E-COMMERCE: A CRITIQUE ON THE DETERMINATION OF A "PERMANENT ESTABLISHMENT" FOR INCOME TAX PURPOSES FROM A SOUTH AFRICAN PERSPECTIVE

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1 Introduction

Before any country can levy a tax on income, a connection or tax nexus must be established between itself and that income. Example of such a connection are the residence nexus, by which residents are taxed on their world-wide income, and the source nexus, by which persons are taxed on income that originates within the geographical confines of the country.[1] If a multinational company incorporates a subsidiary company in another jurisdiction, the subsidiary is considered a separate legal entity that is liable for tax as a resident of that jurisdiction. But if a business entity is not considered a resident[2] of the jurisdiction in which it is situated, that jurisdiction may not levy taxes on its income unless the business profits of the entity can be attributed to a permanent establishment ("PE") located in that jurisdiction.[3] The significance of a PE is that it gives the country in which the business entity is situated (the source country) the right to tax its income, notwithstanding the fact that the PE has no separate legal existence.[4]

The existence of a PE in the form of, for instance, an office or a branch[5] presupposes that an investor has a tax presence in the foreign country. In determining whether such a tax presence exists, a distinction has to be drawn between "trading with" a foreign country and "trading in" a foreign coun-

1 Meyerowitz *Meyerowitz on Income Tax* (2008) para 7 1
2 In South Africa, s 1 of the Income Tax Act 58 of 1962 defines a resident entity as one that is incorporated, established or formed, or has a place of effective management in South Africa
3 Art 7(1) of the OECD Model Tax Convention on Income and on Capital ("OECD Model Convention") July 2008 Condensed Version See also Olivier & Honiball *International Tax: A South African Perspective* (2008) 420; Arnold & McIntyre *International Tax Primer* 2 ed (2002) 73
4 Art 5(1) of the OECD Model Convention; Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* (*Series of International Taxation*) (1991) 71-101; Olivier & Honiball *International Tax* 95; Hoffart "Permanent Establishment in the Digital Age: improving and stimulating Debate through an Access to Markets Proxy Approach" 2007 *Nw J of Tech & Intell Prop* http://www law northwestern edu/journal/njtip/v6/n1/6 para 1 (accessed 30-09-2008)
5 Olivier & Honiball *International Tax* 2

try. "Trading with" a foreign country presupposes the lack of a tax presence in that country, whereas "trading in" a foreign country presupposes such a presence.

With the rise of e-commerce, "trading with" a country as opposed to "trading in" a country has become much more of a reality. In general, the PE concept is based on the premise that there has to be a physical presence of the business before the source country can tax its profits.[6] However, the advent of electronic commerce[7] makes it difficult to identify a taxable presence in a particular country.[8] This article analyses the meaning of the PE concept, sets forth its historical development and discusses the challenges that e-commerce poses for the PE concept. The limitations of applying the Organisation for Economic Co-operation and Development ("OECD") guidelines to tax PEs in the e-commerce era are pointed out and a recommendation is made for the effective taxation of income from e-commerce transactions in a source country.

2 The evolution of the PE concept

The PE concept evolved in the nineteenth century under German domestic law to prevent double taxation by the Prussian municipalities.[9] The concept as developed by Prussian courts, connoted a structure of "bricks and mortar" at a geographic point in the territory of the taxing state. The core elements in the PE concept were that an enterprise was required to have a fixed location and the intention to perform its business activity at that place.[10] In 1899 the first international tax treaty was entered into between Austria-Hungary and Prussia and it relied heavily on the definition of a PE taken from judicial practice in Prussia, particularly the requirement of a fixed place of business.[11] The German Double Taxation Act of 1909 included a basic concept of PE which required three things: (i) the existence of the place of business; (ii) the location of the business at a specific geographical spot; and (iii) permanence of the business activity.

