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Cover Page Footnote

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E-COMMERCE AND THE TAXATION DOCTRINE OF PERMANENT ESTABLISHMENT IN THE UNITED STATES AND CHINA

SUSAN K. DUKE*

I. INTRODUCTION

The People's Republic of China entered into an Income Tax Agreement with the United States in 1984. The signing of that tax treaty began official cooperation between the United States and China regarding taxation of income for their residents. Ratified two decades ago, that document did not address taxation of Internet income. While we await codification of taxation of Internet income by either country, international businesses are left without specific authority to determine what will constitute an e-commerce permanent establishment for purposes of taxation in China or the United States. Other countries are in the same situation as China and the United States, having no taxation laws defining and determining the meaning of permanent establishment in e-commerce. This article will discuss the definition of permanent establishment and its importance in determining what a country's e-commerce tax implications will be. As China emerges as an international business power, and the United States continues to be a world leader, evaluating how they deal with international taxation issues can provide insight to other countries as to the future of permanent establishments in e-commerce.

II. BUSINESS RELATIONS BETWEEN THE UNITED STATES AND CHINA

The Chinese government wishes to maintain an annual growth rate for its economy of 7.2%.¹ Until 2003, the growth rate of China's economy had been predictable, growing between 7% and 8% annually in the five years prior.² However, 2003 saw a change in China's economic growth that has continued in 2004. In 2003, China's economy grew by 9.1%, and the growth surged to 9.7% in the first quarter of 2004.³ The Chinese government is expected to

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1. Siva Yam & Paul Nash, *Cooling China's "Overheated" Economy to Bring it In-Line with a Targeted Annual Growth Rate of 7.2%*, CHINA ALERT, May 1, 2004, at 1, at <http://www.usccc.org/publication/May%201,%202004.pdf> (last visited Feb. 16, 2005).

2. *Id.*

3. *Id.*

take measures to slow the growth of its economy, which could impact businesses operating in or with China.⁴ Slowed growth is expected to negatively impact property developers and cause increased competition between Chinese and U.S. manufacturers.⁵

China is “the world’s largest construction site.”⁶ For this reason, opportunities exist for foreign businesses, including U.S. businesses, in the production of raw materials — such as steel — as China’s own resources are scarce.⁷ An increasing number of U.S. companies are operating in China due to its massive consumer market and low production costs.⁸

China is only beginning to emerge as a powerful player in global commerce. Domestic businesses in China have a long history of government control.⁹ Private Chinese businesses, still in their early stages, have difficulty directly challenging U.S. businesses.¹⁰ However, Chinese businesses are becoming more modernized and willing to invest in new technological developments.¹¹ Increasingly, Chinese businesses are operating outside of China and are willing to make direct investments in the United States to avoid operating through a traditional foreign company intermediary.¹²

The increasing market available for U.S. businesses in China and the increasing willingness of Chinese businesses to operate in the United States means that the two countries will have significantly more taxation issues with foreign companies. As the economic interplay between China and the United States heightens, and the expansion of the Internet and e-business continues, the two countries and their business enterprises must deal with the issues of permanent establishment, taxation, and e-commerce. However, business commentators are concerned that friction in the bilateral relationship between the United States and China, caused mainly by the United States’ astounding \$120 billion trade deficit with China, may cause problems for U.S. businesses seeking an association with China.¹³

4. *Id.*

5. *Id.* at 1-2.

6. SIVA YAM & PAUL NASH, REFLECTIONS ON 2003 AND SOME THOUGHTS ON THE OPPORTUNITIES AND CHALLENGES OF THE COMING FIVE TO TEN YEARS 1, at <http://www.usccc.org/publication/Executive%20Summary%20Year%202004.pdf> (last visited Feb. 16, 2005).

7. *Id.* at 1-2.

8. *Id.* at 3-4.

9. *See id.* at 2-3.

10. *Id.* at 3.

11. *Id.*

12. *Id.*

13. *Turbulence Seen for Sino-U.S. Relations*, PAC. BUS. NEWS, Feb. 16, 2004, at 1, available at <http://www.johnsonchoi.com/pbn021704.pdf> (last visited Feb. 16, 2005).

