TAXATION OF E-COMMERCE: THE CHALLENGES POSED TO THE CONCEPT OF PERMANENT ESTABLISHMENT

BY

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DECLARATION

THIS PROJECT IS MY ORIGINAL WORK AND HAS NOT BEEN PRESENTED FOR A DEGREE IN ANY OTHER UNIVERSITY.

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THIS PROJECT HAS BEEN SUBMITTED FOR EXAMINATION WITH MY APPROVAL AS THE UNIVERSITY SUPERVISOR.

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To my beloved Family David, Michelle and Moses.
For the unsurpassed support and encouragement.
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3. Birmount Holdings Limited Vs. R (1978) CTC 358,
4. Tara Exploration and Development Co. Ltd Vs. MNR (1970) CTC 557
6. Malayan Shipping Co. Ltd Vs. FC of T (1946) CLR 156
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2. OECD Model Tax Convention (hereinafter called OECD).


5. U.S, Inland Revenue Code, section 871(b), 882(a) (1994).


### TABLE OF ABBREVIATIONS

1. ARPAnet - Advanced Research Project Agency Network  
2. CD - Compact Disk  
3. Dot. Com - domain name  
4. E-bay - Electronic bay or auction  
5. E-commerce - Electronic Commerce  
6. EDI - Electronic Data Interchange  
7. E-mail - Electronic Mail  
8. EU - European Union  
9. GST - Goods and Sales Tax  
10. ICT - Information and Communication Technology  
11. ISP - Internet Service Provider  
12. LAN - Local Area Network  
13. MNC - Multi National Corporations  
14. OECD - Organization of Economic Co-operation and Development  
15. OEEC - Organization for European Economic Corporation  
16. PE - Permanent Establishment  
17. RST - Retail Sales Tax  
18. SSTP - Streamlined Sales Tax Project  
19. TAG - Technical Advisory Group  
20. TCP/IP - Transmission Control Protocol/Internet Protocol  
21. UN - United Nations  
22. US - United States  
23. USA - United States of America  
24. VAT - Value Added Tax  
25. WAN - Wide Area Networks  
26. WWW - World Wide Web
<table>
<thead>
<tr>
<th>Term</th>
<th>Meaning</th>
</tr>
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<tbody>
<tr>
<td>Permanent Establishment</td>
<td>The basic definition of PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on. It includes a place of management, a branch, an office, a factory, a workshop and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources and a building or construction sites which last for more than twelve (12) months.</td>
</tr>
<tr>
<td>E-commerce</td>
<td>E-commerce refers to a wide array of commercial activities carried out through the use of computers including online trading of goods and services, electronic funds transfers, electronic transactions, online publishing, on-line trading of financial instruments, electronic data exchanges between companies and electronic data exchanges within a Company. It refers to the use of computer networks to facilitate transactions involving the production, distribution, sale and delivery of goods and services in the market place.</td>
</tr>
<tr>
<td>E-mail</td>
<td>This is a software programme that allows users to send and receive electronic messages over the Internet. The user launches the e-mail programme after a basic connection has been made to the Internet using a dial up software. E-mail programmes reside on users personal computers. E-mail is transferred over the Internet using addresses such as <a href="mailto:grace@ecommercetax.com">grace@ecommercetax.com</a>.</td>
</tr>
<tr>
<td>Domain name</td>
<td>A domain name is a name word or phase that is registered equivalent of a web site’s address. A domain name has two parts; the first is the name itself, for example, mydomain. The second designates the type of organization such as com (commercial), org (organization), gov (government) and edu (education).</td>
</tr>
</tbody>
</table>
Internet

The internet is a world wide network of computers linked mainly by telephone lines. The computers communicate with each other using a common communication language or protocol called transmission control protocol or Internet protocol (TCP/IP). The advantage of protocol is that it allows all types of computers to talk to each other.

World Wide Web

A world wide web is a graphical display of the Internet that allows for the navigation by pointing and clicking. The web enables the users to go from one website to another by clicking on links in web pages. The world wide web and the Internet are sometimes used interchangeably.

Web site

A web site is a collection of programs data and images which may be accessed over the Internet using a browser or some other form of access. Every web site has an address also called a uniform resource locater (URL) such addresses are like www.ecommercetax.com

Electronic Data Exchange (EDI)

It refers to the transfer of data between different Companies using networks such as the Internet. It is an easy mechanism for Companies to buy sell and trade information.

Local Area Network (LAN)

This a term used to describe a computer network that spans a relatively small area. The network may be confined to a single building or group of buildings. Most LANS connect workstations and personal computers.

Wide Area Network (WAN)

Here the computers are farther apart and are connected by Telephone lines or radio waves.

Consumption Taxes

These are indirect taxes that are levied on goods and services. An examples is Value Added Tax (VAT).
CHAPTER ONE

1. PROPOSAL

1.1. Introduction

Tax may be defined as any leakage from the circular flow of income into the public sector\(^1\). It is in effect a contribution designed to reduce private expenditure in favour of public expenditure. It is basically the coercive contribution by citizens to the State or Government, to enable the Government to obtain funds for the provision of goods and services to its citizens, redistribute income, clear market imperfections and stabilize the economy. It is the main source of revenue to the Government. Taxation must expressly be provided for by law and a good tax policy must incorporate all or some of the nine canons of taxation or principles of taxation which are equity, certainty, convenience, economy, productivity (fiscal adequacy), bouyancy, flexibility, simplicity and diversity\(^2\).

International Taxation is an area of Public International Law that straddles various national boundaries and generates foreign and international interests in the formulation and application of both national and international fiscal policy\(^3\). International fiscal policy is stimulated by the flow of trade in goods, services, capital payments, investments, mobility in labour and technology. The factors that influence international fiscal policies also shape domestic policy to the extent of the interaction between the two. Principles of a good tax policy stated above are also applicable to the domestic tax systems. Traditionally international taxation was premised on territorial jurisdiction and taxing rights were interpreted in respect to physical boundaries of the countries involved.

As early as the 19\(^{th}\) century International Community recognized that the mobility of factors of production and businesses across borders in turn led to the opportunities for more taxation as well as openings to avoid and evade taxation altogether. The international Community was led by the Organization for European Economic Corporation (OEEC) that latter changed its name to the Organization of Economic Co-operation and Development (OECD) at the joining

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of United States of America (USA) and Canada. There was need for certainty and equity in taxation and to curb the problem of double taxation. Though the OECD has a membership of thirty countries, mostly in the developed World, it is the leading organization that provides guidelines to matters of taxation in the World. It has gained recognition over the years in that even non-member countries rely on its guidelines on taxation matters. It developed the OECD model tax convention for the prevention of double taxation, tax evasion and equitable distribution of revenues in the world. The United Nations (UN) also developed a tax model law that far and large mirrors the OECD Model. It must be noted that the UN is no longer vibrant in tax matters.

Double Taxation Agreements were then developed to guard against double taxation and evasion. Under this arrangement, contracting parties were to either exercise taxing rights based on residence or source tax systems. Business profits of a Company could be taxed at source while returns on investment were primarily taxed by the country of residence of the owner or investor. It is at this time that the concept of Permanent Establishment (PE) was developed to resolve double taxation conflicts among states.

The basic definition of PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on. Specifically included in the definition are a place of management, a branch, an office, a factory, a workshop and a mine, an oil or gas well, a quarry or any other place of extraction of natural resources and a building or construction sites which last for more than twelve (12) months. Specifically excluded from the definition are activities that are generally of a preparatory and auxiliary nature. Agents can be a PE of an enterprise if they have and habitually exercise authority to conclude contracts on behalf of the enterprise. However independent Agents who act for an enterprise in the ordinary course of business do not constitute a PE of that enterprise.

PE rule has been adopted to govern the tax treatment of goods and services crossing borders and to assert taxing jurisdiction on the basis of source of the income and or the residence of entity earning the income. The main purpose of the concept of PE is to determine the right of

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5 Double taxation is the enforcement of the similar taxes on the same subject matter and entity/individual.
8 Article 5 of the OECD Model Convention Treaty, 1977 model.
a contracting state to tax the profits of an enterprise of the other contracting state. Likewise a contracting state cannot tax the profits of an enterprise of the other contracting state unless it carries on business through a PE situated in that state. It is essentially an international tool for prevention of double taxation.

The definition of a PE carries three major characteristics that are core to the nature and the functionality of the concept. First, there has to be the existence of a place of business, for example, premises, machinery or equipment. Secondly, the place of business must be fixed, that is, it must be established at a certain identifiable place with a certain degree of permanence and thirdly, the carrying on of the business of the enterprise must be through this fixed place of business. This means that persons who in one way or another are wholly dependent on the enterprise such as agents and employees qualify as PE9.

The advent of the Internet10 has put the concept of PE in disarray in that the Internet permits the free flow of most of the factors of production and business across borders thus making it difficult to determine the taxable point. The Internet is a worldwide network of computers linked mainly by telephone lines.11 Information and Communication Technology (ICT) have enabled the growth of Internet. Information technology has revolutionalised the manner in which commerce is carried out today to the extent that every facet of commerce including production, sales, marketing and distribution of goods and services can be conducted electronically.

Electronic commerce (E-commerce) is an outstanding technological example of the information age12. Some examples of electronic commerce include e-procurement; online catalogs; transfer of computer software; photographs which may be transferred digitally; online information such as Lexis-Nexis and other electronic data bases; services such as legal, medical, accounting, and other consulting services; video conferencing; securities trading; and off-shore banking13.

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11 Supra, page 3.
E-commerce has been defined in several ways but for the purposes of this paper the definition that will be adopted is E-commerce refers to a wide array of commercial activities carried out through the use of computers including online trading of goods and services, electronic funds transfers, electronic transactions, online publishing, on-line trading of financial instruments, electronic data exchanges between companies and electronic data exchanges within a Company\textsuperscript{14}. It refers to the use of computer networks to facilitate transactions involving the production, distribution, sale and delivery of goods and services in the market place.

E-commerce being a borderless business model distinguishable from the conventional and traditional model of business, raises questions whether an enterprise engaged in an electronic trade or business in a particular country without a physical place of business can be said to have a PE which could give rise to tax obligations to that particular country. The Question that will be tackled by this paper is whether the existing definition of PE will continue to be relevant and appropriate as a test to the taxation of E-commerce.

1.2. Background to the problem

E-commerce is revolutionizing all aspects of commercial and non-commercial life\textsuperscript{15}. The use of the Internet and other means of communication and the dissemination of information has different implications for different industries and sectors of the economy\textsuperscript{16}. The most significant characteristic of the Internet that is relevant to E-commerce and taxation is the total irrelevance of geographical considerations\textsuperscript{17}. The Internet is a borderless technology. Servers can easily be located almost everywhere and their location is generally unknown and unimportant in a business transaction. There is essentially little control over the Internet. In its current form it is a triumph of private sector capitalism. The features that make E-commerce attractive to businesses on one hand, make tax authorities worry over issues like identification and tracing of transactions in order to determine tax liabilities.

Some of the complex issues that E-commerce has thrust into the tax debate include administration and enforcement of tax rules. Questions such as how to determine when a taxable event has occurred, whether a system based on voluntary compliance is still viable,


\textsuperscript{17} Supra page 7
how to establish audit trails, the proper level of information exchange and the efficient tax collection. A primary issue is the jurisdiction to tax. The question to be examined is whether long-standing tax concepts such as PE retain sufficient vitality and validity to govern E-commerce. In E-commerce, such concepts as residence and source remain difficult to determine. Another substantive issue is that of characterization of income. E-commerce has blurred the distinctions between different types of Income namely royalties, sales income, and income from services. Different tax consequences attend to different classifications of income.

Traditionally taxation systems have used intermediaries to facilitate tax compliance by reporting and collecting taxes on behalf of the taxing authorities. However E-commerce brings the product and customer together thus removing the need for an intermediary such as brokers, warehousing and clearing agents and banks. E-commerce enables the producer to sell its products directly to the consumer thus eliminating the need for storage and distribution services. When buyers interact directly with the producers of goods the issue raised will be the loss of taxes such as excise duty that could have been collected by the intermediaries on behalf of the state.

Internet technology has created a new kind of assets such as web sites and domain names. These assets pose a challenge to the taxing authority as to the treatment of costs of creating and acquiring such assets as well as the characterization of gains and losses arising from the disposal of the assets. Another fundamental challenge is the jurisdiction that the tax liability relating to such assets will rest upon.

Internet allows for paperless transactions in form of electronic data which is characterized by a vendor ordering a digitized item electronically, pays over the Internet and the same is delivered over the Internet. This raises the issue of whether that transaction has been taxed, any audit trail and the jurisdiction in which it ought to be taxed, and if it is taxed whether there has been double taxation of the same transaction.

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19. Hardesty David, *Electronic Commerce Taxation and Planning*, (2002), Warren Gorham & Lamont Boston page 7. A web site is a collection of programs, data and images which may be accessed over the Internet using a browser or some other form of access.
20. Supra page 11. A domain name is a name word or phrase that is registered equivalent of a web site’s address. A domain name has two parts; the first is the name itself, for example, mydomain. The second designates the type of organization such as com (commercial), org (organization), gov (government)and edu (education)
Taxation of E-commerce must be examined against the background of the tenacity of compliance costs and also the fact that illegal taxes may be levied in instances where there are no laws or the existing laws have not been amended. Though the level of trade conducted through E-commerce is still modest in the world it is estimated that total revenues from electronic commerce may reach $1 trillion by the year 2005\textsuperscript{21}, it is therefore imperative that countries devise laws and rules to tax effectively and efficiently this growing business model. Existing principles are too porous to effectively tax E-commerce and it is expected that inaction in this regard will certainly lead to serious erosion of tax bases and distortion of revenues. It must be borne in mind that taxation of E-commerce being a borderless phenomenon will be driven more by international economic and political influence than national legislation.

1.3. Statement of the problem

Having laid the introduction and the background of the paper it is now clear that there are a number of legal issues and challenges that E-commerce as a new business model presents to the application of PE. When we contrast the nature and characteristics of PE on to E-commerce we immediately realize that PE concept is territorially inclined unlike the E-commerce model that has no recognition for borders. PE being an international principle of taxation and having worked for tax authorities and Governments for the last 70 years is at the threshold of being rendered irrelevant in as far as E-commerce is concerned.

As illustrated above tax laws stand on the twin pillars of territoriality and enforceability. Yet in E-commerce these twin pillars become loose at their foundation. The issue is how one can mark territory in a seamless digital world. How can one map nations and taxing jurisdictions in a world that is not based on geographical considerations. That is the world of E-commerce. This throws the application of the PE concept into disarray in respect to the taxation of E-commerce. These issues bring to the fore the legal question which is being investigated by this paper, which is, the continued relevance and validity of the application of PE to the taxation of E-commerce. Whether PE should continue being applied as a test for allocating taxing rights and obligations under E-commerce Taxation or should other criteria be developed.

\textsuperscript{21} IDC Research, <http://www.idcresearch.com>. This research website provides global research in e-business, the Internet and the future trends in technology, accessed on 20\textsuperscript{th} June 2005; see also Forrester Research, Inc. http://www.forrester.com/ER/Press/ForrFind/0,1768,0,00.html accessed on 20\textsuperscript{th} June 2005.
The definition of PE as stated above emphasizes the physical criteria as the guiding test for allocating taxing rights. This definition does not hold any water when applied to E-commerce and therefore leads to a lot of uncertainty in taxation. Issues of characterization of income will be presented by the fact that similar products will attract different taxes only because one is in tangible form and the other is intangible, for example the case of a hard copied book as contrasted with a down loaded copy. The former will be treated as profit income while the latter will be royalty income and taxed accordingly. This raises the problem of tax discrimination between one form of business and another (conventional and E-commerce). The danger here is that it might encourage businesses to be E-commerce driven so as to avoid taxes. Tax abhors uncertainty and therefore any sound taxation policy must be certain and known to the subjects. The cost of compliance also must be reasonable to encourage efficiency and voluntary payment of taxes.

The fact that the Internet and by extension E-commerce allows for the free flow of trade, investment, capital labour and other factors of production means that business can operate in a virtual environment without regard to geographical boundaries. This has the effect of making it difficult for Governments and taxing authorities to effect taxation using conventional principles of taxation that lay emphasis on physical nexus or linkages to the place of production and profit. Taxation systems such as source and residence are underpinned by physical nexus which are very difficult to determine in E-commerce.

1.4. Theoretical framework/conceptual framework

Tax is a multi-disciplinary subject and it encompasses politics, economics, law and business. It is political in that fiscal policies are dependent on the Government for its design and implementation. Without the political will policies cannot stand on their own. Governments also rely on taxes to raise revenue to govern the people and fund its programmes. This is the strongest of the multi-disciplinary facets of taxation. It is economics in the sense that taxation thrives on the economy. It is out of a business activity, that is production of goods and services, that taxation is effected. There is indeed a symbiotic nexus between taxation and the economy. Citizens and Governments depend on business to generate revenues and a good fiscal policy should be one that encourages commerce.