The modern version of the PE concept was developed after World War I (1914-1919), at a time when significant international commerce in foreign markets required the creation of a branch or similar physical presence.[12] In 1927, the League of Nations developed the first draft convention on double taxation which included branches, factories, agencies and offices as examples of PEs. A distinction was made between dependant agents and independent agents, and dealings through a "bona fide agent of independent status" were

6 Sher "A Band-Aid or Surgery: it is time to evaluate the Health of the Permanent Establishment Concept" 1999 *Tax Manag Int J* 415

7 See 4 below

8 SARS *Discussion Document: Electronic Commerce and South African Taxation* (2000) 5-6

9 Skaar *Permanent Establishment* 72-75; Hoffart 2007 *Nw J of Tech & Intell Prop* para 7; Levine & Weintraub "When does E-commerce result in a Permanent Establishment? The OECD's Initial Response" 2000 *Tax Manag Int J* 220; Sher 1999 *Tax Manag Int J* 416

10 Skaar *Permanent Establishment* 72; Levine & Weintraub 2000 *Tax Manag Int J* 220-221

11 Skaar *Permanent Establishment* 75-77

12 Huston & Williams *Permanent Establishments: a Planning Primer* (1993) 1-10; Skaar *Permanent Establishment* 65-101

held not to constitute a PE in that country.[13] In 1943 the League of Nations published the first Model Tax Treaty for developing countries. This model favoured source-state taxation of business activities without the requirement of a PE. However, in 1946 the Model Tax Treaty was revised to include a PE as a condition for source taxation of business profits.[14] The PE rules as promulgated by the League of Nations were embodied in the first report of the OECD which was issued in 1958.[15] The report included the definition of a PE[16] which was subsequently included in the OECD's Draft Taxation Convention on Income and Capital Tax in 1963 that was succeeded by the 1977 Model Tax Convention. This has been maintained in the successive OECD Model Tax Conventions.

Historically, there are two main rationales for the PE concept. First, the presence of a PE was evidence that a foreign company conducted significant business within the source country.[17] Secondly, the PE concept permitted source countries to share in tax revenues from the profits created by commercial opportunities presented by their markets.[18] The concept represented a form of international equity in that it provided a reasonable compromise between the interests of nett-exporting nations and nett-importing nations. The exporting nations derived revenues from taxing value added at the production stage while the importing nations derived revenues from taxing the income generated by sales activities.[19] This sharing of tax revenues also provided an incentive for residence and source countries to cooperate in reducing international double taxation, hence promoting international trade.

3 The definition of the PE concept

For South African income tax purposes, a "permanent establishment" is defined with reference to the definition of the concept in article 5 of the OECD Model Convention.[20] Although South Africa is not an OECD member country, most of its treaties are based on the OECD Model Convention.[21] Section 108(1) of South Africa's Income Tax Act 58 of 1962 ("the Income Tax Act") read with section 231(2) of the Constitution of the Republic of South Africa, 1996 ("the Constitution") provide that once a double tax treaty has been approved by parliament and has been published in the *Government Gazette*, its provisions are as effective as if they had been incorporated into the Income Tax Act. In interpreting the term "permanent establishment", which

[13] Hoffart 2007 *Nw J of Tech & Intell Prop* para 8; Skaar *Permanent Establishment* 82-86; Levine & Weintraub 2000 *Tax Manag Int J* 221

[14] Skaar *Permanent Establishment* 98

[15] Hoffart 2007 *Nw J of Tech & Intell Prop* para 9

[16] See 5 below

[17] Skaar *Permanent Establishment* 78-79

[18] Kaufman "Fairness and the Taxation of International Income" 1998 *Law & Pol'y Int'l Bus* 145; McLure "Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws" 1997 *Tax L Rev* 269 361-362; Tillinghast "The Impact of the Internet on the Taxation of International Transactions" 1996 *Bull Int Fiscal Doc* 524-525; Hoffart 2007 *Nw J of Tech & Intell Prop* para 9

[19] Skaar *Permanent Establishment* 88-95

[20] S 1 of the Income Tax Act 58 of 1962

[21] For example, see Art 5 of the treaty between South Africa and Spain *GG* 30837 of 2008-03-12 Other treaties are available at http://www sars gov za/home asp?pid=3919 (accessed 07-10-2008)

is a treaty term, it was held in *SIR v Downing*[22] that South Africa should take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Convention. It's also worth noting that in terms of the Constitution, South African courts are bound to apply customary international law.[23] This includes the Vienna Convention on the Law of Tax Treaties.[24] Although South Africa is not a signatory to this Convention, as the Vienna Convention is a codification of customary international law, South African courts should be guided by this Convention in respect to treaty interpretation.[25] Article 32 of the Vienna Convention points out that supplementary means of interpretation (which include the OECD Model Convention) can be taken into account in order to interpret terms used in a treaty.