III. THE INCOME TAX TREATY

An income tax treaty — the Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income (Agreement) — between the United States and the People's Republic of China was signed on April 30, 1984.¹⁴ The U.S. Departments of State and Treasury were primarily responsible for negotiating the Agreement on behalf of the U.S.¹⁵ The Agreement is the first and only income tax treaty between the two countries.¹⁶ The Agreement entered into force on November 21, 1986, after it was amended by a subsequent protocol signed on May 10, 1986.¹⁷ The 1986 protocol provided for rules against "treaty shopping."¹⁸ Generally, U.S. citizens, unless they are also U.S. residents, are not covered by the Agreement.¹⁹

The Agreement was created based on model income tax treaties produced by the Organization for Economic Cooperation and Development and the U.S. Department of the Treasury.²⁰ The provisions of the Agreement are reciprocal, meaning that the same rules apply to both countries.²¹ In the Agreement's formation, the importance of determining permanent establishment rules was recognized. In his letter submitting the treaty to President Ronald Reagan, George P. Schultz, then Director of the Department of State, stated: "[I]nvestors will know before undertaking a transaction in China what the income tax consequences will be. Business profits will not be taxable by China unless attributable to a 'permanent establishment,' as defined in the agreement."²²

Article 5 of the Agreement defines the concept of permanent establishment for taxation of U.S. businesses operating in China and Chinese firms conducting business in the United States.²³ A

14. Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, Apr. 30, 1984, U.S.-P.R.C., T.I.A.S. No. 12065 [hereinafter Agreement for the Avoidance of Double Taxation].

15. 1984 U.S.-China Income Tax Agreement, 86 TAX NOTES INT'L 8-34 (Apr. 21, 1990), available at LEXIS 86 TNI 8-34.

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. Agreement for the Avoidance of Double Taxation, *supra* note 14. See Appendix A for the full text of Article 5.

permanent establishment is defined as a "fixed place of business through which the business of an enterprise is wholly or partly carried on."²⁴ A permanent establishment, under the terms of the treaty, includes:

- 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.²⁵

The Agreement provides that the term "permanent establishment" shall also include:

- a) a building site, a construction, assembly or installation project, or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;
- b) an installation, drilling rig or ship used for the exploration or exploitation of natural resources, but only if so used for a period of more than three months; and
- c) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where such activities continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve month period.²⁶

More importantly, the term "permanent establishment" does not include:

24. *Id.* art. 5(1).

25. *Id.* art. 5(2).

26. *Id.* art. 5(3).

- a) the use of facilities solely for the purpose of storage, display or delivery 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;
- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; [or]
- f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) through (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.²⁷

The treaty's definition of permanent establishment can therefore be reduced to requiring a fixed place of business, or the ongoing conduction of business for a period of time within the foreign country, with few exceptions. While the treaty does not define the meaning of permanent establishment within the e-commerce context, the treaty does provide for a broad definition of permanent establishment. The State Administration of Taxation in China "has not ruled on the issue of whether a Web site or computer server, through which e-commerce transactions are conducted between a nonresident vendor and Chinese customers, constitutes an 'establishment' within the meaning of Chinese domestic tax law or a 'permanent establishment' under a tax treaty."²⁸

27. *Id.* art. 5(4).

28. Jinyan Li, *E-Commerce Taxation in China*, WORLDWIDE TAX DAILY, Dec. 4, 2000, at 36.

IV. MODERN APPROACHES

The definition contained in the U.S./China taxation treaty of permanent establishment is substantially similar to that contained in the Organisation for Economic Co-operation and Development (OECD) model convention.²⁹ The OECD model was one source used in the drafting of the treaty.³⁰ Therefore, the commentary on Article 5 of the OECD model convention (dealing with permanent establishment) is relevant to interpretation of the U.S./China tax treaty.³¹ While neither country has codified e-commerce taxation and the definition of permanent establishment in that context, they are likely to turn to this model — frequently referred to in international tax situations — in future formation of their definitions and current applications of the existing treaty provisions. According to the OECD commentary, “an Internet web site . . . does not in itself constitute” a permanent establishment.³² The OECD reasons that an Internet site is composed of software and data, not tangible property, and therefore cannot be considered “a place of business” to lead to inclusion as a permanent establishment.³³ However, a server may rise to the level of a permanent establishment because it is tangible property requiring a physical location, and its location can be “a ‘fixed place of business,’” regardless of whether the server is owned or leased by the business operating the server.³⁴ The presence of business personnel at the location of the server is not necessary to create a permanent establishment.³⁵ If the server is not at the disposal of the business, but rather is operated by a web provider, it should not constitute a permanent establishment because the business has no control over the server and it is not a place of business of the enterprise.³⁶

The OECD states that “[c]omputer equipment . . . may only constitute a permanent establishment if it meets the requirement of being fixed.”³⁷ It does not matter whether the server may be

29. ARTICLES OF THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL (ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT 2000), available at <http://www.oecd.org/dataoecd/52/34/1914467.pdf> (last visited Feb. 25, 2005).