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Every tax system must have set objectives that are intended to achieve, some of which may be to increase revenue, remove market distortions and disparities, redistribute income equally, stabilise the economy, combat anti-social behaviour and moderate social variances. The objectives however vary from country to country. The objectives of the developed countries are very different from that of the developing world. While the developed countries worry about how much they are allocating for social welfare needs, the developing countries have to grapple with providing basic needs for the population arising from insufficient savings and wealth accumulation. This explains why it is difficult to achieve a consensus in international fiscal matters globally. This is because while the rich countries may advocate tax free operation of E-commerce, because they can afford to absorb the losses in revenue, the developing countries face immense consequences such as poverty, hunger and economic downturn as a result of loss of revenue.

This leads to the different approaches that countries have taken towards taxation of E-commerce. Whilst the USA have advocated for tax free E-commerce, with the objective of growing its industries and E-commerce technologies, other countries like the Spain and Portugal have insisted on taxation of E-commerce as a means to safeguard against revenue leaks and loss as well as to boost their revenue collection. It is said that taxation is selfish and at the very core each state will first and foremost determine for itself the gross benefits in terms of the financial gain and how taxes will affect its economy before conceding to any measure. This as will be seen in Chapter 4 is a strong limitation to achieving a global consensus in whether or not to tax E-commerce and if in the affirmative, under what tax laws and rules will be applicable.

Public International Law of Taxation is derived from International Investment Law. It provides a normative framework in fiscal matters for both international and national transactions. Although Treaty Law is central to International Taxation, other sources of Tax Law include International Law, Principles of state jurisdiction and International Economic Law. To resolve International Tax questions, international consensus is required and this is done through the use of treaties. Individual states in adopting or ratifying treaties signify their willingness to be legally bound by the treaties and consequently effect national legislation to

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23 International Economics Law is that branch of Law that governs the economic relations between states.

incorporate the treaty into their domestic laws. In looking for an acceptable legal criteria to
tax E-commerce, international consensus will be core to its success.

It is true that E-commerce is growing and is here to stay and taxation of both conventional
and E-commerce should seek to be neutral and equitable between the two forms of
businesses. Business decisions should be motivated by economic rather than tax
considerations. The systems for taxation should be flexible and dynamic to ensure that they
keep pace with the technological and commercial developments. It is apparent that these
general principles will certainly command a consensus from the stakeholders. Though the
OECD has provided forum for discussions on these matters, its decisions are not binding.
Decisions depend on the will of the state. The OECD has no enforcement power to order the
implementation and only relies on persuasion and negotiation.

Technological advancement is another factor that the concept of PE is facing. The Internet is
growing at a terrific speed that the solution of today becomes obsolete before it is
implemented. Though this paper appears wide, it has deliberately limited itself to the concept
of PE with a focus on taxation of E-commerce.

1.5. Literature review

Though information on the subject of E-commerce abounds in the Internet, there are scanty
scholarly texts on the subject of PE with a special focus on E-commerce and its effects.
However a review of the key books and articles consulted is given below:-

Doernburg, Hinnekens and Jinyan25 have discussed the subject of E-commerce and
jurisdiction and have laid emphasis on the guiding principles or cannons of taxation such as
neutrality, equity (within and without a state), administrative efficiency and non
discrimination as the core principles that a good tax system should have. They delved into
cross border supply of goods and services and intangible property which is the subject of
consumption taxes such as sales tax and VAT. A detailed and impressive analysis of the two
consumption taxes is carried out while contrasting the application of PE under conventional
commerce to E-commerce.

25 Doernberg Richard, Hinnekens Luc, Hellerstein Walter and Li Jinyan, Electronic Commerce and
Whilst discussing multijurisdictional taxation of E-commerce the authors have contrasted the approaches taken by European Union and the Americans and Canada. This is important in highlighting the views taken by the two blocks of the developed world. America is advocating for a tax free E-commerce while the European Union is keen to protect its tax base by unilaterally insisting on VAT on E-commerce cross border activities. The toothless stand of the OECD is exposed further as it is reduced to watching each block take positions that are not globally beneficial to international trade and fiscal policy. The OECD has been criticized for its lay back stand on tax issues. They have concluded by recommending alternative criteria to the existing PE rules for taxing E-commerce such as introduction of bit taxes, transactional tax, withholding taxes, and virtual PE to ensure equity in taxation and seal tax leakages. All these recommendations depend on consensus of the international community to see the light of day.

Hardesty\textsuperscript{26} on the other hand brings an American thinking into the subject and his work is intended for tax practitioners and Corporate companies keen on planning their E-commerce taxation. The book lays a very clear foundation on the attributes of E-commerce and the key ones relevant to E-commerce are location, remoteness, anonymity, digital products and the ever changing rules in a fast growing technology like E-commerce. It brings out how these attributes have challenged the PE rules under E-commerce taxation and how it is upsetting the taxation equilibrium and gives state by state summaries of how each state in the USA is dealing with the issue. It is interesting to note that even within America itself different states have taken different positions on whether to tax E-commerce or not.

It also gives an analytical description of the Internet and related terms to E-commerce thus demonstrating how E-commerce works. It highlights the problems of defining PE in respect to E-commerce that has no recognition to physical considerations. Its shortcomings therefore are that it does not prefer any alternative criteria to the test of PE.

Picciotto\textsuperscript{27} is very helpful on the description of the existing PE definition and the historical development of the concept and the underlying principles of taxation which have been alluded to earlier. It offers meaningful conclusions on the problem of double taxation and the success of the PE then as a solution to the problems of double taxation, evasion and


avoidance. It must be noted that this text was written before the advent of E-commerce and thus contains little knowledge on the subject.

Several articles have been written as evidenced in the references made in the paper. Key articles that will be reviewed include those by OECD\textsuperscript{28} itself. It must be noted that the OECD has been very instrumental in creating discussion forums and taking the lead in seeking views of countries in the way forward in taxation of E-commerce generally. However its shortcomings include the fact that its views and guidelines are not binding on its members and implementation is left to the free will of the states. Another shortcoming of its literature is its inclination to interpret the concept of PE conservatively even in the face of apparent inapplicability of the same to E-commerce. Its writings are also biased towards the developed countries approach due to its membership composition. Major works of the OECD relevant to this inquiry include the OECD Model Tax Convention on E-commerce and its explanatory memoranda of 2002 which has been referred to in the paper.

Arvid Skaar\textsuperscript{29} discusses a very crucial issue of erosion of the concept of PE in the face of a raging advancement of E-commerce and emphasizes the need to amend the rules of PE to suit E-commerce taxation. Sarah Anderson\textsuperscript{30} on the other hand has given a graphical description of how Governments and tax authorities are losing tax revenues through untaxed E-commerce and the level of unpreparedness to deal with this phenomenon. PE being a tax principle peculiar to the brick and mortar business is being eluded by the virtual click and mortar model for which E-commerce thrives.

In Kenya scanty references to the subject was realised. The draft ICT policy does not give much direction on the subject. It is noted that though Kenya Revenue Authority recognizes the problem and the potential loss of tax revenue that may accrue, they are yet to come up with a decision on the way forward. As will be discussed in depth later in the paper the developing countries approach is more of wait and see for the moment.

1.6. Objectives of the study

a). To identify specific challenges posed by taxation of E-commerce to the concept of PE.


\textsuperscript{29} Arvid Skaar, “PE ; Erosion of a tax treaty principle” (1991).
b). To identify the legal mechanisms or alternative criteria to the concept of PE.

c). To make recommendations to changes to the existing concept of PE as a test of taxing E-commerce.

1.7. Broad argument layout/structure
The author appreciates that taxation of E-commerce is a subject of much heated debate and many writers have written on it. However it is intended that this paper will review, analyze and critique interpret the debate and propose a solution that is sound and upholds the canons of taxation which are equity, certainty, convenience and economy. As mentioned earlier there are nine canons of taxation however, the four stated here are relevant to the concept of PE. The argument posed by the proposal is that the concept of PE continues to be eroded and unless it is reviewed modified to suit the taxation of E-commerce, E-commerce will erode tax revenues, create trade distortions and discrimination of conventional and E-commerce model of businesses.

1.8. Assumption or hypothesis
a). Due to the nature of E-commerce and its special attributes, the existing concept of PE is inadequate as a test for the taxation of E-commerce. PE lays emphasis on physical criteria as the core test to allocating taxing rights and obligations and on the other hand E-commerce as a business model is such that it does not recognise geographical considerations.

b). There is need to modify the existing rules under PE and devise legal criteria appropriate for the taxation of E-commerce.

1.9. Research question
What are the challenges posed by the taxation of E-commerce to the concept of PE and to what extent will the concept of PE continue to be relevant as a test for allocating tax revenues between source and residence based systems in respect to E-commerce? What alternative tests can be developed for E-commerce?

1.10. Methodology to be used
The project paper adopts an analytical approach to the search for the solutions in E-commerce taxation. The following research methods will be used;

30 Anderson Sarah, “E-commerce Eludes the Tax Man The Click And Mortar, Artificial Advantage in the New Economy), March 2002 Multinational Monitor Vol. 23, No.3
a). Library research

b). Internet research – web sites such as SSRN, European Union, OECD.

c). Discussions and interviews with persons who have knowledge in this area of study from the Tax authorities such as Kenya Revenue Authority and tax practitioners.

1.11. Limitations of the study

E-commerce being relatively a new business model, the researcher faced limitations such as lack of reference materials that focus on the PE and E-commerce. Though information is available in the Internet its relevance and reliability is a major limitation. Time is also a major constraint in carrying out this study. The researcher has only three months to submit the project paper and therefore unable to carry out an in-depth research into the study. Another limitation is the funding to carry out a full research. Subscription to journals and online bookstores are expensive.

1.12. Chapter breakdown

Chapter one introduces the legal issues being investigated in the paper and starts with the introduction, background of the problem and statement of the problem. It also lays the foundation in the theoretical framework and explains the theory underpinning the study. The hypothesis expresses the argument to be proved or disproved at the end of the research paper. Literature review gives a preview of some of the materials consulted in writing the paper.

Chapter two gives the meaning of the various terms that will be referred to in the project. It also gives the extent of trade in the Internet, which constitutes E-commerce. The origins and history of the Internet is given to shade light on the historical development of E-commerce. The concept of PE is given a historical examination and its attributes are discussed in detail. This Chapter lays the foundation of the whole project.

Chapter three discusses the various tests essential for the determination of PE. It examines the treatment of attribution of profits, characterization of income, consumption taxes, web sites and servers as PEs and place of management under conventional commerce and the application of the same principles to E-commerce and its results.

Chapter Four looks at the model test of E-commerce and discusses how E-commerce is challenging its critical components. It discusses approaches that various tax systems have
adopted to the taxation of E-commerce and the extent that they have succeeded or failed. This chapter analyses the various challenges being faced by the Governments and taxing authorities in their attempt to devise new laws and taxing policies to effectively deal with taxation of E-commerce. It also gives alternative tests that may be adopted to the taxation of E-commerce in place of the current physical test found in the concept of PE.

Chapter Five addresses the recommendations and conclusions of the project.
2. E-COMMERCE AND THE CONCEPT OF PERMANENT ESTABLISHMENT (PE) DEFINED.

2.1. Introduction

No other innovation or way of doing business has revolutionized the international economy faster than the Internet. It took generations for the Industrial Revolution to spread around the world while the Internet Revolution has unfolded in less than a decade\(^{31}\). The rapid growth of the Internet is evident from the fact that while it took the telephone close to 74 years to reach 50 million users, it took the World Wide Web\(^{32}\) four years to reach the same number\(^ {33}\). With the unprecedented growth in the Internet came the growth in E-commerce which brought with it challenges, one of which is the issue of the taxation of E-commerce. It is estimated that there are 600 million people worldwide who have access to the Internet spending more than $1 trillion online, 40% being in the United States alone while the 60% is found in the European Union and the Asia Pacific Countries\(^ {34}\).

The emergence of the commercial Internet has opened new ways for the exchange of goods and services. Almost any kind of goods and services that are capable of being digitized can be bought, sold, and distributed quickly and inexpensively through the Internet to consumers worldwide. Countries the world over assert taxing jurisdictions based on two systems; resident and source or both\(^ {35}\).

Taxation of E-commerce also depends on the provisions of the international bilateral treaties which in many cases are designed along the OECD model tax Treaty. The OECD is the organization that is developing guidelines in liaison with Governments of member countries.

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\(^{32}\) World wide web means a system of Internet server that support specially formatted documents, see <www.webopedia.com> accessed on 6\(^{th}\) September 2005.


\(^{34}\) IDC Research, <http://www.idcresearch.com> this research website provides global research in e-business, the Internet and the future trends in technology, accessed on 20\(^{th}\) June 2005; see also Forrester Research, Inc. which as fund that worldwide E-commerce in 2000 was more than $650 billion. It is predicted to be ten times that amount- $6.8 trillion in 2004. Forrester Findings, Internet Commerce, http://www.forrester.com/ERIPress/ForrFind/0,1768,0,00.html.

in matters relating to international taxation in the World. To prevent double taxation\footnote{Supra, page 16.} of an international economic activity countries tend to restrict their taxation of business profits to those profits that are attributable to a PE in their jurisdiction. International double taxation is defined as the imposition of comparative taxes in two or more states in respect of the same subject matter and for identical periods.

The advent of information technology has challenged this century long concept of PE and its applicability and relevance. ICT is the main driver of the Internet. E-commerce relies on organizational business processes, access to the electronic data networking systems such as voice and data communication networks, broadcasting networks and telephony. The list is inexhaustive since the Internet keeps developing and evolving depending on the usage and users needs. ICT creates the opportunity of using technologies for communicating and sharing information, business ideas and provides for mobility of goods and services on a global scale, thus promoting E-commerce.

\textbf{2.2. Definition of E-commerce and its related terms.}

To understand E-commerce\footnote{The term E-commerce and Electronic Commerce shall be used interchangeably.}, one must have some background of the meaning and operation of the Internet and its related terms. E-commerce refers to a wide array of commercial activities carried out through the use of computers including online trading of goods and services, electronic funds transfers, electronic transactions, online publishing, on-line trading of financial instruments, electronic data exchanges between companies and electronic data exchanges within a Company\footnote{Doernberg Richard, Hinnekens Luc, Hellerstein Walter and Li Jinyan, "Electronic Commerce and Multijurisdictional Taxation" (2001) page 3}. It refers to the use of computer networks to facilitate transactions involving the production, distribution, sale and delivery of goods and services in the market place. E-commerce involves the streamlining of the relationship between consumer and business and creates efficient business process within a firm\footnote{An intranet is a network belonging to an organization, accessed only by the members of the organization with authorization. A firewall surrounding an intranet sends off unauthorized. \texttt{<http://en.wikipedia.org/wiki/intranet.>} accessed on 6\textsuperscript{th} September 2005.} and between firms\footnote{An extranet is a private network that uses Internet technology and the information or operations between one company to another \texttt{<http://en.wikipedia.org/wiki/extranet>}. Accessed on 6\textsuperscript{th} September 2005.}.
Application of E-commerce include paperless exchange of business information from one business computer to another business computer using electronic data interchange (EDI)\(^ {41}\) technology, electronic mail (e-mail), electronic bulletin boards and conferencing software, electronic funds transfers, and many other technologies. It also includes online approach to conducting business with customers such as advertising, marketing, order entry and processing, payment and customer support.

The Internet (interconnected networks) is a term that refers to thousands of interconnected logical networks linking millions of computers worldwide. These interconnected computers include stand-alone computers and computers connected to the Internet through various networks including local area networks (LANs) and wide area networks (WANs) among others. The term world wide web\(^ {42}\) (WWW) is sometimes used interchangeably with the term Internet. The web allows access to information in a multimedia format featuring colour, graphics, audio and video. Users can access the web through web browser software, such as Microsoft’s internet Explorer, Netscape communicator among others.

Conventionally commerce has been conducted based on a variety of physical exchanges such as business plans, face to face meetings, reports, physical delivery of goods and services, exchange of contracts, invoices for goods and services performed and payments made by barter, cheques or cash. These transactions shall involve physical events or changes. Technology has however enabled some of these transactions to be carried out through the global movement of bits\(^ {43}\) that are colorless, size less and weightless. This process is known as digitization\(^ {44}\). Once information has been converted it can be sent at the speed of light throughout the world where a recipient can convert the information back into its original format or otherwise manipulated. It is the efficiency and speed that is attractive to business processes.


\(^{42}\) The web is a navigation tool for locating and accessing information presented in graphic form available on the hard drives and other storage facilities of computers known as web serves on the Internet http://www.webopedia.com accessed on 6\(^{th}\) September 2005.

\(^{43}\) A bit is the most basic of information <http://www.webopedia.com> accessed on 6\(^{th}\) September 2005.

\(^{44}\) The digitization of information is the process of converting information into a sequence of numbers. The converted information may be images, speech, music, diagrams or words http://www.webopedia.com accessed on 6\(^{th}\) September 2005.
Internet cannot be complete without a physical infrastructure. Physical infrastructure that includes computers, modems, telephone lines and satellites provides the pavement for the information superhighway. To facilitate the smooth flow of information down the highway, there is need for a logical infrastructure, which is the laws that govern the movement of the information down the network highways. Each network forming part of the internet must be set up to provide laws concerning the upkeep of the system such as packaging, information paths, destination addresses and routing.