Article 5(1) of the OECD Model Convention defines a PE as "a fixed place of business through which the business of an enterprise is wholly or partly carried on".[26] From this definition, three elements can be identified: (i) a place of business; (ii) the place of business must be "fixed"; and (iii) the business of the enterprise must be carried on through this fixed place of business. These elements are analysed below.

3 1 Place of business

A PE will only exist if the enterprise has a physical presence in the source state.[27] Under Article 5(2) of the OECD Model Convention, the following are examples of a place of business: a place of management, a branch, an office, a factory and a workshop. The size of the premises and the equipment required to constitute a place of business depends on the nature of the business and it is irrelevant whether the premises are rented or owned.[28] It should be noted that the above-mentioned activities in themselves are not conclusive evidence of the existence of a PE. The *prima facie* PEs of Article 5(2) must still meet the general test in Article 5(1).

3 2 The place of business must be "fixed"

For a place of business to be fixed, two requirements must be met, namely a specific geographical spot (the location test) and a certain degree of permanence at each geographical spot (the duration test). The location test requires a link between the place of business and a specific geographical point, but the place of business does not necessarily need to be physically connected to the ground. In applying this test, the context of the business has to be understood.

[22] 1975 4 SA 518 (A) 524
[23] S 232 of the Constitution
[24] 23 May 1969
[25] Olivier & Honiball *International Tax* at 33
[26] OECD *Model Tax Convention: Commentary on Article 5 – Permanent Establishment* (2003) para 2
[27] Olivier "The 'Permanent Establishment' Requirement in an International and Domestic Taxation Context: an Overview" 2002 *SALJ* 866 871
[28] OECD *Commentary on Article* 5 para 4; Skaar *Permanent Establishment* 155-157; Levine & Weintraub 2000 *Tax Manag Int J* 221

The key requirement is that the business should commercially and geographically consist of a coherent whole.[29]

Under the duration test, a certain degree of permanence is required in order for a PE to exist. The business should not be temporary in nature.[30] It should also be noted that the word "fixed" does not mean that no interruption of operations may occur, but operations must at least be carried out on a regular basis.[31]

3 3 Through which business is carried on

The business of the enterprise has to be carried on wholly or partly through the fixed place of business.[32] The phrase "carried on through" implies that the business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose.[33] A distinction has to be made between a PE "serving" an enterprise and one through which the businesses of the enterprise are carried on. To "serve" an enterprise, the activities of the PE may be the main activities of the enterprise or they may be auxiliary; they may be substantial or insignificant.

Although the business of the enterprise needs to be carried on through the PE, this does not mean that a PE will only exist if individuals are present. Thus, while the presence of individuals may be required for the setting up of a PE, their ongoing presence is not required.[34] The presence of fully automated equipment operated and maintained by the enterprise in the host country may constitute a PE. However, if the enterprise merely sets up the machines and then leases them to other enterprises, a PE does not exist.[35]

3 4 Exclusions to the PE concept

Article 5(4)(a)–(f) of the OECD Model Convention sets out certain activities which are excluded from the PE definition. The common feature of these activities is they are, in general, preparatory or auxiliary activities. Although it is difficult to distinguish between activities that are of a preparatory or auxiliary nature and those that are not, the OECD takes the view that the decisive criterion is whether or not the activity of a fixed place of business in

[29] Olivier & Honiball *International Tax* 97; Pijl "The Concept of Permanent Establishment and the Proposed Changes to the OECD Commentary with special reference to Dutch Case Law" 2002 *Bull Int Fiscal Doc* 554 555

[30] Olivier & Honiball *International Tax* 99; Levine & Weintraub 2000 *Tax Manag Int J* 222; Gárate "The Fixed Place of Business in the Context of Electronic Commerce" in Hans-Jörgen & Züger (eds) *Permanent Establishments in International Tax Law* (2003) 46; Pijl 2002 *Bull Int Fiscal Doc* 556