30. See *supra* note 20 and accompanying text.

31. OECD COMMITTEE ON FISCAL AFFAIRS, CLARIFICATION ON THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN E-COMMERCE: CHANGES TO THE COMMENTARY ON THE MODEL TAX CONVENTION ARTICLE 5 (Dec. 22, 2000) [hereinafter OECD CLARIFICATION], at <http://www.oecd.org/dataoecd/46/32/1923380.pdf> (last visited Feb. 25, 2005).

32. *Id.* at 5.

33. *Id.*

34. *Id.*

35. *Id.* at 6.

36. *Id.* at 5.

37. OECD CLARIFICATION, *supra* note 31, at 5.

moved, but rather if it is actually moved.³⁸ A server must remain in the same location “for a sufficient period of time” (at least twelve months) to constitute a permanent establishment.³⁹

The existence of computer equipment, even if in a fixed place, will not create a permanent establishment where the business conducted through the equipment is limited to preparatory or auxiliary services.⁴⁰ Whether particular functions can be considered preparatory or auxiliary services must be decided on a case-by-case basis, with regard for all the functions performed by the business through the computer equipment.⁴¹ Examples of activities considered preparatory or auxiliary by the OECD include:

- providing a communications link . . . between suppliers and customers;
- advertising of goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise; [and]
- supplying information.⁴²

Where activities performed through the computer equipment are essential and significant to the business as a whole, they go beyond the meaning of auxiliary or preparatory services and create a permanent establishment.⁴³ Businesses should note that any core activities carried on through a server will cause that server to be classified as a permanent establishment under the OECD model, and thus expose them to taxation in the jurisdiction where the server rests.⁴⁴ As an example, the OECD commentary refers to the “e-tailer,” an enterprise that sells products through the Internet.⁴⁵ The mere fact that an e-tailer uses a server to perform some part of its business is insufficient to show that the uses of that server are more than preparatory or auxiliary.⁴⁶ Rather, consideration must be given to “the nature of the activities performed at that location in light of the business carried on by the enterprise.”⁴⁷ For example, if a server is used to operate a web site used only for advertising,

38. *Id.*

39. *Id.*

40. *Id.* at 6.

41. *Id.*

42. *Id.*

43. OECD CLARIFICATION, *supra* note 31, at 6.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

providing information, or displaying a catalogue, it will not constitute a permanent establishment."⁴⁸ However, if the web site is able to perform the functions of a typical sale (such as the processing of payment by the buyer and the processing of delivery of the products automatically through the server), it will be sufficient to cause the server to create a permanent establishment for taxation purposes.⁴⁹

Generally, the OECD does not consider independent service providers (ISPs) to constitute permanent establishments.⁵⁰ Because ISPs are typically not authorized to contract on behalf of businesses operating through their networks, they therefore constitute independent agents, which is often demonstrated by ISPs hosting the web sites of multiple businesses.⁵¹ As such, they are not considered permanent establishments.⁵² Furthermore, since an ISP or a web site is not a "person" according to Article 3 of the OECD, they would not qualify as permanent establishments under the agency principles outlined in paragraph 5.⁵³

The United States will more than likely follow all of the recommendations of the OECD when it decides to amend or supplement its international tax treaties, including its treaty with China. The United States has already indicated that it believes the OECD should be the leader in determining such international taxation issues, and that the United States should support the OECD's findings and principles.⁵⁴ In its report to Congress in 2000, the Advisory Commission on Electronic Commerce recommended "affirm[ing] support for the principles of the OECD's framework conditions for taxation of e-commerce, and support[ing] the OECD's continued role as the appropriate forum for: (1) fostering effective international dialogues concerning these issues; and (2) building international consensus."⁵⁵

However, in 1999, prior to the release of the report, the U.S. Department of the Treasury released a report conflicting with the OECD model in regards to servers as permanent establishments.⁵⁶

48. *Id.* at 6-7.

49. OECD CLARIFICATION, *supra* note 31, at 7.

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

54. ADVISORY COMMISSION ON ELECTRONIC COMMERCE, REPORT TO CONGRESS, at 42 (Apr. 2000) [hereinafter ADVISORY COMMISSION REPORT TO CONGRESS], available at http://www.ecommercecommission.org/acec_report.pdf (last visited Feb. 17, 2005).

55. *Id.*

56. U.S. DEP'T. OF THE TREASURY, OFFICE OF TAX POLICY, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE (Nov. 1996), available at <http://www.ustreas.gov/offices/tax-policy/library/internet.pdf> (last visited Feb. 17, 2005).