Information in the Internet is transmitted through protocols. These protocols govern the physical connections that carry the electronic impulses, how the information is packaged, delivery, display and use by the end user. For example, a customer in Kenya sending an email to a business supplier in Sweden, the message is directed by software instructions from the customer's computer into a regional network (say, Africa online). The message travels in pieces called packets, each packet containing the customer's address. Each packet travels through routers to a European backbone and onto a regional network and finally to the supplier's computer where it is acknowledged and received. Should there be an error a message is sent back to the customer's computer explaining the error and stating that the message has not been sent.

The origins and development of the E-commerce cannot be complete without the mention of that of the Internet. The Internet can be traced to the United States of America's military project, the ARPAnet commissioned by the United States Department of Defence in 1969. The aim of the project was to establish back-up for its information and secrets in the event of a nuclear war. In the early 1970s and 1980s the Universities in liaison with the Military carried out further experimental works. The TCP/IP was introduced for use by the ARPAnet in 1983. Applications protocol developed for and used in TCP/IP include the file transfer system, e-mail protocol and the remote login facility telnet. In 1989 a group of

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45 A physical infrastructure refers to the physical components that allow computers to transmit information to each other.

46 Protocols operate in the background, standardizing the transmission of information over the internet. Examples are Transfer Control Protocol (TCP) and Internet Protocol (IP). Gilder, Telecom (2000), at page 63-68.

47 A router delivers a connectionless network service where each packet is sent through the network independently

48ARPAnet stands for the Advanced Research Project Agency, a US military project.

49 TCP/IP means Transmission Control Protocol/Internet Protocol. The TCP/IP is a packet switching control. In packet switching the messages are split up into segments (packets). and dispatched into network their source and destination address, accessed on 6th September 2005.

50 Also known as file transfer protocol, see accessed on 6th September 2005.
scientists at the European Laboratory for Particle Physics in Geneva Switzerland developed an Internet tool that was capable of linking multiple pieces of information in a web-like manner. In 1993 United States of America scientists at the University of Illinois developed the discovery further and created a software tool called the Mosaic which is an interface that permits text, graphics, sound and video to be hyperlinked. Mosaic was the first Internet tool now referred to as the web browser. The first commercial web browser was Netscape then followed by Microsoft Explorer and a host of others that are in the market today.

Various commercial entities took up the development of the Internet and this led to the sprung up of Internet companies all over the world. The Internet companies interconnect through peering agreements. As the Internet moved from an academic and government run enterprise to a commercially dominated enterprise, Internet service providers (ISPs) have emerged to offer commercial access to the Internet and provide resources to companies and individuals. Internet applications are very vital to the operation of E-commerce. They are divided into the following general categories; communications, information databases, information processing services and resource sharing. These applications enable people to send and receive messages in communicable state.

2.3. The concept of PE and its historical development.

The PE concept first appeared at the end of the 19th Century in a bilateral Treaty between Austria, Hungary and Prussia that has been recognized as the first international tax treaty. This treaty introduced the concept that business profits earned through a PE in the other country were to be taxed in that other country and also introduced the concept that a fixed place of business was necessary in order to create a PE. The definition of a PE in that early

51 Simple mail transfers protocol. It is used for all Internet e-mail, <www.webopedia.com> accessed on 6th September 2005.
53 Bajaj K Kamlesh and Nag Debjani, E-commerce: The cutting edge of business (2003), Tata Megrav-Hill Publishing Company Limited New Delhi, page 74. Tim Bernes-Lee of the European Laboratory for Particle Physics (known as CERN, a research and development group of European physics researchers) proposed the web project to facilitate research collaboration
55 Network Internet projects such as CSNET, BITNET, DFN (Germany), UNINET (in Norway), SDN (in Korea) and JUNET (in Japan) sprung up at this time.
56 A peering agreement, which may be a bilateral or multilateral is a reciprocal agreement by an Internet service provider to carry the traffic of another service provider on its backbone.
57 Kalakota and Whinston, “Frontiers of Electronic commerce” (1996) page 125
59 Ibid, at page 75.
treaty however was much broader than the current definition found in most treaties in that it resulted in all fixed places of businesses constituting a PE if they served as a business activity of a foreign enterprise, its partner or an agent. For example a fixed place of business used solely for the purpose of purchasing goods or storing goods would have constituted a PE under that definition.

The concept of PE developed when borders and tax jurisdictions coincided with national states. The existence of national borders allowed states to adopt sovereign and largely independent monetary and tax policies. The ongoing globalization fuelled by technological advances has radically altered the environment of tax policies and in particular the relevance and applicability of PE as a test to tax E-commerce. Today shrewd businessmen can take advantage of low taxes by simply moving their businesses to tax havens by trading online.

The legal concept of a PE developed in earnest at the beginning of the 20th century after the industrial revolution at a time when many new manufacturing based industries were developing. The economic assumption at the time was that production factors such as production, labour and capital, were mobile within countries but relatively immobile between countries. The focus of the PE definition was on industrial establishment with a fixed location (main or head office). Little attention was given to service industries or to enterprises performing business without a fixed place of business in a host country. Because the PE definition rarely led to any controversies between the source and residence states the PE concept thrived and became entrenched as the guiding principle in taxation of business profits.

The modern version of the Permanent Establishment concept sprung up after the First World War when Nations under the League of Nations became concerned that international double taxation was inhibiting international trade and investment. As a result of the growing concern of the problem of double taxation, the League of Nations commissioned a group of tax experts to come up with a mechanism to ensure that double taxation would be avoided. At the multilateral level the wording of the various draft conventions has evolved from the League of Nations drafts of 1923, 1927, 1933, 1943 and 1946 through the OECD Model Tax

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treaty law in 1963\textsuperscript{65} and its revision in 1977. All these discussions by the Fiscal Committee of the League of Nations developed the framework of double taxation treaties that culminated into the present PE concept that is enshrined in the 1963 OECD model tax treaty (as well as subsequent revisions of this model treaty in 1997 and 1992).

The PE concept was developed to address the problem of international double taxation that exists when a citizen earns income in one country while resident of another country and both the country where the income is earned (source country) and the country where the investor or earner resides (the residence country) have legitimate claims to tax the income\textsuperscript{66}. The definition of a PE was designed to provide a uniform standard for determining which country has priority to tax such cross border income.

The purpose of the PE requirement was to establish a particular threshold for determining when a foreign enterprise providing goods and services had established a sufficient taxable presence or connection with a jurisdiction to entitle that jurisdiction (the source country) to tax the transaction including the business profits generated by it\textsuperscript{67}.

The PE concept satisfied the requirement of certainty and predictability of tax law in that it provided Multi-National Companies (MNCs) with relatively clear rules to determine in advance whether and in what way their activities abroad would be taxed by foreign tax authorities. The PE presented states with an internationally equitable rule for sharing the benefits of cross border commerce.

The concept of PE marks the dividing line for businesses between merely trading with a country and trading in that country. In the Indian case of C.I.T Vs. Visakhapatnam Port Trust Justice Jannadha Rao described the concept as;

\textsuperscript{65} Supra, page 20, the committee had expanded to 13, with the joining of the USA.
\textsuperscript{66} Supra, page 28 - There was a report called the Carroll report of 1933 which dealt with the issue of tax allocation of income and the twin problem of transfer pricing.
\textsuperscript{67} Supra, page 49, The Fiscal meetings of the League of Nations were held in Mexico with the aim of targeting the capital importing states and these meetings resulted in the amalgamation of the 1928 and 1935 conventions into a single graft model convention for the prevention of double taxation of income referred to as the Mexico draft of 1946.
\textsuperscript{68} Supra, page 49, the tenth session held in London – produced a new draft that included property and wealth taxation.
\textsuperscript{69} Supra, page 53, the League of Nations left the mantle to the new organization, the Organization for Economic Cooperation and Development (OECD) which published its draft double taxation convention on income and capital together with commentaries in 1963.
\textsuperscript{70} OECD Model Tax Convention on E-commerce (hereinafter called OECD), Article 7.
"The words Permanent Establishment postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country that can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country" 68.

If an enterprise has a PE, its presence in a country is sufficiently substantial to be termed as trading in the country. There are two types of PE under the OECD; First, is the associated PE which is part of the common ownership and control such as an office or a branch and the second one is the unassociated PE which comprises an agent that is legally and economically separate from the enterprise, but nevertheless is dependent on the enterprise to the point of forming a PE.

A PE is essentially a fixed place of business through which the business of an enterprise is wholly or partly carried on. It includes a place of management, a branch, an office, a factory, a workshop and a mine, oil or gas well, a quarry or any other place of extraction of natural resources. A building site or construction or installation project constitutes a PE only if it lasts more than twelve months 69.

Article 5(4) proceeds to give six exceptions to the definition of a PE, which are not deemed to be a PE:-

a). Where an enterprise acquires the use of facilities for storing, displaying or delivering its own goods and merchandise.

b). Where the stock of merchandise of an enterprise is maintained for the purpose of storage, display or delivery.

c). Where a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, the first mentioned enterprise.

d). The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for example a newspaper bureau which has no other purpose other than to act as a collection and distribution center.

e). A fixed place of business through which an enterprise exercises solely an activity

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69 OECD Model Treaty, Article 5.
which has a preparatory and or auxiliary character. Examples are fixed places of businesses solely for advertising, supply of information or for scientific research.

f). A fixed place of business solely for any combination of activities mentioned above provided that the overall activity is of preparatory and or auxiliary nature\(^70\).

### 2.4. Fundamental PE characteristics

The PE concept contained in the OECD model treaty essentially determines which of the two contracting states has the primary right to tax the business profits of an enterprise\(^71\). The enterprise’s home country or country of residence is generally given the primary right to tax an enterprise’s income. If the enterprise has a PE in the other country (the source country) then the source country is given the primary right to tax the enterprise’s business profits that are attributable to such foreign country’s PE. In order to prevent double taxation of the enterprises’ income the residence country will either exempt the income taxed in the other country from tax or will grant a credit\(^72\) for the foreign taxes paid on the income attributable to the foreign country’s PE\(^73\).

There are classes of income and capital, which may be taxed without any limitation in the source country provided that there exists a PE;

a). income from immovable property situated from that state including gains from the disposal and alienation of such property and capital representing it\(^74\).

b). profits of PE situated in the source state, gains from the disposal of such a PE and capital representing movable property forming part of the business property of such a PE except if the PE is maintained for the purposes of international shipping inland waterways and international air transport\(^75\).

c). income from the activities of artists and sportsmen exercised in that state irrespective of whether such income accrues to the artiste or the sportsman himself or another person\(^76\).

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\(^71\) OECD Model Treaty, *Article 7(1)*.

\(^72\) OECD Model Treaty, *Article 23*.


\(^74\) OECD Model Treaty, *Articles 6(1), 13 and 22*

\(^75\) OECD Model Treaty, *Article 8*.

\(^76\) OECD Model Treaty, *Article 17*. 
d). income from independent personal services being income attributable to a fixed base situated in that state\textsuperscript{77}.

e). directors fees paid by a company which is a resident of that state\textsuperscript{78}.

f). remuneration in respect of employment in the private sector exercised in that state unless the employee is present therein for a period not exceeding 183 days in any 12 month period commencing or ending in the fiscal year\textsuperscript{79} and the remuneration and pensions paid in respect to government services\textsuperscript{80}.

Other classes of income that are subject to limited taxation in source country are dividends and interests\textsuperscript{81}. As a general rule income and capital such as royalties\textsuperscript{82}, gains from alienation of shares or securities\textsuperscript{83}, private sector pensions\textsuperscript{84}, payments received by a student for purposes of education or training\textsuperscript{85}, business profits and income derived from independent personal services are not attributable to a PE\textsuperscript{86}.

Where a taxpayer who is a resident of a Contracting State receives income from sources in the other Contracting State or owns capital situated therein, which is taxable in the resident country no case of double taxation occurs since the source country will automatically refrain from taxing the said income. However where income or capital is to be taxed in the source country the state of residence has the obligation to refrain from taxing the same income in order to avoid double taxation by either exempting the income and capital or giving a tax credit in respect of the same\textsuperscript{87}.

Once it is determined that an enterprise has a PE in a treaty country, the next issue to consider is what business profits are attributed to that PE and are thus taxable by the treaty country. The OECD model Treaty [article 7] provides that when an enterprise carries on a business through a PE in another country, that country may tax the profits of the enterprise but only so much of them as are attributable to the PE. This principle is based on the view that in taxing

\textsuperscript{77} OECD Model Treaty, Article 14.
\textsuperscript{78} OECD Model Treaty, Article 16
\textsuperscript{79} OECD Model Treaty, Article 15
\textsuperscript{80} OECD Model Treaty, Article 19
\textsuperscript{81} OECD Model Treaty, Article 10, 11(5)
\textsuperscript{82} OECD Model Treaty, Article 12
\textsuperscript{83} OECD Model Treaty, Article 13(4)
\textsuperscript{84} OECD Model Treaty, Article 18
\textsuperscript{85} OECD Model Treaty, Article 20.
\textsuperscript{86} OECD Model Treaty, Articles 7 and 14
the profits that a foreign enterprise derives from a foreign country, the fiscal authorities of that country should apply to each type of income to be taxed. This refers to the PE test\(^{88}\).

In general, Art. 7(2) of the OECD model Treaty provides that the profits attributed to a PE are those which an enterprise might be expected to make if it were a distinct and separate enterprise engaged in the same or similar conditions dealing wholly independently with the enterprise of which it has a PE. The Commentary elaborates on this rule stating that profits to be attributed to a PE are those which a PE would have made if instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at the prices prevailing in the ordinary market. Normally the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy.

For purposes of computing the business profits of a PE, deductions are allowed for expenses that are incurred for the purposes of the PE. These expenses include general and administrative expenses, research and development expenses and interest incurred by the home office to the extent attributable to the PE.

2.5. Attributes of E-commerce

There are various attributes of E-commerce that create new challenges to the existing tax systems that were initially designed with physical presence in mind. The key attributes of E-commerce that have challenged the PE concept are explained below\(^{89}\):

2.5.1. Location
A contracting state can only determine a tax liability if the entity has a physical presence or permanent establishment in that country. However, the Internet allows a company to have customers in many different locations while having very few physical locations. It also allows new companies to operate in many states without needing any capital for physical (brick and mortar) expansion. An online vendor can easily sell to customers throughout the world from a single physical location. The model also involves more customized inventories so storage needs are reduced. The model involves less vertical integration and more outsourcing, meaning that a vendor uses fewer physical locations and also can easily be relocated without

\(^{88}\) OECD Model Treaty, *Commentary to Articles 7*, note 5.

any interruptions to the business operations. The location of the server is not relevant for business purposes and thus may not be a logical taxing point.

2.5.2. Nature of products
E-commerce allows some types of products such as newspapers and music CDs to be delivered in digitized (intangible) form rather than in tangible form. Digitized products raise issues at the state level as to whether sales tax applies and in which state the income is generated for state income tax purposes. The nature of products can also raise income tax issues regarding the type of revenue generated and how it is to be reported as well as whether digitized products are subject to traditional inventory accounting roles. For conventional transactions in material products, the source of a product, the location of the suppliers and distributors, and the respective responsibilities and liabilities of the buyer and the seller can be verified relatively easily.

On the other hand intangible transactions blur the distinctions between domestic and foreign business and between on-shore and offshore transactions. The most difficult conceptual aspect of E-commerce transactions of intangible products is the difficulty to define the location at which a transaction actually takes place and hence the jurisdiction in which it ought to be taxed.

Because fewer physical locations are needed, businesses are most likely to have customers in another country but without physical presence or nexus. At the international level, countries will find that businesses have a PE in fewer countries thus not paying taxes nor benefiting from tax credits.

2.5.3. New marketing opportunities.
The Internet has enabled the development of new ways of selling and buying goods and services, for example individuals can offer their unwanted items to a world wide group of potential buyers as well as auction sites such as e-bay. The Internet can also be used to easily link business buyers and sellers through exchange web sites whereby buyers post what they have to sell and sellers match up with them vice versa. Such sites can operate without human intervention for the matching function. In addition, the Internet has increased the use of bartering, most notably with respect to the exchange of web banners that serve as advertisements. These new techniques raise various tax issues at different levels. For
example, for tax purposes, issues include whether an exchange intermediary or broker should be accounting for inventory and what amount of information reporting should be required for low value bartering transactions and how such transactions should be valued. At the international level, the source of income generated (which country) might be uncertain. At the state level issues exist as to when individuals have sold enough goods to be required to become sales tax collectors and how to enforce such rules. E-commerce also enables buyers to interact directly with foreign manufacturers thus by passing the domestic retailer who would ordinarily collect excise tax.

2.5.4. New types of assets.
Some of the new assets created by commercial use of the Internet are domain names and websites. For income tax purposes issues exist as to how to treat the cost of creating or acquiring such assets as well as characterization of any gain or loss generated upon disposal of the assets. Sellers of such assets may face uncertainty as to how to characterize the gain or loss generated from the disposal.

2.5.5. Remote workforce.
The workforce of an Internet Company may be scattered throughout a state or a country rather than working in a single work location together. This can raise issues as to whether the presence of an employee in a particular state creates tax obligation for the employer in that state.