[31] OECD *Commentary on Article* 5 paras 6 1, 11; Olivier & Honiball *International Tax* 99; Doernberg, Hinnekens, Hellerstein & Li *Electronic Commerce and Multijurisdictional Taxation* (2001) 206; Pijl 2002 *Bull Int Fiscal Doc* 557

[32] OECD *Commentary on Article* 5 para 7

[33] Doernberg et al *Multijurisdictional Taxation* 206; Levouchkina "Relevance of Permanent Establishment for Taxation of Business Profits and Business Property" in Hans-Jörgen & Züger (eds) *Permanent Establishments in International Tax Law* (2003) 20-21

[34] OECD *Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention Article 5* (2000) http://www oecd org/dataoecd/46/32/1923380 pdf (accessed 04-09-2008) 36

[35] 36

itself forms an essential and significant part of the activity of the enterprise as a whole.[36]

3 5 Deemed PEs (dependent agents)

Although an enterprise may not have a fixed place of business in a host state, a PE is deemed to exist where a dependent agent has authority to conclude contracts on behalf of the enterprise and habitually exercises this authority in the source country.[37] The person making use of the authority must do so repeatedly and not merely in isolated cases.[38] Persons (whether natural or juristic) whose activities may create a PE should not be independent agents. According to the OECD, the following factors play an important role in deciding whether a person is a dependent or independent agent:

- the amount of freedom the person has to enter into contracts on behalf of the enterprise. Where the person operates under detailed instructions and control, this indicates a dependent status; and
- whether the risk is born by the enterprise or the agent. If the risk is born by the agent, then that person acts independently.[39]

From the above, it can be concluded that there has to be a physical presence at a "fixed place of business" or "agency presence" in a given jurisdiction to establish a PE.

The effective application of the PE concept, however, faces challenges when trade is conducted electronically. This is because with e-commerce, physical locations are not always required in foreign markets in order to engage in significant commercial activities. Below follows a discussion of what e-commerce is and the challenges e-commerce poses to the PE concept.

4 What is e-commerce?

E-commerce is broadly defined as the use of electronic networks to exchange information, products, services and payments for commercial and communication purposes between individuals (consumers) and businesses; between businesses themselves; between consumers themselves; within government; or between the public and government.[40] This technology enables the transmission of data, images, voices, and video information to take place in cyberspace by using the Internet.[41] The Internet is a global network of computers that allows people to communicate with other people from all over

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36 OECD *Commentary on Article* 5 para 24

37 Art 5(5) of the OECD Model Convention; Dazinger *International Tax Law* (1991) 34; Rohatgi *Basic International Taxation* (2002) 77; Pijl 2002 *Bull Int Fiscal Doc* 560

38 Olivier & Honiball *International Tax* 105

39 OECD *Commentary on Article* 5 para 37-38

40 Department of Communications *Green Paper on E-commerce: making it your Business* (2000) 9; Doernberg et al *Multijurisdictional Taxation* 2; Thorpe "International Taxation of Electronic Commerce: is the Internet Age rendering the Concept of Permanent Establishment obsolete?" 1997 *Emory International Law Review* 633 646-651; Westin *International Taxation of Electronic Commerce* (2000) 2; Hofman *Cyberlaw: A Guide for South Africans Doing Business Online* (1999) 30

41 Sher "Taxation of E-Commerce" 2000 *Income Tax Reporter* 172

the world.[42] It provides an environment in which automated functions can undertake significant business with little or no physical activity.[43] These functions can be easily and quickly moved from one jurisdiction to another without detection.[44]

These global computer-based communications cut across territorial borders, creating a new realm of human activity and undermining the feasibility and legitimacy of laws based on geographical boundaries. Because the Internet ignores international boundaries, "place" has little meaning in the networked world.[45] This makes it difficult to establish international norms for identifying the source of taxpayers' income.[46] It is feared that e-commerce may change the distribution of taxable activities, alter the balance of taxing authority and result in the erosion of countries' tax bases.[47]

