexus?
• **Scenario 2:**
  
  - Modify the facts so that Canada Co. actually leases specific servers from U.S. Co. for the purpose of hosting its website, and has exclusive rights to those specific servers.
• Question 1: Does Canada Co. have a U.S. trade or business?
  ▪ Now the risk of a U.S. trade or business is substantially increased.
  ▪ Leasing tangible property in the United States on which Canada Co. is conducting its business operations exposes it to increased risk of a U.S. trade or business.
• Question 2: If Canada Co. is engaged in a U.S. trade or business, is its income nonetheless exempt from U.S. tax under the U.S./Canada treaty because it does not have a U.S. permanent establishment?

  ▪ Once Canada Co. leases the servers, the commentary to the OECD Model Treaty would suggest that Canada Co. has a permanent establishment in the U.S.

  ▪ Highlights the importance of understanding the specific terms of any web hosting/services contracts with U.S. parties (related and unrelated)—is it truly a right to the physical server or simply a right to store software?

  ▪ Assuming there is a PE, the next question is how much income is attributable to the PE.
Question 3: Does Canada Co. also have potential state tax exposure?

- Whether leasing servers creates nexus may depend on whether Canada Co. is actually leasing the physical servers on which its books reside or whether it is leasing cloud computing capacity.
- Leasing a physical server in the state would create nexus in all states and subject Canada Co. to the state’s income and franchise tax.
- However, question whether states would consider leasing cloud computing capacity as creating nexus.
  - Economic presence? Revenue from customers?
Avoiding Fouls and Foot Faults
Avoiding Fouls and Foot Faults

- **Permanent establishment**
  - Carefully define the scope of employment and terms of any service contracts for services performed outside the country of tax residence.
  - Material negotiations and completion of contracts take place only in country of tax residence.
    - If employees engage in negotiations outside the country, carefully define the scope of authority and ensure direction is coming from the tax residence country.
  - Management of the entity, including board meetings and other material decision-making processes take place in the country of tax residence or, at a minimum, in a tax neutral location.

- **Nexus**
  - Avoid having an employee living or working in a state where otherwise no nexus.
  - Important not to exceed protected activities under P.L. 86-272.
  - Be careful of ownership interests in partnerships and LLCs where state tax presence could flow through to the owner.
The End
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