2.5.6. Nature of transactions.
The Internet allows for paperless transactions and the potential for the use of electronic cash. This raises administrative concern for the revenue authority as to whether transactions were properly reported and whether an audit trail exists and whether new reporting rules are needed.

2.5.7. Inexpensive systems.
The ability to establish public and private global communications systems that are secure and inexpensive to operate is a positive attribute of the E-commerce businesses model. The opportunities that these opens up for new forms of commercial activities will not be limited to large companies only as small and medium size enterprises will find it easier to engage in international commerce. Due to the low start up capital requirements, more and more small companies and individuals are expected to participate in the rapid expansion in cross border
2.5.8. Reduced number of intermediaries (dis-intermediation).
This is a process whereby the Internet eliminates or substantially reduces the need for intermediaries in the sale and delivery of goods and services and in the provision of information. Commerce that uses the Internet requires a small number of distributors, sales representatives, brokers and other professional intermediaries. Already it is possible for a producer of software to sell and to deliver its products directly to the final consumer. Similarly, an airline company can deliver tickets directly to passengers. The main enterprise no longer requires intermediaries in foreign countries to be able to conduct business there. Moreover E-commerce activities require far less human intervention. The disintermediation has the effect of eliminating agents who would ordinarily collect taxes on behalf of that taxing authority. Disintermediation creates new types of intermediaries such as Internet Service Providers (ISPs), virtual malls, repair services and various portals, all of which are internet or virtual related and have the effect of removing physical nexus for tax purposes.

2.5.9. Security of the Internet.
The development of encrypted information that protects the confidentiality of the information transmitted on the Internet gives an impression of security over the Internet. Whilst this may encourage many people to use the Internet encrypted information may also act as a barrier to the taxing authorities in their quest to determine tax obligations.

2.5.10. Flexibility.
The Internet provides greater flexibility in the choice of the structure by which an enterprise carries out its local and international trading. This has led to fragmentation of the economic activity, in that the physical location of an activity whether in terms of the supplier, service provider or buyer of goods or user of the service becomes less important and it becomes more difficult to determine where an activity is carried out. On the positive and attractive part to businesses, E-commerce has the capacity to increase responsiveness, flexibility, efficiency and accountability in business structures. Increased business efficiency coupled with the development of new kinds of products and markets has positive implications for the health and rapid development of the economy as a whole. In general, the flexibility of E-commerce enables the increased mobility of enterprises across physical borders.

90 Owens Jeffrey, "The Tax Man cometh to cyberspace", (2nd June 1997), Tax Notes International 1833 at 1835-36.
91 In many cases these intermediaries may be replaced by other intermediaries such as web page designers, Internet security experts, web hosting companies, web storage companies etc.
2.5.11. Global market place.
E-commerce is difficult to contain within geographically defined trade areas and frontier based regulatory and administrative regimes. This possesses the greatest challenge to the concept of PE which is border oriented. The scope of the market penetration is unlimited and knows no borders thus providing a sharp contrast with the conventional business and the concept of PE that is premised on physical presence to determine tax obligations. Small businesses find it easier and cheaper to sell goods and services in the global market place. Though this may be a positive development, small businesses may also find themselves entangled in complex international tax issues.

2.5.12. Anonymity
E-Commerce is transacted on a non face-to-face basis and therefore the seller and the consumer may not know each other and this raises the issue of the identity and the jurisdiction of the taxpayer as well as the type and amount of tax payable. All the above attributes of E-commerce have in one way or another affected the application of the concept of PE as defined in the OECD model Treaty tax law. The main argument in this paper is that due to the nature and characteristics of E-commerce the concept of PE is no longer relevant as a test to determine taxes in an electronic environment.

2.6. Conclusion
The challenges enumerated above tend to get more complex with the application of different laws and regulation by different states. A state’s tax being an internal matter, each country will always want to guard against loss or erosion of its tax base by implementing taxation policies and laws that secure their tax revenues. The tax mix for one Government differs from another Government and the challenges raised by E-commerce to tax differ as well.

To forge a uniform solution to these challenges in my view and in that of the OECD might be a difficult task to achieve. This is so when certain countries may push certain laws and policies that tend to benefit the growth of E-commerce by arguing for a tax free environment as a way of protecting and growing their industries, while others will legislate on E-commerce as a way of securing their tax revenues.

CHAPTER THREE

3. THE CHALLENGES OF E-COMMERCE

3.1 Jurisdiction to tax- Residence based taxation

An individual or corporate taxpayer's residence may be defined in terms of domicile, place of incorporation, place of effective management or any other criterion of similar nature. The above definition does not have any correlation to E-commerce trade in which the taxpayer engages in. Accordingly in so far as conventional taxation relies on the residence principle as the basis for taxation, E-commerce tax payers have the freedom to actually relocate their businesses from high to low tax jurisdictions by locating servers in that jurisdiction and without being detected by the taxing authorities thus avoiding the due payment of taxes. This defeats the residence test of allocating taxing rights amongst contracting parties.

3.2 Source based taxation

The jurisdiction to tax difficulties confronting taxing authorities relying on residence based taxation in E-Commerce pose similar problems in source-based taxation as well. Most countries tax source income of non-resident individuals and corporations arising from business activities within their borders. Under income tax treaties contracting parties assert their taxing rights on source trade or business income of foreign individuals and corporations only when such income of foreign individuals and corporations is attributable to PE in that country.

To apply the above to E-commerce poses a number of challenges, for example conventional business is conducted in a typically identifiable physical location while E-commerce can be conducted through telecommunications and computer links that have no physical connection to the jurisdiction in which the income producing activity occurs.

Since E-commerce can be conducted without a fixed place of business in a contracting country, income that would have been earned was it a conventional business will escape the taxing authority through E-commerce.

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93 OECD Model Treaty Article 4
95 The United States asserts jurisdiction to tax income which is effectively connected with the conduct of a trade or business within the United States -Internal Revenue Code 871 at 882.
Applying current PE rules to E-commerce would favour residence state taxation. E-commerce enables servers to be installed in source countries thus the company operates in the residence country as there will be no need to set up offices, sent employees or even engage agents in the source country. Source country therefore loses its tax revenue.

3.3 Assets/activities test

A physical PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on. The place of business requirement embodies the centralization concept. A place of business includes any premises facility or installations for carrying on business, whether or not it is used exclusively for that purpose. A place of business may include tangible assets used in carrying out the business. For example machinery or equipment may in certain circumstances constitute place of business for an enterprise. Even an empty room in which the enterprise conducts business could qualify as a PE. The place of business must have a definite spatial location, it must be fixed, that is there must be a link between the places of business and the specific geographical point. The fixed requirement connotes permanence. Whether the fixed place of business meets the requirement of permanence depends on all facts and circumstances surrounding each individual case.

The business carried on through a fixed place of business must be an activity. Even the letting or leasing of facilities, equipment and real property can render a place of business through which the letting is effected constitutes a PE. Likewise letting or leasing intangible property such as patents to third parties through a fixed place of business can generate a PE. The activity need not necessarily performed by a human being. Vending machines and other automated devices could constitute PE if the enterprise engages in business beyond the mere installation of machines. It therefore follows that fully automated pumping stations and similar facilities should be considered a PE.

The above principles are applicable to E-commerce in this way, where a company operates a server in another country, the server may constitute a PE. It may not be necessary for the company’s employees or agents to be present for it to constitute a PE. If the server solely functions for purposes of storage, display or delivery of goods or merchandise, it would not

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96 OECD Model Treaty, 2001, Article 5
97 OECD Model Treaty, 2001, commentaries to Article 5, para.4
98 OECD Model Treaty, 2001, commentaries to Article 5, para.2
99 OECD Model Treaty, 2001, commentaries to Article 5, para.4
100 OECD Model Treaty, 2001, commentaries to Article 5, para.5
101 OECD Model Treaty, 2001, commentaries to Article 5, para.8
be considered a PE\textsuperscript{103}. The rationale being that such activities are of preparatory and auxiliary manner. The difficulty to determine what constitutes preparatory and auxiliary in E-commerce, advertising is one of the major ways that trade is carried on and in my view cannot be said to be of preparatory or auxiliary in nature. What is important is the functions performed and in the server and whether the server is at the disposal of the company. If the company uses the server of a third party service provider for other companies as well, the server will not constitute a PE.

The OECD has revised its commentaries to Article 5 to address the application of PE concept in the context of E-commerce\textsuperscript{104}. A web site in and of itself cannot constitute a PE\textsuperscript{105}. Consisting of electrical impulses, it is not a place of business. However the server on which the web site is stored is tangible property and has a geographical location and may therefore constitute a PE\textsuperscript{106}. The use of the word "may" does not connote mandatory and therefore whether a server and its geographical location constitute a PE depends on certain facts, one of which is whether the taxpayer has the server at its disposal and control\textsuperscript{107}. The OECD however does not define the term "at the disposal". It is unclear whether the same refers to control or physical access to the server that enables the customer to make changes and additions. It is possible for a taxpayer to modify the contents of its web site managed by an ISP without having physical access of the same. It remains to be seen whether this definition will stand the test of time in the face of the fast evolving technology.

The OECD commentaries have clarified that personnel are not necessary to determine the existence of PE\textsuperscript{108}. Where the activities carried on through a server are an essential and significant part of the commercial activity of the company, a PE would be established\textsuperscript{109}. A major controversy that arises from the OECD commentaries is where the company operates multiple servers, each of which may perform a particular function. Taken together the servers might be conducting the core activities of the company, but individually each server might fall under the preparatory and auxiliary clause. In such a case the OECD has held that each place of business has to be viewed separately in deciding whether or not a PE exists. This has

\textsuperscript{102} OECD Model Treaty, 2001, commentaries to Article 5, para.10
\textsuperscript{103} OECD Model, 2001, Article 5 Para. 28
\textsuperscript{104} OECD Model Treaty, 2001, commentaries to Article 5, para.42.1-42.10
\textsuperscript{105} OECD Model Treaty, 2001, commentaries to Article 5, para.42.2
\textsuperscript{106} OECD Model Treaty, 2001, commentaries to Article 5, para.42.4
\textsuperscript{107} OECD Model Treaty, 2001, commentaries to Article 5, para.42.3
\textsuperscript{108} OECD Model Treaty, 2001, commentaries to Article 5, para.10
\textsuperscript{109} OECD Model Treaty, 2001, commentaries to Article 5, para. 24,42.8
the consequence that multiple servers at the same location might constitute a PE but multiple servers in different locations within the same jurisdiction could not be cumulated into a single PE.

It must be noted that technologically the location of a server is largely insignificant in that the customers computers may be fixed with browsers which can access the companies products at the click of a mouse. This definitely would be stretching the OECD language too far to constitute a PE.

Various countries have interpreted the above principles differently; others strictly while others have sought to enlarge them. In the Pipeline case\textsuperscript{110}, the German supreme Tax Court held that a Dutch corporation that supplied oil and oil products through underground pipelines in Germany constituted a German PE for purposes of German net worth tax. German oil companies maintained delivery stations that supplied the companies with oil. The necessary oil pressure for transportation of the oil was supplied in the Netherlands. The Dutch Company had no employees in Germany. Independent contractors did all maintenance and repair of the pipelines in Germany. The Court reasoned that it was irrelevant that the Dutch taxpayer operated the pipeline through a remote control system without any employees present in Germany. Fully automated equipment could constitute a PE.

3.4 Agency PE.

The enterprise will be deemed to have a PE in the source state if it utilizes a person even if the enterprise does not have a fixed place in the source state\textsuperscript{111}. A dependent agent which is described in Article 5(5) is subject to extensive control by the principal who generally bears the entrepreneurial risk\textsuperscript{112}. For a PE to exist, the agent must have authority to conclude contracts that bind the principal. The authority need not be that of a legal nature, for example the agent may negotiate contracts but the principal in the state in which it is located completes the actual signing\textsuperscript{113}.

To constitute a PE the agent must have authority to contract on behalf of the enterprise, which authority must be habitually exercised. The requirement to exercise authority must reflect the permanence aspect of the PE. The determination of whether the authority is

\textsuperscript{110} Bundesfinanzhof (BFH)II Betriebs-Berater, 52 (1997), 138; see also article by Sweet, John K, University of Pennsylvania Law Review Vol. 146, issue No. 6 at page 13
\textsuperscript{111} OECD Model Treaty, 2001, Article 5(5)
\textsuperscript{112} OECD Model Treaty, Article 5, Commentary to Article 5, para 38.
\textsuperscript{113} OECD Model Treaty, Article 5, Commentary to Article 5, para 33
exercised habitually is a question of fact. An agent who has authority and exercises the same habitually shall not be deemed an agent PE if the activities are of preparatory and auxiliary in nature.

To apply this to E-commerce it is argued that an ISP cannot constitute an agent of the enterprise. An ISP would fall under an independent agent operating in its ordinary course of business. Another question is whether a software agent can constitute an agent. An intelligent software agent installed in an enterprise's computer and dispatched to the customers' browser is able to answer questions, display products, provide pricing information, negotiate terms of payment and conclude a contract of sale that binds both the enterprise and the customer. All these are done without additional human input and are activities that would ordinarily be done by a dependent agent. Notwithstanding the abilities of the software agent, it cannot constitute a PE. The OECD model as currently written, the term "person" is defined to include an individual, a company and any other body of persons. A software agent is not a person within the meaning of the OECD Model. This is a case where the activities of an enterprise may be conducted technologically and thus fall outside the arm pit of the OECD model treaty law thus untaxed. The OECD Model law should be reviewed to capture these technological advancements in determining whether an enterprise has a PE. In my view as long as the activity has been done whether through a human person or an intelligent software agent the fact remains that the enterprise is carrying out an economic activity that should be taxed by the source country. This calls for the abandonment of the physical presence test and adoption of an economic activity test.

3.5 Independent Agent
The issue whether an enterprise has an agency PE in a Treaty country often depends on whether the person acting on its behalf in the Treaty country is an independent agent or not. The OECD model treaty provides that an enterprise shall not be deemed to have a PE in a contracting state merely because it carries on business in that 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 trade or business.

114 OECD Model, commentaries, 2001, Article 12, para 12.1. Software may be described as a programme containing instructions for a computer required either for the operational processes of the computer itself or for the accomplishment of other tasks. It can be transferred through a variety of media such as CD, disk.
115 OECD Model Treaty, Article 3(1)
116 OECD Model Treaty, Article 5(6).
An independent agent is defined as a person that is firstly independent of the enterprise both legally and economically, and secondly, acts in the ordinary course of his business when acting on behalf of the enterprise\textsuperscript{117}. The commentary to the OECD model provides that a person is considered to have legal independence if the persons commercial activities are not subject to detailed instructions or to comprehensive control by the enterprise. The 2002 OECD draft model commentary also provides that another factor to be considered in determining independent status is the number of principles represented by the agent.

A person is considered to have economic independence if the person bears entrepreneurial risk\textsuperscript{118}. The 2002 draft OECD model commentary provides that the character of the remuneration which an agent receives may provide a useful indication of whether, or to what extent, the agent bears the commercial risk of his activities\textsuperscript{119}. For example if the agent is contractually protected from losses and guaranteed a stream remuneration,\textsuperscript{120} such as through a cost plus service arrangement that is indicative of a dependent agent status.

### 3.6 Related business entities.

The existence of a subsidiary Company does not by itself cause the subsidiary Company to be treated as a PE of its parent or of another affiliated company\textsuperscript{121}. This follows from the principle that for the purposes of taxation, such a subsidiary Company constitutes an independent legal entity\textsuperscript{122}. This is true even if the trade or business carried on by the subsidiary Company is managed by the parent Company\textsuperscript{123}. A subsidiary will constitute a PE of its parent however if it cannot be regarded as an independent agent and if it has and habitually exercises an authority to conclude contracts in the name of the parent company, that is, if it acts as a dependent agent PE for its parent\textsuperscript{124}.

### 3.7 Attribution of profit to a PE involved in an E-commerce transaction

The OECD Model allows the state of the PE to tax business profits, but only so much of them as is attributable to that PE\textsuperscript{125}. The model rejects the “force of attraction” principle for taxing

\textsuperscript{117} OECD Model Treaty, Article 5(6), commentary note 36 and 37.
\textsuperscript{118} OECD Model Treaty, Article 5, Commentary to Article 5, note 38.
\textsuperscript{119} OECD Model Treaty, Article 5, Commentary to Article 5, note 38
\textsuperscript{120} the principle commits itself to pay the agent a guaranteed remuneration for the sales.
\textsuperscript{121} OECD Model Treaty, Article 5, Commentary to Article 5(7).
\textsuperscript{122} OECD Model Treaty, Article 5, Commentary to Article 5, note 40
\textsuperscript{123} OECD Model Treaty, Article 5, Commentary to Article 5, note 38
\textsuperscript{124} OECD Model Treaty, Article 5, Commentary to Article 5, note 41
\textsuperscript{125} OECD Model Treaty, Article 7(1)
PE income\(^{126}\). In general profits are attributable to a PE if they result from the economic activities of the PE. Taxation of business profits of the enterprise in the state in which the PE is located is permitted only where there is a connection between the activities of the PE and the profit the enterprise derives.