E-commerce creates difficulties in the identification and location of taxpayers, the identification and verification of taxable transactions and the ability to establish a link between taxpayers and their taxable transactions, thus creating opportunities for tax arbitrage.[48] The rise of Internet-based companies in the mid-1990s, commonly referred to as dot-coms,[49] had governments throughout the world concerned that they would not receive their fair share of the revenues associated with e-commerce transactions.[50] However, it has been noted that the rise of the dot-com bubble and the associated fiscal challenges was generally over-estimated. By the mid-2000s, concerns that dot-coms posed a significant threat to countries' income tax bases appeared to have declined and for the past few years, countries seem not to be over-protective about the taxation of income from e-transactions. The concern of the international community seems to have shifted to the challenges e-commerce poses to indirect taxes like Value Added Tax, which is not the focus of this article. Nevertheless, the challenges posed to income tax by e-commerce are still a reality as they have not yet been fully resolved. It is thus necessary to address the dormant yet unresolved issue of the challenges involved in taxing the

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42 Buys *Cyberlaw @ SA: the Law of the Internet in South Africa* (2000) 11-12; Melvin *Cyber Law and E-commerce Regulation: an Entrepreneurial Approach* (2005) 52; Chen "United States and European Union Approaches to Internet Jurisdiction and their impact on E-Commerce" 2004 *University of Pennsylvania J of International Economic Law* 423 426-427

43 York & Chia (eds) *E-commerce: a Guide to the Law of Electronic Business* (1999) 257; Stravitz "Personal Jurisdiction in Cyberspace: something more is required on the Electronic Stream of Commerce" 1998 *South Carolina Law Review* 925

44 Schwartz "Transfer Pricing and Electronic Commerce" 1999 *Bull Int Fiscal Doc* 289; Oguttu "Transfer Pricing and Tax Avoidance: is the Arm's Length Principle relevant in the E-commerce Era" 2006 *SA Merc LJ* 156

45 Johnson & Post "Law and Borders: the Rise of Law in Cyberspace" 1996 *Stan L Rev* 1367 1370-1371; Cox "The Residence of Cyberspace and the Loss of National Sovereignty" 2002 *Information & Communication Technology Law* 241 244-245

46 SARS *Electronic Commerce* 5-6

47 York & Chia (eds) *E-commerce* 255; Hickey, Mathew & Rose *E-commerce: Law, Business and Tax Planning* (2000) 261

48 SARS *Electronic Commerce* 31; Buys & Cronjé *Cyber Law: the Law of the Internet in South Africa* 2 ed (2004) 307; Department of Communications *Green Paper on E-commerce* 22-23

49 For example, Amazon com Inc , an American on-line bookstore company Another example is eBay Inc , an American online auction and shopping company See Tetelman "Foundations of Electronic Commerce" http://learnlink aed org/Publications/Sourcebook/chapter5/Foundations_ecommerce_modelofuse pdf (accessed 20-11-2008)

50 Wikepedia "Dot-com Bubble" http://en wikipedia org/wiki/Dot-com_bubble (accessed 4-11-2008)

income of an e-commerce enterprise which has no taxable presence (PE) in a foreign country.

5 Challenges posed by e-commerce to the PE concept

5 1 The challenges in determining the existence of a fixed place of business

Multinational corporations have traditionally required some type of physical presence within foreign markets in order to engage in significant business activities.[51] Such a presence could for example take the form of a sales office in a foreign market to facilitate advertising and sales promotion to consumers within the market. These physical intermediaries may constitute PEs under tax treaties that permit source countries to tax the profits attributable to the intermediaries.

With the development of the Internet, online retailers can now accomplish much of their sales and advertising strategies via a website that transfers transaction costs to customers. An Internet website allows an enterprise to interact directly with its customers[52] thus eliminating the need for the presence of intermediaries in a given jurisdiction.[53] Customers do not have to visit physical places to buy certain commodities or gain access to certain services. By logging onto the website, customers can select products for purchase from an online catalogue and buy them by filling out a form and charging the purchase on their credit card.[54]

With the Internet, multinational companies can centralise many of their operations including sales, marketing and customer support that previously required employees or fixed bases within source countries. Websites can perform administrative functions such as communicating with the head office when a sale is registered within the source country, automatically taking into consideration exchange rates, and crediting accounts to the head office's accounting software program.[55]