The Treasury does not believe servers should be classified as permanent establishments for taxation purposes.⁵⁷ The Treasury reasoned that computer servers can easily be located anywhere in the world, and that its users are indifferent to its location.⁵⁸ Further, a server is often not significantly involved in the creation of income so as to be considered in “determining whether a U.S. trade or business exists.”⁵⁹ The Treasury also feared that foreign persons would simply locate their servers outside of the United States, since their location is unimportant from a business standpoint.⁶⁰ However, since the U.S. Advisory Commission on Electronic Commerce later released a report indicating its loyalty to OECD principles, the Department of the Treasury may withdraw its prior stance against servers as permanent establishments in order to defer to the ideal of international cooperation. Deference to the OECD model may also lead to increased taxation revenues for the United States as clear rules for the right to tax, the method of collection, and agreements to submit to such taxation are reached.

The Treasury report suggested that no new taxes should be applied to e-commerce and that current traditional rules of international taxation should be modified as necessary to adapt to the global Internet business world.⁶¹ Economically similar transactions should receive the same tax treatment, whether made digitally or conducted through non-electronic means.⁶² E-commerce should not shoulder more tax burdens or administrative burdens related to international taxation than its traditional “brick and mortar” competitors. All nations should defer development of their own tax codes related to international e-commerce taxation until such time as an international consensus may be reached on these issues.

V. CONCLUSION

The Advisory Commission on Electronic Commerce Report directed that no U.S. legislation be enacted that is contrary to the Commission’s recommendations on international e-commerce taxation.⁶³ If the report’s recommendations are followed, the United States is unlikely to take any specific action on codification of international e-commerce permanent establishment taxation issues

57. *See id.* at 26.

58. *Id.* at 25.

59. *Id.*

60. *Id.*

61. *Id.* at 19.

62. *Id.*

63. ADVISORY COMMISSION REPORT TO CONGRESS, *supra* note 54, at 43.

any time in the near future. The report clearly indicates that the United States should not advance its own laws on these issues unless and until, in working with the OECD, an international consensus is reached on such taxation matters.⁶⁴ While many countries are actively cooperating in this process, including the United States and China, divergent ideas from a multitude of nations with different laws and concepts of taxation will likely impede progress towards international consensus. Also, developing countries are likely to have different agendas and needs than large economic powers such as the United States and, more recently, China. Developing countries may be adversely affected by the proposed permanent establishment rules, which only allow a country to tax an entity with a physical location within its boundaries. The buyer's resident country receives no tax revenues while the country of the seller's place of business (typically the more developed country) does. These types of disputes and competing interests make it unlikely that a consensus on international e-commerce taxation can be reached.

Without any codes, statutes, or legislation from either China or the United States telling international businesses how their permanent establishments, and thus their country of taxation, will be determined, businesses must turn to the OECD model for the most accurate indication of how they may be taxed. As stated earlier, the taxation treaty between the United States and China was largely based upon this model. The United States and China, both explicitly and implicitly, have consented to the OECD taking the lead in international taxation issues as both countries freely participate in the OECD's activities and determinations.

If the OECD model is followed, this would mean that the presence of a web site is unlikely to give rise to the existence of a permanent establishment for taxation purposes, but the presence of a computer server in China or in the United States could be considered a permanent establishment and thus expose its owner to taxation by that country. Currently, international companies in both countries should expect any meaningful Internet activities that include some fixed place of business (from a computer server to a full-fledged business operation) within China or U.S. borders to grant taxation rights to that country. As U.S. companies continue their expansion into the large Chinese market, and as Chinese businesses begin to tap U.S. sources, these organizations will increasingly pressure their governments for clear, favorable rules regarding permanent establishments in e-commerce. These

64. *Id.* at 42-43.

pressures may lead the countries to amend their treaty to include e-commerce taxation definitions sooner than expected as the wait for global consensus becomes infinite.

APPENDIX A

Article 5 of the Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, April 30, 1984, US-P.R.C., T.I.A.S. No. 12065:

1. For the purposes of this Agreement, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. 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.
3. The term "permanent establishment" also includes:
 - a) a building site, a construction, assembly or installation project, or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;
 - b) an installation, drilling rig or ship used for the exploration or exploitation of natural resources, but only if so used for a period of more than three months; and
 - c) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where such activities continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve month period.
4. Notwithstanding the provisions of paragraphs 1 through 3, the term "permanent establishment" shall be deemed not to include:
 - a) the use of facilities solely for the purpose of storage, display or delivery 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;
- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
- e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) through e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person, other than an agent of an independent status to whom paragraph 6 applies, is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that Contracting 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, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other Contracting State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph if it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of

the other Contracting State, or which carries on business in that other Contracting State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.