In E-commerce the issue of attribution of profits creates complex challenges to tax authorities. For example, a company in country X may have its manufacturing facility in country Y, but the design of the manufacturing plant, the manufacturing process, and the manufactured goods may have the input of engineers and other employees scattered in many countries communicating through video conferencing or various design programs over the network. Allocating the business profits resulting from such a manufacturing process complicates allocation rules that were designed for conventional forms of business.

The OECD has formed a Technical Advisory Group (TAG)\(^{127}\) to explore the application of existing treaty norms for the taxation of business profits. The TAG has identified two steps that should be applied in determining profits attributable to a PE; first, a functional analysis of the PE is used to determine the activities undertaken by the enterprise as a whole and in the PE in particular. This should include a determination of the assets used and the risks assumed by the PE. Secondly, the profits of the distinct and separate enterprise are determined based on transfer pricing guidelines. It is difficult to apply functional analysis to the activities of a company doing business over the Internet since any given function may be performed in several places. There is no consensus yet on the proposed guidelines by the TAG and the guidelines in themselves are confusing and complex to apply.

The OECD\(^{128}\) provides that only so much of the profits of an enterprise as are attributable to a PE in a country may be taxed in that country. The profits attributed to the PE do not include profits that an enterprise may derive otherwise than through the PE. This limits the taxing rights of a host country so that profits of a non resident enterprise that are not attributable to the PE cannot be subject to tax. The OECD\(^{129}\) states that the profits to be attributed to a PE are those that would have been made if it had been a separate enterprise engaged in the same

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\(^{126}\) OECD Model Treaty, Commentary to Article 7, para 5.Under the “force of attraction” principle, If an enterprise of a contracting state maintains a PE in the other contracting State, the state in which the PE is located is entitled to tax all income the enterprise derives from sources within that state as PE income (business profits) whether or not that income is connected with the PE.


\(^{128}\) OECD Model Treaty, Article 7(1)

\(^{129}\) OECD Model Treaty, Article 7(2)
or similar activities under the same or similar conditions dealing with other parts of the enterprise wholly independently. This is referred to as the arms length principle.

3.8 Characterization of income

New technological developments involving the electronic transfer of digitized information\textsuperscript{130} complicate the application of existing income classification principles. E-commerce offers choices to consumers that did not exist when Governments first addressed income classification issues. For example instead of one purchasing ten copies of a book, he may purchase one electronic copy and acquire the right to make one additional copy of the book as opposed to purchasing ten copies in bound form. Technically, the income would be classified as royalty income. However it may be treated as the purchase of ten copies of the book. Some electronic transactions may blur the distinction between income from the sale of goods and income from the provision of services.

E-commerce raises thorny questions not only in respect to jurisdiction to tax income but also with respect to characterization of such income once it is determined that the tax payer is indeed subject to tax. Characterization of income is important because both national and international income tax rules assign different categories of income to different jurisdictions. For example under the OECD model treaty income from personal services is taxed in the contracting state where the services were performed\textsuperscript{131}, income from rentals and royalties is sourced according to the location of the property or in case of the intangible the place where the intangible property is used\textsuperscript{132}.

Income is assigned to a contracting state according to the character of the income. To apply the above rules and principles to E-commerce poses a challenge, for example the purchase of a digitized image may be argued to be a purchase of services of the enterprise that purveyed the image over the Internet. Under such circumstances, the income would ordinarily be sourced to the country in which the service was performed. In the alternative the transaction may be viewed as the license to use an intangible namely the digitized image transmitted over

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\textsuperscript{130} Howard Abrams and Doenburg Richard, “How Electronic Commerce works” 14 Tax Notes International 1573, 1573-74 (1994) Digitization is the process of converting information into a sequence of numbers. The converted information may be images, speech, music, diagrams or words, can be sent at the speed of light throughout the world whereby a recipient can convert it back into its original format.

\textsuperscript{131} OECD Model Treaty, Article 14 and 15.

\textsuperscript{132} OECD Model Treaty, Articles 6 and 12. OECD Model Treaty, Article 7(2)
the Internet. Under such characterization the income ordinarily would be sourced to the
country in which the intangible right is used.\textsuperscript{133}

In a transaction relating to a purchase of a photograph, it might be viewed as being
economically identical to the purchase of an item or inventory. Under such characterization
the income would ordinarily be sourced to the country in which title to the photograph passed.\textsuperscript{134}

The OECD TAG Committee discussed the difficulties on Treaty characterization issues
arising from E-commerce.\textsuperscript{135} In a transaction such as where the customer selects an item
online through a catalogue, orders the product electronically from a commercial provider,
pays electronically, and downloads the digital product on its own hard drive, the TAG
believed that the transaction gave rise to the business profits.\textsuperscript{136} This was based on the
theoretical premise that the transaction was equivalent to the electronic ordering of tangible
products and that the form of delivery should not change the treaty classification of the
transaction. Others have argued that the transaction should be characterized as payment of
royalties under Article 12 on the basis that the substance of the transaction was the right to
copy the programme onto the customer's hard drive. I concur with the latter argument
because of the absence of the physical delivery of the product. It is evident that the stand
taken by the OECD is a conservative one. Placing so much reliance on the definition of a PE
under conventional commerce is likely to complicate further the characterization of income
thus widening the gap between what constitutes profits and what constitutes royalties.

Some of the most difficult classification of income problems arises with respect with income
generated by the acquisition of computer software. If the software is shrink-wrapped and sold
through a store it would be treated in the same manner as a sale of a book. However if it is
customized for the customer such that the customer may download and use it for some time,
the same will be treated as a license, hence constitute royalties. Further problems are
experienced in the provision of online services such as databases and online subscriptions.
These might be considered as income from performance of services or royalty depending on

\textsuperscript{133} OECD Model Treaty, Article 12, Under OECD, it depends on whether the royalties are effectively connected
with PE or arise from a fixed place in a country in which the royalties accrue.

\textsuperscript{134} OECD Model Treaty, Article 7 -business profits under OECD would depend on the passing of the title in a
sale attributable to a PE.

\textsuperscript{135} OECD TAG, Characterization of Electronic Commerce payments under Existing Treaty provisions, March
24\textsuperscript{th} 2000.

\textsuperscript{136} OECD Model Treaty, Article 7
whether the service is considered intangible or tangible. If it is intangible the issue of royalties will arise in respect to the license to use the service, otherwise if it is tangible, such as the service being packaged in a CD or a cassette, then it will be treated as a sale of a product and the income classified as such.

There are at least three source rules that could be implemented with respect to the performance of services; income could be deemed to arise where the service is performed, secondly, where the benefit of the service is received and finally where the benefit of the service is utilized. Problems arise in E-commerce income classification such as where a Company offers financial advise through the exchange of electronic messages or teleconferencing, should the source of income be where the server is located (i.e country of service provider) or where the customer is located (place of utility of service). OECD in its 2000 amendment eliminated article 14 and the applicable clause on service income is Article 7.\textsuperscript{137} Even then it only reiterated that service income should be derived from a PE in a contracting state. OECD was more keen in maintaining status quo than dealing with the confusion that the treatment of service income is causing under E-commerce.

Royalty income may attract several treatments depending on how the transaction is interpreted by the taxing authority. If the product is disseminated electronically at a fee, the payment may be royalty for the use of intellectual property. In some cases the customer could be paying for the use of tangible property such as a hard disk or server, in which case the payment would constitute a rental payment. If the customer acquires both the tangible and intangible property, the fee paid would constitute sales proceeds. Any of the characterization depends on the rights acquired.

There is no consensus on the above issue and some countries have articulated broad standards for what constitutes royalties while others have applied a restricted meaning. If the international community does not reach an agreement on these classifications there is a likelihood of double taxation. For example one country may regard a payment as royalty and thus apply withholding tax while another may treat it as a purchase price thus withholding tax is inapplicable for purposes of granting relief from double taxation in the other contracting state.

\textsuperscript{137} OECD commentaries 2001, introduction, Para 35.
3.9 Consumption taxes

Consumption taxes in E-commerce may fall into four categories; business to business transaction sales of tangible property consummated over the internet (such as purchase of a computer through the internet by a tax payer from a remote vendor); second, business to business sales of digital products or services (such as the purchase over the internet of an electronic data base by a business taxpayer from a data base vendor); thirdly, business to customer sale of tangible property or service consummated over the internet (such as purchase of clothing from by an individual from a remote vendor), fourthly, business to Customer sales of digital products or services (such as purchase over the internet of a downloadable video by an individual from a remote vendor.

The OECD taxation framework conditions concluded that the consumption tax rules for cross-border electronic commerce trade should result in taxation in the jurisdiction in which consumption took place. It is believed that taxation at the place of consumption promotes certainty and prevents double taxation or unintentional non taxation. This may occur where two jurisdictions employ non compatible place of taxation rules, for example at the source and destination. Tax at the place of consumption serves to create a level playing field and is thus more neutral within and amongst conventional and electronic forms of commerce.\(^{138}\)

Place of consumption of cross border supply of conventional goods can be based on the recipients place of delivery, for example at the delivery address. The taxing authority through the customs department will collect the relevant taxes payable at the port of entry and before collection of the imported item. In contrast where products are digital in nature delivery would be digital downloading.

A consumption tax in services proves a difficulty in determining the place of consumption especially in intangible services. For tangible services such as architectural, hotel accommodation, handling services, hairdressing and physical performances the place of taxation can rightly be the jurisdiction where the service is actually performed. Intangible services are services such as Consultancy, accountancy, legal advertising, and provision of information and telecommunications services. These services cannot be said to have been physically performed. The services are offered at a particular location and are deemed to be

consumed where the provider or the customer is located. Intangible services capable of being
delivered electronically present a challenge in defining the practical consumption place.

Under a pure consumption test intangible services would be defined as consumed in the place
where the customer actually consumes or uses the services. With a pure definition of
consumption, tax should in principle accrue to the country in which the actual consumption
takes place. The problem with this classification is the identification of the transaction. If
the same is through the Internet and is in respect to an intangible product, it becomes more
difficult to identify because of lack of paper trail to facilitate an audit. The concept of PE gets
fully eroded in this scenario. The global nature of E-commerce coupled with the mobility of
telecommunications makes it impossible to apply the pure consumption test. For example
where a French business contracts with a Canadian business to provide electronically
delivered services. The staff of the Canadian business uses portable computers and receives
the services all over the world. Consumption would be said to take place in whichever
country the staff member actually uses the services. In practice it is difficult to identify the
place of consumption especially in a case where the employee is situated in another country
and offers services online to an enterprise in another country.

Alternatives to the place of consumption principle have been suggested namely, the location
of the suppliers, profit -generating operations, place of contract, location of customer and the
location of the supplier or the recipients business. This may include the establishment to
which the supply is made, which may comprise the headquarters, a branch, a registered
office, or a seat of economic activity. Another approach is to tax services where they are
performed in more than one place, the location of the supplier would be deemed to be the
place of taxation.

In summing up the issue of consumption tax it is pertinent to define the actual place of
consumption of services or products to ensure that the business structure or the mobility of
telecommunications are not used to avoid taxes by routing services through temporary
establishments in low tax jurisdictions.

The question of verifying the jurisdiction of the customer is the next hurdle to enable the tax
authority to tax based on place of consumption. Some have argued that the residence as

declared by the customer to the supplier may be used. Another is the country of residence as evidenced by credit card information and personal tax identification number declared by the recipient to the supplier. However it is thought that this may not be sufficient comprehensive to the revenue authorities. Digital certificates of origin may provide the solution to the problem of identification of the customer and subsequent assessment of tax based consumption. Credit card information may be inaccurate as evidence of jurisdiction or residence. It would be disruptive to online business transactions and only serve to encourage alternative payment methods. Neither does the use of Internet provider number tracing as a proxy for jurisdictional verification. A proxy Internet provider has the capacity to be manipulated. There is also the problem of personal privacy and data protection concerns as well as the collection and administrative costs of verification of a party in business to customer transaction. Businessmen are reluctant to collect more information from customers that are required for commercial purposes, thus cannot be relied upon to gather information for tax purposes.

Collection of consumption taxes in intangible products is a complex matter and some OECD countries like the European Union have encouraged the use of self-assessment or reverse charge. Recipients are required to determine the tax owing on imports of services and intangible property and to remit the amounts to the taxing authorities. The problem of self-assessment is that it is dependant on the honesty and willingness of the taxpayer. In the case of intangible products the taxing authority may not capture the transaction and hence will go untaxed. However self-assessment or reverse tax system can work in Business to Business transactions and not Business to Customer as seen above.

A second method of tax collection is collection of taxes at source and the transfer option. In this case a business collects consumption taxes on exports and non-residents and remits the amount to their domestic tax authorities that would then forward to the revenue authority in the country of consumption. The challenge posed by this method is first, there has to be a double taxation treaty between the two countries and secondly, the cost of administering such a system has the potential of making business costly. It has however been argued that intelligent networks may be used to minimize the administrative costs involved. In that case the tax payable would be routed to the relevant tax authority. This raises the issue of privacy
and protection of data. It also raises the constitutionality of installing eavesdropping intelligent networks in the telecommunications systems across borders.

A third method is the use of third parties such as financial intermediaries. It must be noted that the onus of tax collection should not be shifted to a third party. Needless the third party should not be burdened with the task of tax collection. It should be on voluntary basis and as well as commercial viability coupled with incentives.

The fourth method is the Technology based collection systems. This involves the use of tamper proof software that could automatically calculate the tax due on a transaction and remit the tax to the destination jurisdiction. Bilateral agreements would be required to provide for the installation of the software in taxing authorities of the affected jurisdictions. It is stated that Netherlands are experimenting on such a system. This method can only function well if there is a uniform system of characterization of income taxes.

The OECD Ottawa meeting concluded that; firstly, in order to prevent double taxation or unintentional taxation, rules for the consumption of cross border trade, should result in taxation in the jurisdiction where the consumption takes place, secondly, the supply of digitized products should not be treated as a supply of goods and thirdly, where the business acquires services and intangible property from a non resident vendor, consideration should be given to the use of either a reverse charge based on self assessment mechanism.

3.10 Web sites and Servers as PEs

A web site of an E-Commerce business is a combination of software and electronic data stored on and operated by server. A web site is an intangible asset and as such there has to be a facility such as premises or in certain circumstances, machinery or equipment to hold it. In that case therefore it cannot on its own constitute a place of business. An Internet server consists of tangible computer equipment networked to the Internet. A server is usually dedicated to the storage and Internet accessibility of Web site email. Accounts, databases and software programmes resident on the server can automatically administer the electronic

141 Information obtained from Maurice Ochieng, Deputy Assistant Commissioner, KRA on the 7th August 2005.
144 Ibid at page 5.
transmission of digitized E-Commerce products or services to end users. E-Commerce ventures may use the web hosting services of internet Service Providers who allocate and make available to them sufficient server space for their E-Commerce requirements.

Typically, foreign E-Commerce operations are carried out by means of servers located in the target markets. Dot.Com ventures can adopt various working models or server combinations. An E-Commerce transaction can involve a number of servers strategically located in different countries. Online consumers from any part of the world can host on different servers or on one and the same server situated anywhere in the world and access the firm’s web site and its online store. For the downloading of the soft merchandise purchased from the e-store, the web site retrieves the data from a server elsewhere on which the data is stored and sends it electronically to the customer. Alternatively the consumer is redirected, either voluntarily or unknowingly, to another sever which holds the firms data145.

The question as to whether the mere use in E-commerce operations of computer equipment in a country could constitute a PE is a debatable issue that Governments and taxing authorities are grappling with. The OECD model convention has stipulated the circumstances under which a server may establish a PE146. Computer equipment such as a server may constitute a PE if it meets the requirement of being fixed at a particular place. In order to constitute a fixed place of business a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of a PE147.

A distinction needs to be made between computer equipment that may be set up at a location so as to constitute a PE under certain circumstances, and the data and software that is used by or stored on that equipment. For example, an Internet web site that is a combination of software and electronic data does not in itself constitute tangible property. It therefore does not have a location that can constitute a place of business, as there is no facility such as a premise or in certain cases machinery or equipment that is affixed to a permanent physical place. On the other hand the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a fixed place of business of the enterprise that operates that server148.

146 OECD Model Treaty, (2000) draft, section 42.1
148 ibid, section 42.2.
Another question that calls for answers is whether a web site hosted on an ISP's server constitutes a PE for the enterprise. It is common for the enterprise to pay fees to an ISP calculated based on the disk space used to store the software and data required by the web site in the web hosting contract. However the enterprise has no control of the server and its location. The server is not at the disposal of the enterprise because it remains solely under the control of the Internet Service Provider. In such a scenario the enterprise cannot be said to have gained a physical presence by merely having its web site hosted by an Internet provider in another state. The reason for this argument is that the web site is not tangible and therefore cannot constitute a physical presence.

However in a case where the enterprise leases or owns and operates the server on which the web site is stored and used, the place where the server is located could constitute a PE of the enterprise, if the other requirements of a PE such as a fixed place are met. This brings us to another question whether the business of an enterprise may be said to be wholly or partly carried out on a location where the enterprise has equipment such as a server at its disposal. There is still no consensus on this issue and the issue has to be looked into on a case-by-case basis. This kind of lacunae in the definition of a PE in E-Commerce transactions leads to leakage of taxes, non-taxation and distortion of the economic wealth of nations.