The Internet also encourages the re-intermediation process, which is essentially the development of new intermediaries to facilitate business transactions over the Internet. These new intermediaries are online companies that do not require fixed places of business within source countries. These intermediaries link buyers and sellers on the Internet, thereby reducing transaction costs.[56] With such developments, multinational firms with existing PEs may begin to

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[51] Hoffart 2007 *Nw J of Tech & Intell Prop* para 2; Skaar "Erosion of the Concept of Permanent Establishment: Electronic Commerce" in Lindencrona, Lodin & Wiman (eds) *International Studies in Taxation: Law and Economics (Series on International Taxation No. 21)* (1999) 307 309-310

[52] Arnold & McIntyre *International Tax* 153; Oguttu & Van der Merwe "Electronic Commerce: Challenging the Income Tax Base?" 2005 *SA Merc LJ* 305; Craig "E-commerce: where to go with Taxation" in Schulz (ed) *Legal Aspects of an E-Commerce Transaction: International Conference in The Hague 26 and 27 October 2004* (2006) 231

[53] Shapiro "Digital Middlemen and the Architecture of Electronic Commerce" 1998 *Ohio North University Law Review* 795

[54] Arnold & McIntyre *International Tax* 153

[55] Cockfield "Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation" 2001 *Minn L Rev* 1179

[56] 1179.

shift part of their business operations from the PE in the source country to the Internet in order to consolidate their operations and outsource non-essential functions to foreign affiliates. This has the potential of reducing the amount of income that is attributable to a PE in the source country.[57]

5 2 Challenges to dependent agent PEs

Multinational companies often employ dependent agents in source countries to perform functions such as finalising complex contracts or exploring new business opportunities. With the Internet, the need for human intermediaries such as brokers, distributors or representatives is greatly reduced as Internet technologies can fully automate the order filling, contract negotiating, and payment processing that was traditionally performed by dependent agents.[58] This makes it difficult to find a PE based on the traditional formulation under the OECD Model Convention.[59]

Furthermore, independent agents can be hired if necessary at a fraction of the cost to accomplish many dependent agent functions.[60] Consider the hypothetical example of a software company resident in the United Kingdom that develops a procurement software program for the e-commerce business-to-business market. Instead of sending its own software engineers to start the program in South Africa, the company can hire independent foreign contractors in South Africa to code its software program at a minimal cost. The South African software engineers can be e-mailed their tasks through the company's intranet and can then return completed portions of the code via e-mail. Pursuant to the South Africa-United Kingdom tax treaty, South Africa would not be permitted to tax any profits associated with the development and ultimate sale of the procurement software (although it can tax the salary paid to the software coders) because the United Kingdom company does not maintain a PE within South Africa.[61]

6 How the OECD deals with the challenges e-commerce poses to the PE concept

In order to address the challenges e-commerce poses to the PE concept, the OECD developed certain guidelines which incorporate traditional principles in determining whether a website or a server qualifies as a PE (a fixed place of business through which the business of the enterprise is carried on or a dependent agent).

6 1 Can a website constitute a PE?

A website is essentially a location on the World Wide Web. It contains a home page, which is the first document users see when a web address is

57 1179.
58 1179.
59 Pinto "The Need to reconceptualise the Permanent Establishment Threshold" 2006 *Bull Int Fiscal Doc* 266 See also Skaar *Permanent Establishment* 316-318
60 Olivier & Honiball *International Tax* 104-105
61 Example adopted from Cockfield 2001 *Minn L Rev* 1187

accessed.[62] Websites consist of the software and electronic data stored on the server that allows an enterprise to interact directly with its customers.[63] According to the OECD:

> "An Internet website, which 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 premises or, in certain instances, machinery or equipment as far as the software and data constituting that website is concerned."[64]

Arnold and McIntyre also note that a website is a "virtual office".[65] As intangible property, it does not provide a regular link between the place of business and a specific physical geographical point and therefore cannot qualify as a PE.[66]

6 2 Can a server constitute a PE?