Another twin issue is whether the presence or absence of personnel would constitute a PE. Where an enterprise operates computer equipment at a particular location, a PE may exist even though the presence of employees is not required, for example an activity in which the equipment operates automatically such as an automatic pumping equipment used in the exploitation of natural resources, vending machines, automatic cash dispensers. The test here is whether the equipment is located in a physical place and is capable of having a fixed place of business. This in my view is an expanded definition of a PE. The OECD article 5 (1) does not envisage such definition and this calls for the redefining the concept to include these facets of E-Commerce transactions.

No PE is considered to exist if the activities being carried on by the enterprise are of preparatory or auxiliary nature. The issue here is how to determine what activities are preparatory or auxiliary in the area of E-Commerce. Such activities that would ordinarily be termed as preparatory or auxiliary under conventional commerce, such as providing

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OECD Model Treaty, (2000) draft, section 42.6

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communication links, advertising of goods and services, supplying information and market data are indeed considered an essential and significant part of E-Commerce transactions and cannot qualify to be auxiliary or preparatory. The apparent lack of criterion in this area leads to confusion and inequity of taxation of activities that may under conventional commerce be deemed preparatory or auxiliary but are taxable under E-Commerce and vice versa\(^{150}\).

It has been argued that where the above activities are considered to be the core business of the enterprise, even though they may ordinarily be preparatory or auxiliary, they may constitute a PE under certain circumstances. What constitutes core functions for a particular enterprise depends on its nature of business. If for example a sale (conclusion of a contract, payment is processed and delivery is made automatically through the equipment located therein) is performed at that location then the activity cannot be said to be merely preparatory or auxiliary\(^{151}\).

Can an Internet service provider be deemed to be a PE? ISPs provide the services of hosting the web sites of other enterprises on their own servers and the issue is whether it can be deemed a PE of an enterprise. The answer could be no because the Internet Service Provider can not constitute an agent of the enterprise to which the web site belongs. This is due to lack of authority to constitute contracts in the name of the enterprise. The Internet Service Provider is an independent agent acting in its ordinary course of business. They also host the web sites of many other different enterprises\(^{152}\). Neither can a web site constitute a dependent agent of the enterprise because it is not in itself a person in the sense of the OECD Model\(^{153}\).

It must be argued that by and large the above distinction is very narrow and it is possible for an enterprise to operate and own a server without the tax authorities being aware of the same thus not constituting a PE for purposes of determining its tax liabilities. Further more, the argument that a server can constitute a PE while a web site does not is still fictional to say the least and herein lies the challenge that E-Commerce posses to the concept of PE. Another fundamental challenge is the identification of the ownership and location of the website and the server in view of the fact that they are not capable of registration.

There is no consensus on the above question and several OECD member countries have taken different views on the issue. For Example Spain and Portugal have dissented from the OECD

\(^{150}\) OECD Model Treaty, Article 4(e).
\(^{151}\) OECD Model Treaty, (2000) draft, section 42.8 and 42.9
\(^{152}\) OECD Model Treaty, (2000) draft, section 42.9
\(^{153}\) OECD Model Treaty, Article 3.
position and have maintained that a web site may give rise to a PE, depending on the nature of the web site\textsuperscript{154}. These states hold the position that an enterprise carrying on business in a state through a web site could be treated as a PE in that state\textsuperscript{155}. The United Kingdom on the other hand has taken the view that in no circumstances do servers of themselves or together with the web sites constitute a PE\textsuperscript{156}. This is presumably driven by the United Kingdom’s desire to attract E-Commerce to its jurisdiction.

3.11 Place of management

Under the OECD model tax treaty a PE includes a place of management\textsuperscript{157}. A place of effective management is not defined but under the new amendment the meaning is given as;

"......The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the enterprise’s business are in substance made. The place of effective management will ordinarily be where the most senior person or group of persons (for example a board of Directors) make decisions, the place where the actions to be taken by the enterprise as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An enterprise may have more than one place of management, but it can have only one place of effective management at any one time\textsuperscript{158}.

The new paragraph reinforces the fact that the determination of a place of effective management is a question of fact\textsuperscript{159}. As described above, a place of management may be described as the place where the decisions of the enterprise are made. The place of management is located where the key management works and where decisions necessary for conducting a business are made. This is normally the place where the most senior persons such as the Board of Directors meet to take decisions concerning the management of the enterprise. It may also be defined as the headquarters of the enterprise. The definition of the place of management assumes a hierarchical organization which implies that the management can be located at one specific point at a time\textsuperscript{160}.

A number of court cases have determined that the place of management or central management and control is a question of fact. It is the place where the directors of the


\textsuperscript{156}Supra, page 82.

\textsuperscript{157}OECD Model Treaty, Article 2.

\textsuperscript{158}OECD Model Treaty, (2000), para. 24

\textsuperscript{159}OECD, “Taxation of Electronic Commerce, implementing the Ottawa Taxation Framework Conditions” (2001), page 143.

company exercise their power and authority. A leading case is De Beers Consolidated Gold Mines\(^{161}\). In this case a Company registered in South Africa and worked diamond mines, had its head office and held its general meetings of the shareholders in South Africa. Its directors held meetings both in South Africa and the United Kingdom. It was held by the Court that the place of management was where the real control of the Company was exercised. Accordingly the Company was found to be a United Kingdom resident.

In a number of Canadian cases\(^{162}\) Birmount Holdings Limited Vs. R, Tara Exploration and Development Co. Ltd Vs. MNR\(^{163}\) and Capitol Life Insurance Co. Vs. R\(^{164}\), the Court relying on the statement of the Lord Chancellor in the De Beers Case have held the place of central management and control is where the Company “really keeps house and does business”. Some of the factors taken into account in determining the place of management included; place of incorporation, place of residence of shareholders and directors, place of business operations, place where the financial dealings of the company occurred and also where the seal and minute books of the Company were kept.

There are no conclusive factors that the Courts have applied in arriving at the definition. For example in the case of Malayan Shipping Co. Ltd Vs. FC of T\(^{165}\) the court held that the Company was a resident of Australia because the managing Director exercised complete management and control of the business operations of the Company from Australia notwithstanding that the trading operations were conducted abroad.

In certain cases the place of a controlling shareholder may be relevant in determining the central management and control of the company. In the case of Unit Construction Co. Limited Vs. Bullock (Inspector of Taxes)\(^{166}\) three wholly owned subsidiary companies were incorporated in Kenya. By their Articles of Association, powers of management were vested in the directors who were located in Kenya and who could not validly hold meetings in the United Kingdom. However, these management powers were not in fact exercised by the local directors who stood aside in all matters of real importance, so that it was the board of directors of the parent company in the United Kingdom which effectively made all the decisions. This resulted in the subsidiary being held to be a United Kingdom resident.

\(^{161}\) De Beers Consolidated Gold Mines (1906) AC 455
\(^{162}\) Birmount Holdings Limited Vs. R (1978) CTC 358,
\(^{163}\) Tara Exploration and Development Co. Ltd Vs. MNR (1970) CTC 557
\(^{165}\) Malayan Shipping Co. Ltd Vs. FC of T (1946) CLR 156
\(^{166}\) Unit Construction Co. Limited Vs. Bullock (Inspector of Taxes) (1959) ALL ER 831
In modern management of an enterprise, the hierarchical structures may be replaced by horizontal object-oriented and matrix structures whose characteristics is a management structure devoid of a traditional centre of management that could be located at a particular place. The management therefore consists of a bi and poly-centric network and is spread across many different countries. It is also possible for a group of managers to meet in different locations of the enterprise on a rotational basis, in that case a mobile place of effective management is created. By using ICT managers and employees residing and doing their work in multiple jurisdictions can communicate via electronic communications such as e-mail, electronic discussions group applications or video conferencing. Therefore it is no longer necessary for a group of persons to be physically located or meet in one place. The Directors do not need to meet physically to take decisions that are necessary for the conduct of the entity’s business. Each jurisdiction where the manager is located at the time of making the decision can be regarded as a place of management. It is difficult to pinpoint the one single most significant place of management for the enterprise in such a circumstance.

Cognition must be made of the fact that the use of ICT makes it possible for the Directors of the Company to be independent of the location of the enterprise itself. Decisions can be taken while they are on the move. The place of management may therefore be located in another jurisdiction different from the main activities of the enterprise.

Increasing number of enterprises are conducting trans-national businesses using ICT. In addition, the rapid improvement in global transportation systems are also likely to have an impact on the place of effective management concept. This will result in increased incidences of mobile places of effective management. A board of directors may arrange to meet in different places throughout the year. For example a board of a multinational enterprise may agree to meet at the offices of the enterprise around the globe on a rotational basis. This could lead to having a mobile place of effective management.

From the above it is clear that the place of effective management as constituting a PE needs to be re-looked afresh in respect to E-Commerce. The continued use of this definition as a criterion for a tie breaker rule will lead to cases of double taxation on the income of the company even though there may be sound commercial reasons for their central management
and control structuring.

3.12 The work of the OECD

The primary concerns of the OECD members was the belief that the Internet would facilitate increased cross-border commerce and increase mobility of business and capital. Members also feared that tax havens and offshore banking facilities would become more accessible and more widely used to avoid or evade tax, therefore threatening Government revenues\textsuperscript{167}. The members were keen to have continuity of the PE meanings as explained in the Typical PE test model, a system that had for over 70 years created stability to the attribution of tax liabilities to businesses.

OECD made recommendations that taxation framework for E-commerce should be guided by the same taxation principles that guide governments in relation to conventional commerce. Any new administrative measures should be directed toward the application of existing taxation principles and should not be intended to impose a discriminatory tax treatment on E-Commerce at this early stage of its development. From this it is clear that the OECD taxation framework guidelines had the objective of creating an enabling environment for the growth of E-Commerce by using a self defeating mechanism, that is applying the same taxation principles developed and applied to conventional commerce. E-Commerce being essentially non-physical cannot be comparable to conventional commerce that is on the existence of a physical presence such as building, equipment and or persons. On a positive score however, it was agreed that the cannons of taxation generally applicable to taxation of conventional commerce should equally apply to E-Commerce, namely, Equity, certainty, convenience, economy, productivity, buoyancy, flexibility, simplicity and diversity\textsuperscript{168}.

Most OECD members endorse the view that servers can constitute PEs in some circumstances\textsuperscript{169}, while acknowledging the importance of a fair share of tax base internationally. Net E-Commerce importers facing the prospect of losing their grip on taxable


\textsuperscript{168} Smith, Adams, The wealth of Nations, (ed Edwin Cannan), New York, the modern Library, pages 777-79.

Though the cannons of taxation are nine, namely, Equity, certainty, convenience, economy, productivity, buoyancy, flexibility, simplicity and diversity, only seven have been mentioned above. The reason for this is that tax being a give and take discipline, it is not ideal to comply with all the nine cannons in designing a tax policy.

\textsuperscript{169} OECD, “Tax Treaty Characterization Issues Arising from E-commerce” 2001, page 34. A server can constitute a PE if it is fixed and it if performs the core business of the company.
PEs are actively pursuing consensus on mechanisms that serve to protect their tax base. In negotiating bilateral treaties net-importing countries may be willing to give up certain PE criteria in exchange for other tax concessions granted by the net exporting countries.

The OECD concluded that whatever solutions are adopted to the taxation of E-commerce should be simple, facilitate voluntary compliance and should not artificially advantage or disadvantage E-commerce over conventional commerce. It has tried to advocate for the application of PE as described in 3.2 above on E-commerce. The initiatives by OECD have been credited for creating a focal point or forum to discuss E-commerce taxation matters rather than providing a concrete solution. The legitimacy of the guidelines of the OECD TAG committees is based on consensus of the members and not legally binding. The effectiveness of the guidelines is therefore uncertain. Implementation is at the will and discretion of each member state. Notwithstanding its shortcomings, the OECD guidelines are part of an international process of law making and should not be ignored.

On its part, the OECD recognizes that arriving at a uniform tax system is not an easy task. There is bound to be conflicts and furthermore to devise a system that is equitable to all is almost impossible. Governments and businesses will take into consideration the trade-offs that will be involved in settling the conflicts. At the onset there is already a conflict between the economic objectives of E-commerce tax policies (tax free growth of E-commerce) and Government fiscal policies (maintaining tax systems that ensure continued collection of tax revenues for the Government) that requires cultivation of international cooperation and consensus from all the stakeholders.

Technological advancement in E-commerce is another challenge to OECD. Technology is being churned out so fast that the guideline of yesterday becomes obsolete before its implementation is brought into fruition. Another problem is the disparity that exists in the economic agendas of the member states. E-commerce exporting states argue for a tax-free E-commerce to enhance its growth while the poor countries advocate for taxation of E-commerce to safeguard their tax revenue bases.

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171 Supra, page 456.
3.13 Conclusion

The application and the enforcement of traditional tax rules is proving complex in the face of E-Commerce than in the brick and mortar conventional business. Events that would normally give rise to tax liability in the brick and mortar business models are likely to escape detection by fiscal authorities in the electronic world and unintentional non-taxation would result. “Dot.Com” Companies can easily exploit these new business avenues to gain competitive tax advantage over their traditional competitors. It is therefore evident that Governments and all the stakeholders must react to this new threat to their fiscal effectiveness.
CHAPTER FOUR

4. TAX SYSTEMS’ APPROACHES TO THE CHALLENGES.

4.1. Introduction
This chapter will therefore briefly examine the approaches that various tax systems have taken vis a vis the PE definitions illustrated in the diagram below. The diagram on page 55 serves a useful purpose in understanding the operation of PE. This Chapter will examine how the various tax systems have tried to deal with the challenges and how they have attempted to change their laws and tax policies to accommodate the new business model.

Explanatory Notes; -

The general rule is that a contracting state acquires taxing jurisdiction over non-resident entity (NRE) only if it can demonstrate that it has a PE under a fixed place of business or a dependent agent.

1. Under the “fixed place of business” rule;

1a). It is the place of business of the non-resident entity that must exist in the contracting state.

1b). The business of the non-resident entity must be carried out in the fixed place of business. It requires a location in the contracting state that is fixed meaning that there must be a geographical situs. The fixed place of business must be at the disposal of the non-resident entity, (that is the non-resident entity must have the liberty to use the location as it wishes in the conduct of its business). It must have a certain degree of permanence.

1c). The business may be carried on either through the assets of the non-resident entity or the presence of its employees in the jurisdiction.

1d). The business may also be carried out by a dependent agent who is under the control
and authority of the non-resident entity. Employees may also be defined as dependent agents of the enterprise.

1e). The employees must be offering services to the business, they must be exclusively conducting the business of the entity. To constitute a PE the services must be core to the business of the entity.

1f). A PE will not exist if the activities carried on are of preparatory and or auxiliary in nature. What is preparatory and auxiliary is a question of fact.

The non-resident entity may operate through a separate legal entity in the jurisdiction. This is referred to as an agency rule:-

2a). The entity may be an agent of the non-resident entity.

2b). Where the agent is dependent on the non-resident entity, that is the non resident entity has full control of the agent and the agent works from the fixed place of business of the non-resident entity, that agent is called a dependent agent;

(i). For an agent to constitute a PE of a non-resident entity, it must be dependent on it.

(ii). Where the agent acts in its ordinary course of business connotes its independence from the non-resident entity. For this agent to constitute a PE it must have authority to habitually conclude contracts on behalf of the nonresident entity, in addition to its own other businesses. Lack of authority deprives it from being a PE.

2c). If the agent habitually concludes contracts on behalf of the entity then it constitutes a PE.

2d). The independent agent must perform services that are core to the business of the company and not of a preparatory and auxiliary nature.
Typical Permanent Establishment Model Tax Treaty

Is there physical space available for use of NRE in the Contracting State?

- No

Is there a separate legal entity in local jurisdiction?

- No

Does the NRE use Space/Place?

- Yes

Is the space/place fixed?

- No

NRE has fpob under 5(1) Need further tests to determine if NRE has PE under 5(1)

- Yes

Is there an agent?

- No

Is there a dependent agent?

- Yes

Does the dependent agent work at the NRE's fpob?

- Yes

Ordinary course of independent agent's business?

- No

Has the agent authority to, and does be habitually conclude NRE's contracts?

- Yes

Are the NRE's business activities carried out locally through an NRE employee or a dependent agent at the NRE's fpob?

- No

Are there NRE paid employees performing services?

- Yes

Are services/activities preparatory or auxiliary under 5(4)?

- No

PE under 5(1)

- Yes

PE under 5(5)

4.2. Sales tax system approach

Sales tax system is used in the United States of America (US) amongst other countries and hence reference will be made to the US as one of the countries that use the system. The US government’s view was that it should adopt a non-regulatory, market oriented approach to policy development on E-Commerce. It expressed its view that the Internet should be a tax-free environment whenever it is used to deliver products or services. It further emphasized that taxation of Internet sales should neither distort or hinder commerce; should be simple and transparent and be able to accommodate tax systems used by the US and its international trading partners. Having set the stage the Government enacted the Internet Tax Freedom Act of 1988. This Act established the three year moratorium on the state and local taxation of the Internet access and multiple or discriminatory taxes on electronic commerce.