A server is automated equipment on which an Internet website is stored and through which the website is accessible.[67] Because a server is a piece of equipment that has a physical location, paragraph 42.2 of the OECD *Commentary on Article 5* provides that that location may constitute a fixed place of business of the enterprise that operates that server. Furthermore, a server which is used regularly for enterprise business may constitute a PE if it is at the disposal of the enterprise for that purpose.[68] When an enterprise conducts its business through a website that is hosted on the server of an Internet Service Provider (ISP),[69] such hosting arrangements do not result in the server and its location being controlled by, and at the disposal of, the enterprise even though the website of the enterprise is hosted on a specific server at a specific location.[70] This is because the enterprise does not have a physical presence at the location of the server since the website through which it operates is not tangible.[71] However, if the enterprise owns (or leases) and operates the server on which the website is stored and used, then the place where that server is located could constitute a PE since the server and its location are at the enterprise's disposal.

Even if the enterprise has a server at its disposal, the server must be "fixed" at a certain place for a sufficient period.[72] It is not the possibility of the server being moved which is relevant, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain

62 Sher 1999 *Tax Manag Int J* 422-423
63 Buys & Cronjé *Cyber Law* 303
64 OECD *Commentary on Article* 5 para 42 2; OECD *Clarification on Permanent Establishment* 5
65 *International Tax* 153-154
66 Buys & Cronjé *Cyber Law* 303; Gárate *Fixed Place* 54; Levine & Weintraub 2000 *Tax Manag Int J* 226; Duke "E-commerce and the Taxation Doctrine of Permanent Establishment in the United States and China" 2005 *J Transnat'l L & Pol'y* 280
67 OECD *Clarification on Permanent Establishment* 5; Buys & Cronjé *Cyber Law* 303; Levine Weintraub 2000 *Tax Manag Int J* 226
68 OECD *Commentary on Article* 5 para 42 3
69 Para 42 3
70 Para 42 3.
71 Para 42 3
72 Para 42 4

place for a sufficient period of time so as to become fixed within the meaning of Article 5(1) of the OECD Model Convention.[73]

Even if the enterprise has control over the server at a fixed place of business, the meaning of PE still requires that the business of the enterprise should be wholly or partly carried on through the place where the server is located. This requires a case-by-case analysis. For instance, the fact that the enterprise does not require personnel at the location for the operation of the equipment does not mean that there is no PE.[74] The presence of personnel is not necessary for the finding that an enterprise wholly or partly carries on its business at a location, when no personnel are in fact required to carry on business activities at that location.[75]

Paragraph 4.7 of the OECD *Commentary on Article 5* further provides that a server will only be considered a PE of the enterprise if the specific exclusions stated in Article 5(4) do not apply. Consequently, where the activities carried on through a server are restricted to preparatory or auxiliary activities, it will not constitute a PE. Such activities would include the provision of a communication link between supplier and customer, advertising of goods or services (for example, a display of a catalogue of certain products), relaying of information through a mirror server for security and efficiency purposes, gathering market dates for the enterprise and supplying such information.[76] However, if such functions go beyond preparatory or auxiliary activities in that they form the main or core function of the enterprise and they are an important and significant part of its business activities, then a PE will be deemed to exist.[77] For instance, some ISPs are in the business of operating their own servers for the purposes of hosting websites or other applications for other businesses. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary.[78]

From the above, it can be concluded that a PE based on a "fixed place of business" will only be deemed to exist when an enterprise carries on business through a website that has a server at its own disposal, at a fixed location, and the business of the enterprise is not of a preparatory or auxiliary nature. However, very few enterprises carry on business through their own servers and consequently they would not be taxable.

6 3 Can an ISP constitute a dependent agent PE?

An ISP is a company that supplies connections to the Internet, usually for a monthly fee.[79] It is common for ISPs to provide the service of hosting the websites of the enterprises on their own servers. The question then is whether an ISP constitutes a dependent agent PE of the enterprises that carry on

[73] Para 42 4.
[74] Para 42 6
[75] Paras 42 5-42 6
[76] Para 42 7
[77] Para 42 8
[78] Para 42 9
[79] Para 42 9.

e-commerce through the websites hosted on servers owned and operated by these ISPs. According to the OECD *Commentary on Article 5*, an ISP does not constitute a dependent agent of the enterprise to which the website belongs, because it does not normally have the authority to conclude contracts in the name of these enterprises.[80] ISPs normally act independently, in the ordinary course of their own business which entails hosting websites of many different enterprises.[81]