The Internet Tax Freedom Act was designed to grow E-commerce unburdened by discouraging any tax on Internet access unless the tax existed prior to the Acts’ enactment. This grandfather provision was designed to preserve the right of states that taxed Internet access prior to the enactment of the Act to continue to do so. Further the Act excluded telecommunication services from the definition of Internet access thus preserving the states’ right to tax telecommunications services despite the ban on taxing Internet access. On the 3rd December 2004, President Bush signed the Bill extending the Internet Freedom Act until 2007.

The Act prevents the states from claiming jurisdictional nexus with a remote seller for purposes of requiring the remote seller to collect a use tax on its internet sales into the state, by characterizing an internet access provider as the remote sellers’ agent, solely as a result of the display of a remote sellers information or content on the out of state computer server of the Internet access provider or the processing of orders through the out-of-state computer server of the internet access provider. The Act also bars multiple tax on E-commerce. A multiple tax is defined as any tax that is imposed by one state on the same or essentially the same E-commerce that is also subject to another tax imposed by another state for taxes paid in other jurisdictions.


\[174\] ibid, s.1101(a) (2).
The United States of America (USA) generally taxes the U.S source income of non-resident individuals and foreign corporations. With respect to income that arises from a trade or business however, the United States generally asserts jurisdiction only with respect to taxable income that is effectively connected with the conduct of a trade or business within the United States. Under the income tax treaties, which the United States has entered into with Forty Eight (48) countries, the U.S, asserts its right to tax U.S source trade or business income of foreign individuals and corporations only when such income is attributable to a PE or fixed base in the United States.

The national and international interest in E-Commerce has had considerable effect on the American retail sales tax (RST). Retail sales tax generally applies only to sales of tangible personal property and not to sales of services or intangibles. Forty Five states and the District of Columbia have adopted RSTs. While a few states tax a wide range of services (including information and data processing services), most of the states sales taxes are limited to sales of tangible personal property.

RST was enacted in the depression period and the main objective was to protect loss of revenue and business to the states and merchants respectively, in the event that their residents shopped in neighbouring states with low or without RST. Under the Commerce and the due process clauses of the American Constitution, one state cannot impose a sales tax on a sale that occurs in another state. A use tax was introduced to solve this problem. A use tax is imposed on the use, storage or consumption of tangible personal property and selected services in the state. It is equivalent to a sales tax and is imposed with respect to the same transactions and at the same rates as the sales tax that would have been imposed on the transaction had it occurred within the states taxing jurisdiction. The use, storage or consumption of property and services within the state are subject to the states taxing power and therefore no constitutional objection can arise to the imposition of such a tax. This is set

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176 The US Internal Revenue Code No. 871, 881, 882.
177 ibid, Internal Revenue Code 871, 882.
179 ibid at page 345.
out in the Internet Freedom Act and affirmed by the Supreme Court\textsuperscript{181}. It would have been otherwise with the sales tax.

In principle, the in-state consumer must pay use tax if he purchases an item in a state that does not charge sales tax, and the use tax will be equivalent to the sales tax that he would have paid if the state jurisdiction in which he bought the item, imposed the same. For example if the state of Washington resident purchases a car in the state of Oregon, he would pay no tax in Oregon but would pay use tax in Washington upon registration of the car, equal to the sales tax that he would have paid in Oregon. Each state that imposes sales tax has a complementary use tax. It must be noted that the payment of use tax is difficult in some instances where the item need not be registered, for example purchase of books, personal items and intangible property or services. In that case therefore the use tax will entirely depend on the good will of the taxpayer to disclose and pay otherwise it would go untaxed.

Unless the out of state vendor has a substantial connection or nexus with the state, the states lack the constitutional power to require the vendor to collect use tax that the consumer owes with respect to the purchased item. In the case of \textit{National Bellas Hess, Inc Vs. Department of Revenue}\textsuperscript{182}, the US Supreme Court held that the Commerce and Due Process Clauses of the Federal Constitution prohibited the state of Illinois from imposing a use tax collection obligation on a mail – order seller with no physical presence in the state. The Court pointed out that the lack of harmonization among the state and local RSTs as the basis for barring the collection obligation on the remote seller. In the US two constitutional requirements must be satisfied when states seek to tax non-resident and interstate commerce; the due process clause\textsuperscript{183} and the Commerce clause\textsuperscript{184}.

Twenty five years later in 1992, the Court in \textit{Quill Corp Vs. North Dakota}\textsuperscript{185} reaffirmed the holding of Bellas Hess, that states may not require a mail – order seller without physical presence in the state to collect the use tax due on goods sold to out-of-state purchasers. In the Quill case, Quill Company sold office equipment and supplies exclusively through mail order. It advertised using mailed catalogues, print advertisements in national publications and

\textsuperscript{181} Henneford V. Silas Mason Co. 300 U.S 577 (1937).
\textsuperscript{182} National Bellas Hess, Inc Vs. Department of Revenue 386 U.S 753 (1967).
\textsuperscript{183} Due process clause provides the tax payer purposefully directs its activity into the taxing state and it provides little protection from a duty to collect use tax.
\textsuperscript{184} Nexus clause provides out of state vendors substantially more protection from a duty to collect use.
\textsuperscript{185} Quill Corp Vs. North Dakota 504 U.S 294 (1992)
telemarketing. It did not have any physical presence in North Dakota since it had no employees located there and it did not own or use any property in the state.

The Treasury department has given recommendations on the exception of a warehouse, that for a business that sells information instead of goods, a computer server might be considered the equivalent of a warehouse. Therefore a local server that merely stores or displays information of a foreign web site owner should not result in a PE in the local jurisdiction. The auxiliary activity exception may apply where a foreign owner of a web site merely supplies information accessible to users in the US who connect via a local server. Because activity of a preparatory and or auxiliary character would normally include the supply of information, a PE should not arise in this instance considering the extensive presence of advertising in E-Commerce. The OECD commentary also lists advertising as an activity of a preparatory and auxiliary nature. It can therefore be concluded that merely supplying information or advertising over the Internet does not constitute taxable presence\(^{186}\). It must be noted that the US, which was, initially against the server/PE rule, ultimately signed on to the new server /PE rule as a bait to encourage other countries to sign as well. The US treasury felt that the new server/PE rule would not expand source-based taxation and that it in fact promoted residence based taxation that the US has always been in favour. The streamlined sales tax project (SSTP)\(^{187}\) is currently attempting to simplify and standardize the US tax system with the aim of ensuring that taxation takes place at the point of consumption and is collected from the taxable vendor.

### 4.3. The European Union (EU) VAT system

There is little involvement by the EU on matters regarding direct taxation of E-commerce. It is however actively involved in indirect taxes such as VAT. EU is not a member of the OECD however 15 of its members are.

Under the EU the major issues being dealt with are the impact of E-Commerce and the changing concept of Permanent establishment. VAT is a sales tax levied on the sale of goods and services. In some countries such as Singapore, Australia and Canada, this tax is known as goods and services tax or GST. VAT is an indirect tax in that the tax is collected from someone other than the person who actually bears the costs of the tax. Maurice Laure

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invented VAT, in 1950s\(^{188}\) with the objective of discouraging high sales taxes and tariffs which encouraged cheating and smuggling. Being a general tax on consumption, revenue should go to the member state where actual consumption took place. One of the major objectives of the common VAT system therefore is to assign the tax to the member state where the final consumption of goods or services occurs via the rules governing the place of taxable transactions.

Personal end users of products and services cannot recover VAT purchases but businesses are able to recover VAT on the materials and services that they buy to make further supplies or services directly or indirectly sold to end users. In that way the total tax levied at each stage of the economic chain of supply is a constant fraction of the value added by a business to its products, and most of the cost of collecting the tax is borne by business rather than by the state.

VAT in the EU is organized under a compulsory system for member states and is imposed by a series of the EU directives, the most important being the sixth VAT directive\(^{189}\). Under the VAT system where a person carrying on an economic activity of supplying goods and services to another person and the value of the supplies passes the de minimis limit, (which currently stands at 100,000 Euros) the supplier is required to register with the local taxation authorities and charge its customers and to account to the local taxation authority for VAT.

Under the provisions of the 6\(^{th}\) Directive\(^{190}\) the determination of taxable place of electronic services is complex as it depends on the nature of the service, the tax status of the customer, the establishment of the supplier and customer, either their principal place of establishment or their fixed establishment involved in the transaction. The general rule is that electronic services are supplied at the place of the establishment of the supplier under Article 9(1). It must be noted that this rule was enacted in 1977 when most services were incapable of direct delivery from a remote place. It is therefore outdated and at the very least inapplicable to E-commerce.

Exceptions to the general rule, supply of services to non –EU customers is where the customer is established.\(^{191}\) The services include advertising, Consultancy services, data


\(^{191}\) ibid, Article 9(2)(e)
processing and supply of information. Such services are free of VAT at the establishment of the supplier if supplied over the Internet either to customers outside the EU or to VAT registered persons in other EU member states. If they are supplied by a non-EU supplier to a private consumer in the Community, the taxable place is again that of the establishment of the non-EU supplier and no EU VAT is due. These rules present challenges to the supply of digital products and services. Online services are not listed under Article 9. It has therefore been interpreted that Article 9(2)(e) applies to the supply of electronic books and software because they can be characterized as supply of information. This has brought uncertainty in the treatment of virtual goods generally and some countries like Spain treat the downloading of standard software via the Internet as the supply of goods rather than services for purposes of determining the place of supply rule.

Though the 6th Directive contains expressions such as the “place of business”, “fixed establishment” and “permanent address or usual address”, the terminologies are not defined. Neither are they defined in the OECD that uses the term PE or a fixed base. There is therefore need to harmonize the terms in order to create certainty and clarity in the treatment of various tax matters. Various interpretations have therefore been given for the definition of the place of business as used in the directive. Some have given the meaning of the registered office irrespective of where the actual business takes place, while others apply the place of actual business. A virtual Company supplying computer information without any significant operational substance or staffing could not fit in any of the definitions. The European Court of Justice in its various rulings requires a fixed establishment to have sufficient degree of permanence and human technical resources as well as the capability of supplying goods and services in an independent capacity. It concluded that a fixed establishment must therefore carry out its activities in an autonomous manner as a domestic enterprise. The presence of web servers therefore does not satisfy the concept of fixed establishment as interpreted by the European Court.

The distinction between the supply of goods and services is blurred and in most cases the classification by member states are not uniform. A supply of intangible goods when delivered in digital form is treated as a supply of a service. For example computer software that is

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192 Virtual goods are products and services capable of being delivered over the Internet.
195 6th Directive, Article 6
categorized as a good when supplied off the shelf (mass marketed, shrink wrapped). If it is customized for a particular customer it is treated as a service. The classification issue raises the problem of consistency in application among countries and also among categories of products depending on their nature. It appears the classification of a product changes not due to its fundamental product changes but due to the mode of storage and transmission. The differential treatment of a similar product based on whether it is digital or non digital is against the principle of tax neutrality. Trade distortions and tax arbitrage may occur where the switching between the two distribution forms take place.

Following changes introduced on the 1st July 2003, E-commerce transactions have been expressly provided for in the 6th Directive. Electronic services will become taxable where they are consumed. When the services are supplied by a taxable person to a taxable person (such as Business to business) the business customer is liable for VAT under the reverse charge mechanism. Taxable persons established outside the community supplying services by electronic means to non taxable persons, such as private customers are required to become identified for VAT in member states into which that taxable person supplies such services. Non-EU businesses providing digital electronic commerce and entertainment products and services to EU countries are also required to register with the tax authorities in the relevant EU member state, and to collect VAT on their sales at the appropriate rate according to the location of the purchaser. Alternatively, under a special scheme, non-EU businesses may register and account for VAT on only one EU member state. This produces distortions, as the rate of VAT is that of the member state of registration, not where the customer is located.

When goods are imported into the EU from other states, VAT is generally charged at the border at the same time as customs duty. Acquisition VAT is payable when goods are acquired in one EU member state from another EU member state. This is done through an accounting mechanism. Exports are zero-rated when crossing the EU borders. These rules apply to the movement of goods in transactions involving E-commerce (non-digital delivery) as they are applied to trade in conventional commerce.

The EU Directives therefore proposed to maintain the reverse charge for Business-to-Business transactions but impose a registration obligation with respect to non-EU suppliers engaged in Business to Customer transactions. It also made clear that EU suppliers to non EU

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196 Under directive 2002/38/EC.
customers would not be saddled with a VAT, which placed them at a competitive advantage to non EU suppliers. The EU is attempting to extend the VAT jurisdiction beyond the physical borders of the EU, an attempt which has been challenged by the American Chamber of Commerce, for fear of losing commercial advantages for their traders.

The unilateral impetus in the EU to tax electronically delivered products might trigger a world wide reaction with many countries following on the steps of the commission and enacting laws that will allow them to levy indirect taxes on all electronic deliveries that are finally consumed within the territory, irrelevant of the country of origin. This would make e-businesses wrestle with tens of different VAT regimes worldwide and the burdens of compliance would be so immense that non-compliance would be the order of the day. The directive is likely to bring conflicts between the EU and the US companies. Firstly, the US companies will be barred by the constitutional ruling from collecting VAT taxes on behalf of the EU companies and secondly the possible trade retaliation by US companies on the EU.

Another problem with the directive is the method to accurately verify the customers jurisdiction. To be able to assess which member state is applicable to the sale, the non-EU suppliers are going to have to be able to verify their customers' identity (business or final customer) and the jurisdiction in a real time, online environment. The challenge here will be the availability of reliable technology with the capacity to achieve 100% accuracy. Finally the EU as a block is facing serious disharmony in the taxation of E-commerce. Despite the guidelines various interpretations of the directives abound amongst the members, some contradicting not only the directive but another members internal laws and policies thus leading to the possible risk of double taxation, non – taxation or under taxation in some circumstances.

4.4. The Developing Countries’ approach

Outside the developed countries (outside the OECD member countries) various countries have adopted widely varying policies toward E-Commerce taxation. Some are seeking to tax the income of foreign companies based solely on an economic rather than a physical presence. As such, countries may characterize payments from domestic subsidiaries for use of the their foreign parent computer systems as royalty income rather than payment for services. For example, Singapore has adopted an approved cyber-trader tax incentive regime to

promote E-Commerce operations. This tax regime includes a 10% concessionary tax rate on incremental off-shore trading income derived by the approved cyber-trader from the Internet transactions in non-Singapore currency, a 50% investment allowance on approved cyber-trader from Internet transactions in non-Singapore currency, a 50% investment allowance on approved capital equipment, and a full or partial relief on certain royalty payments made to non-residents.\textsuperscript{199}

In Countries that adopt source based taxation such as Hong Kong, taxation of E-Commerce has been given the same treatment as conventional taxation with the aim of achieving neutrality of taxation. The operational test, that is the trade must be carried out in Hong Kong, is the benchmark in identifying the source of the profit.\textsuperscript{200} This was the decision in the case of CIR V, The Hong Kong & Whampoa Dock Co. Limited.\textsuperscript{201} If the source is Hong Kong the profit is fully taxed and if it is outside Hong Kong the profit is fully exempt. In contrast to the OECD definitions, Hong Kong considers a server not to constitute a PE. The taxing authority looks more to the physical location of the business rather than that of the server. It therefore follows that Hong Kong still follows the concept of a PE in the conventional business model. Though, Hong Kong has not legislated on the taxation of E-Commerce, the taxing authority has given the above guidelines which in many respects amounts to non-recognition of the E-Commerce business model and its relation to the concept of a PE in taxation. What this portends is that E-Commerce in its virtual form goes unnoticed and therefore untaxed by the Hong Kong taxing authority.

Some countries like Malta, though it has legislation on E-Commerce generally has elected not to legislate on taxation of E-Commerce. It is therefore deemed that taxation of E-Commerce shall be based on the taxation principles and concepts of the conventional Commerce. E-Commerce therefore operates in a tax free environment and the argument the Maltese

\textsuperscript{200} Noronha, Carlos, Taxation of E-Commerce in Hong Kong, 2003, Article found at \texttt{<http://www.emeraldinsight.com/026-6902.htm> accessed on 23\textsuperscript{rd} August 2005, page 703.}
\textsuperscript{201} Noronha Carlos, “Taxation of E-Commerce in Hong Kong”, 2003, Article found at \texttt{<http://www.emeraldinsight.com/026-6902.htm> accessed on 23\textsuperscript{rd} August 2005, page 703.}
Government has adopted is to develop its E-Commerce industry as a way of encouraging foreign investment\textsuperscript{202}.

South Africa has enacted legislation on E-Commerce namely, The Electronic Communications and Transactions Act, 2002\textsuperscript{203}. The preamble of the Act states the objectives as the provision for the facilitation and regulation of electronic communications and transactions and to encourage the growth of E-Commerce. South Africa changed its taxation system from source/residence to world wide/resident system in the year 2002 and it is expected that the issue of taxation of E-Commerce shall take center stage in ensuring that the country gets revenue from all profits within and outside South Africa.

Most of the other countries in the African Continent are still behind in the development of E-Commerce. Lack of intellectual capacity to develop E-Commerce, poor ICT infrastructure, lackluster support from bureaucratic Governments, lack of legislative and policy framework, lack of capital market to fund E-Commerce ventures, amongst other myriad of economic and social problems have contributed to the lack of ICT infrastructure on which E-commerce would thrive.

The development of ICT is indeed the limiting factor to the development of E-Commerce in developing countries mainly in Africa. Unless ICT is permitted to flourish so that businesses can take advantage of the same in conducting their day to day businesses, E-Commerce will not thrive. The ICT frequencies need to be freed, licensing of ISPs and the availability and affordability of hard and software made possible. The number of companies must be increased and the population should be enabled to use computers by training. This requires cooperation and involvement of both industry/business and the Government.

For developing countries to attract foreign direct investments they must be proactive to use fiscal legislation to encourage investment. In that regard therefore it is pertinent that though most developing countries are not members of OECD they should attempt to adopt those taxation rules and regulations that will enable them to, secure both the foreign investment and guard against leakages of tax revenues. This is especially important because the taxation systems in these countries are mainly source based, meaning that unless they strategically


\textsuperscript{203}cited at \url{<http://www.Internet.org.za/ect_act/}} accessed on the 17\textsuperscript{th} August 2005.
review their fiscal policies they will continue to lose revenue because online businesses have no regard to physical boundaries, anyway.

It must be noted that protectionist tax policies may ultimately be self-defeating because the Internet allows developing countries to compete in global markets in ways that previously were impossible. For example, software development and data processing firms in India have used the Internet to win business customers around the world and developed as a strong exporter of Internet Technology in the developing world. The many software and hardware development firms that have mushroomed in India attests to this. Other than it being a huge market in itself and for the Asian Market generally it also has one of the lowest business setups in the world.

As an introduction to this chapter, it must be recalled that the emergence of E-Commerce as a new business model has sparked a huge debate on whether or not to tax this phenomenon. If the answer is in the affirmative then the next question would be under what tax rules and laws shall it be taxed. Some have argued with convincing reasons that E-Commerce should not be taxed (either by legislation or Government inaction), so as to enable it to grow out of its infancy and compete with the conventional commerce. That it should be given a grace period or an incubation period before the tax man can raise his tax hammer on it. Another school of thought has vigorously opposed the above argument and maintained that to achieve equity in taxation, E-Commerce must be taxed just like the conventional business. This group has supported the introduction of bit taxes. It is argued that E-Commerce is just another business model like conventional commerce and there is no reason why it should be exempted. Any attempt to exempt E-Commerce will lead to business being E-Commerce-driven with the objective of avoiding taxes, hence leading to distortion of tax revenues to Governments and taxing authorities.

Neither of the above two extreme views have proved acceptable to Governments. The first argument (tax free E-Commerce) would lead to Governments being unable to meet legitimate demands of the citizens for the provision of public services. It could also have the effect of inducing tax distortions in trade patterns internationally. The second argument (introduction of bit taxes) could hinder the development of E-Commerce and lead to technology

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204 A bit tax is a tax imposed on the bits used in Electronic transactions. It has been argued that a bit tax cannot give the transactional value and basis for sound taxation.
becoming tax driven.

4.5. Suggested approaches

4.5.1. Introduction

There are various recommendations that have been proposed as alternatives to the concept of PE under E-commerce. They are discussed below:-

4.5.2. Expanded definition of Permanent Establishment.

In the Pipeline Case\textsuperscript{205}, the concept of PE was given a broad interpretation. A Dutch Corporation owned underground pipelines in the Netherlands and Germany through which it supplied oil to German oil companies. The pressure for the transportation of the oil was supplied from the Netherlands, from which all the oil transportation within Germany was regulated by remote control through a computer. The Dutch Company had no employees in Germany, and all its technical and marketing personnel were situated in the Netherlands. Independent contractors did all maintenance and repair of the pipelines in Germany. The Court held that the German Corporation did have a PE in Germany. In so holding the Court interpreted the term "Permanent Establishment" to include any fixed place of business that serves the business activities of the taxpayer with a fixed nexus with the earth's surface, of certain duration and over which the taxpayer has more than only temporary dominion and control. Significantly, the Court explained that in the case of fully automated equipment, a PE can exist even in the absence of a human presence.

4.5.3. Formulary apportionment.

Formulary apportionment assigns income to a country by reference to a mathematical formula that reflects the factors of production, or are deemed to produce the income. Under the apportionment method, the taxing country considers the income generated by all the enterprises' activities, out of country as well as in the country and then apportions a share of such income to the taxing country by means of a formula that compares the enterprise' in-country activities to all of its other activities. An apportionment formula might attribute income to a country on the basis of the percentage determined by averaging the ratios of the enterprises property, payroll and sales within the taxing country to its property, payroll and sales everywhere\textsuperscript{206}. The OECD takes the position that the apportionment method is generally

\textsuperscript{205} Bundesfinanzhof (BFH)II Betriebs-Berater, 52 (1997), 138; see also article by Sweet, John K, University of Pennsylvania Law Review Vol. 146, issue No. 6 at page 13, entitled "Formulating International Tax Laws in the Age of Electronic Commerce; The Possible Ascendancy of Residence Based Taxation in an Era of Eroding Traditional Income Tax Principles".

\textsuperscript{206} OECD commentaries, 2001, Art.7 para. 27.
not as acceptable as the arms length method for attributing income to a PE and should be used only in exceptional situations where as a matter of history, it has been customary in the past and is accepted by tax payers and taxing authorities in the country concerned.

Income from E-commerce may be allocated to each jurisdiction in which the income was earned on the basis of a formula. Each jurisdiction’s taxing authority will be limited to the amount of income so allocated. The proponents of the formulary apportionment based on criteria such as property, payroll and sales argue that E-commerce blurs the geographical borders making it difficult to determine arm’s length transactions and hence the attraction offered by the formulary apportionment. One formulary apportionment method that is currently being advocated is for tax authorities to negotiate advance pricing agreements that apply to specific types of operations by specific taxpayers. This certainly bears the problem of obtaining an international forum where all the countries involved can negotiate and sign the agreements. It must be agreed that the use of formulary apportionment may or may not offer a better method of allocating income than the current PE test.

4.5.4. Introduction of transactional taxes.

This tax would be levied on financial flows over the internet and on payments for online services. The tax would be withheld automatically by banks or other financial intermediaries involved in the transaction. Although it has been contended that this tax would be based on the inflow of money there is no fixed relationship between money flows and taxable income (business profits). The tax would therefore have adverse effects on the allocation of resources and on the manner in which business is organized. Further the bank would need information on the underlying transaction which information may be difficult to verify. In addition, it is uncertain whether the place of money transfer offer a sufficient nexus to establish taxing jurisdiction.

4.5.5. Introduction of bit tax.

A bit tax could be levied on transmission of digital information, irrespective of the value of information. It is argued that bit tax can be collected on a global basis then tax revenue can be allocated fairly to all countries that participate in E-commerce. However potential administrative and compliance problems have virtually challenged this idea. The Cayman’s

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Island contracted with Cable and Wireless to collect a bit tax from its customers and remit a percentage to the Government. The imposition of the tax proved very unpopular with individual and low volume commercial users and was abandoned except for high volume commercial users with permanent connections\textsuperscript{209}. It is understood that the growing interest in bit tax is the objective to collect a share of the revenue generated by E-commerce.

The EU have rejected this tax arguing that the VAT system applies to the same transactions and therefore it would amount to duplication of taxes. The proponents of bit tax believe that bit tax recognizes the value added by the network interactivity. It is also thought that bit tax will reduce the congestion on the information superhighway. The school of thought that is opposed to bit tax has argued that bit taxes have the effect of burdening E-commerce, impeding its growth, eroding its productivity, and discriminating against internet users and providers. It is also argued that it does not satisfy the tax policy criteria of neutrality and equity. It is not neutral since it is only imposed on digital transfers. It is not equitable since it taxes consumers without regard to the nature of the message being transmitted, for example a vital medical report would be taxed in the same manner as unsolicited junk e-mail.

At the moment there is no consensus on the viability of bit tax as an alternative to the concept of PE to E-Commerce. Until such time that global E-commerce shall have created mobile tax bases that are difficult or impossible to capture by traditional consumption taxes, a bit tax might remain an idea of the future.

4.5.6. The use of Withholding tax.

It has been recommended that the low rate withholding tax imposed by source countries on business to business E-commerce sales may be an appropriate alternative to the current application of the PE concept\textsuperscript{210}. The gross tax should be creditable in the country of residence to avoid international double taxation. The residence based tax payer should have the option to file a return in the source country and pay a net income tax instead of the gross withholding tax. The Indian Ministry of Finance has supported this approach but with a slight variation, that is, that withholding tax should be applied to all cross border transactions,

\textsuperscript{208} Avi- Yonah, "International Taxation of Electronic Commerce" (1997) 52 TAX LAW REV. 507, AT 545-9.
\textsuperscript{209} Soete and Kamp, "The Bit Tax; Taxing Value in the Emerging Information Society" in Cordell and Ide Editions; "The New Wealth of Nations; Taxing Cyberspace" Toronto; 1997, page 214
(both E-commerce and conventional commerce) that erode source state revenues. The withholding tax should represent the firms final tax liability\textsuperscript{211}. In addition, India’s tax authorities have been aggressive in characterizing cross border E-commerce payments as resulting in royalty income in order to impose royalty withholding taxes pursuant to its tax treaties\textsuperscript{212}.

The OECD has argued against the use of withholding taxes on the grounds that these taxes are often placed on unprofitable activities hence punishing or distorting cross border trade and investment. On the other hand, it has led a worldwide trend toward reduction in withholding taxes to stimulate more international investment and trade. In my view withholding taxes work well in practice and represent the best way for tax authorities with few resources to protect their tax base from erosion that results from remote cross border transactions.

4.5.7. The Economic presence test.

This approach involves the creation of an economic presence test PE within model treaty that would permit source countries to tax significant cross border economic activity. A quantitative threshold such as gross sales will ensure that source countries can only subject non resident companies to their tax jurisdiction if these non residents conduct significant business activities within their borders. This rule is designed to protect source country income tax base erosion and promote greater business certainty surrounding the taxation of many cross border transactions.

The Economic presence test is similar to the League of Nations draft of 1940 (popularly known as the Mexico Draft) that permitted source state to tax despite an absence of a fixed place of business\textsuperscript{213}. It must be noted that the Mexico draft which was viewed by the industrialized nations as expressing a developing world’s view was not adopted by the League of Nations and was shelved for the London draft that emphasized the current PE principles.

\textsuperscript{212} Ibid, at page 11-14
The Economic presence test would encourage a balanced sharing of revenues between capital exporting and capital importing nations. The sharing will in turn discourage aggressive practices by capital exporting nations that are losing revenue due to the changing commercial practices. Economic presence test would discourage double taxation and may forestall the growing use of withholding taxes.

4.5.8. Introduction of a Virtual PE.

To serve E-commerce taxation, a virtual PE has been proposed where source countries could be permitted to tax cross border profits as long as the non resident company conducts continuous and commercially significant business activity within the source country\(^{214}\). In order to determine source state nexus, a facts and circumstances criterion could be developed that employ qualitative criteria for example presence of computer servers or use of trade marks as well as a quantitative criteria such as significant volumes of sales. The problem with this approach is the uncertainty it is likely to create. Further empirical analysis is required to determine the efficacy of the approach.

4.5.9. Maintain status quo.

This approach envisages a case of inertia. It advocates for Governments to do nothing. In my considered opinion inertia is not an option given the fast growing significance of E-commerce. This approach is premised on the argument that it is too early to regulate E-commerce taxation. It is felt that there is no sufficient knowledge and experience to enable proper amendments of the current international principles of taxation. That the timing is not yet right. This stand has been taken by many countries developed and developing alike, but for different reasons. The developed countries’ reason is to enable E-commerce to develop unburdened while the developing is either fear of losing revenue or lack of understanding of the whole concept.

4.5.10. Enhanced source taxation.

This approach is based on the concept that it is the place of income generating activity rather than the jurisdiction where the income producer resides that economically contributes to the production of income and should be compensated for that contribution. The Government of the source country contributes to the business environment by providing security, peace, enabling legislation and infrastructure and should have a higher right to tax the income being

generated therein. As many Companies continue to become global enterprises, the accuracy of determining the place of effective management declines. They may not be a single locus where management decisions are made. There may be made in many jurisdictions or through video conferencing in cyberspace. Focusing on where income is generated may offer a better chance of international taxing authorities to collect an appropriate tax and not inflict double taxation on entrepreneurs. For this approach to work there has to be an international consensus on the determination of source. This approach will be attractive to source based taxation countries because it will allow them the right to tax income from E-commerce that arises in the source country but not generated through a PE.

4.6. Conclusions
An increasing amount of commerce is done in digital (non-physical) form where the existence of customers and payment methods are not traceable. From the above, it is evident that each economic block is struggling to find solutions to the challenges that E-Commerce is posing to the traditional principles of taxation. There is yet no consensus on how E-Commerce is to be taxed. There is also no consensus on the treatment, application and interpretation of the concept of PE in relation to taxation of E-Commerce. Each economic block and country is dealing with the matter from a taxation point of view, that is, how much tax shall be lost or gained from the application of PE to E-Commerce taxation. Big economies like the US, are happy to operate a tax free E-Commerce to boost their industries while the EU on the other hand is trying to protect their own economies and revenues from tax and investment losses.

The challenges being faced by the developing countries are very different from those facing the industrialized countries. The effect that the opportunities and threats brought by E-Commerce is quantitatively and qualitatively different as between developed and developing countries. International strategies and methodologies derived from organizations such as the OECD which is dominated by the US and the developed world, means that the solutions devised shall be beneficial to the developed world. Developed countries have the financial strength to withstand the revenue loss whereas the developing countries have huge budgetary deficits and any change in revenue base will jeopardize their already fragile economies. The present zero tax options for E-Commerce that seem to have been preferred by Industrialized
countries will result in huge potential loss of revenue for developing countries. All the benefits of a zero tax policy will go to industrialized countries, thus increasing the digital gap between the developed and the developing countries. The present initiatives seem to ignore or side step these differences and it is up to the developing countries being net importers of technology to take up the challenges and review their fiscal and technological laws and policies to be able to benefit from E-Commerce. It is therefore evident that developed countries have taken measures either to legislate for or against taxation of E-commerce while the majority second and third world countries have adopted a wait and see attitude.

Any approaches to deal with the challenges of E-Commerce must as of necessity reflect the following considerations; interpersonal and international equity, economic efficiency and competitiveness, simplicity, low compliance costs, legal certainty and coherence and the flexibility in keeping pace with technological and structural development. The OECD has already set the pace by stating that whatever solution is adopted should be relatively simple, facilitate voluntary compliance and should not advantage or disadvantage E-commerce over conventional commerce.\(^\text{215}\)

CHAPTER FIVE

5. RECOMMENDATIONS AND CONCLUSIONS.

The challenges facing taxation of E-commerce are enormous and requires International cooperation and consensus. International consensus is essential in achieving the common objective of establishing a stable tax environment that will enable E-commerce to develop its full potential, while at the same time enabling governments to protect their revenue bases. It is however realized that to achieve international consensus on an equitable and acceptable tax policy to all countries is not easy because of the varied and individual interests.

The argument of this paper was that the concept of PE should be abandoned for an alternative criteria which is adaptive to E-commerce. However from my research it is clear that E-commerce being an evolving business model requires time to develop and also Governments require a workable alternative criteria that will not only secure their tax revenues but prevent double taxation. It is therefore recognized that Governments and taxing authorities at this stage cannot be expected to jettison tax principles and rules and operate in a vacuum. Tax as it is said is as sure as death.

I would like to recommend that the definition of PE as given under the OECD Model Tax Treaty and described in chapter 3, section 3.2 should be amended to incorporate the unique attributes and characteristics of E-commerce, the essential one being non-physical in that it occurs electronically. It is difficult therefore to find a taxable physical presence within a country since there are often no physical business offices in existence anywhere. The individuals responsible for a web page are often located in various parts of the world. The server can be located anywhere in the world regardless of where the information it contains is derived from and the web page is accessible to people all over the world. It is evident that E-commerce cannot be taxed using the existing PE test that lays emphasis on physical presence as its cornerstone. Virtual E-commerce compliant definitions must be designed to capture E-commerce transactions. Unlike conventional commerce E-commerce can be transacted through a different set of intermediaries and agents such as a server. The need for human intervention is dissipating quickly thus to constitute a PE, an entity need not be represented
by a human agent or employee physically in the jurisdiction.

I recommend a complete break from the physical test as a criteria of determining PE for purposes of allocating taxing rights under E-commerce and adopt an economic test. This can be achieved by amending the definition of PE in respect to E-commerce taxation. For this test to work, there has to be an agreement on how to determine the quantitative threshold of business volumes conducted in the jurisdiction.

However it is the conviction of this paper that continued application of the current PE test should continue to serve conventional commerce while Governments and taxing authorities continue discussing and evaluating new alternatives for taxation of E-commerce. All these efforts must be undertaken to ensure that the cannons of taxation namely neutrality, equity, efficiency, certainty, simplicity fairness and flexibility are upheld.
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