The OECD also makes it clear that the website through which an enterprise carries on its business cannot be considered a dependent agent since it is not a "person" as defined in the OECD Model Convention.[82] Consequently it does not comply with the dependent agent provision which specifically refers to a person acting on behalf of an enterprise.[83]

The discussion above on the tax treatment of servers as "computer equipment" has to be distinguished from the "automatic equipment" provision in paragraph 10 of the OECD *Commentary on Article 5*. This paragraph refers to automatic equipment such as gaming and vending machines, which are fixed in location and enter into completed transactions with customers. These are contrasted with computer equipment (servers) whose location is irrelevant to the customer and thus poses tax challenges.[84]

7 Other countries' responses to the OECD's Guidelines

A number of countries do not agree with the OECD guidelines on the taxation of PEs. According to Canada's Tax Administration, whether a file server fits the definition of a PE will depend on the facts and circumstances of the particular case. This issue will be dealt with on a case-by-case basis in a manner that is consistent with the Department's current published interpretations and rulings.[85]

In 1996, a German court argued that automatic equipment could constitute a PE.[86] However, in 1999, the German tax authorities issued a pronouncement that "for the time being" a server would not be considered a PE under the definition in the OECD Model Convention because the activities associated with the server are preparatory in nature.[87]

80 Para 42 10
81 OECD *Clarification on Permanent Establishment* 7; Arnold & Mclntyre *International Tax* 153
82 A person is defined in Art 3(5) of the OECD Model Convention as including an individual, a company and any other body of persons
83 OECD *Commentary on Article* 5 para 42 10
84 Levine & Weintraub 2000 *Tax Manag Int J* 229
85 Dhaliwal *Electronic Commerce and Canada's Tax Administration: a Response by the Minister of National Revenue to his Advisory Committee's Report on Electronic Commerce* 1998 http://www ccra-adrc gc ca/tax/business/ecomm/index-e html (accessed 13-07-2008) 6 3 2 4
86 *Bundesfinanzhof* decision of October 30, 1996 (IIR 12-92 published in Betriebs-Berater 1997 139) The Second Chamber of the German Supreme Court held that an underground oil pipeline, located in Germany but regulated by a computer from the Netherlands, constituted a PE in Germany for purposes of German business property tax For comments on this case, see Levine & Weintraub 2000 *Tax Manag Int J* 224; Olivier & Honiball *International Tax* 96
87 Karlsruhe Regional Tax Office *Decree (11 Nov 1998)* IStR (1999) 439; Hey "German Tax Authorities rule that Server does not constitute PE" 1999 *Tax Notes Int'l* 635

The United Kingdom's observation to Article 5 is that "a server used by an e-tailer, either alone or together with websites, could not as such constitute a PE".[88] The United Kingdom's Inland Revenue has also indicated that servers will not constitute a permanent establishment for United Kingdom tax purposes.[89]

Spain and Portugal have expressed a number of reservations about the OECD report entitled *Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention Article 5*. Their observation to Article 5 of the OECD Model Convention is that since the OECD's study of e-commerce taxation is ongoing, they will not necessarily take into consideration the OECD's guidelines until it has come to a final conclusion on the matter.[90]

The United States Treasury Department also rejected the view that a server could constitute a PE.[91] The Treasury noted however, that it is important to distinguish the situation where a server is integral to the realisation of the non-resident's profits.[92] For example, in the case of the equipment of a foreign telecommunications service provider, such equipment is integral to providing the service, and therefore the server may be deemed a PE as it would not meet the "auxiliary or preparatory" exclusion to the general rule in Article 5(1).[93]

The Dutch Advisory Group on electronic commerce has also recommended to the Dutch Tax Authorities not to regard a mere electronic presence through a server as a PE in the Netherlands.[94]

As stated above, South Africa is not an OECD Member State. However, non-OECD member countries can also indicate a reservation to any articles in the OECD Model Convention.[95] Since South Africa has not indicated such a reservation, it can be assumed that its courts could accept the OECD interpretation of taxing servers as PEs in the e-commerce context (although they are not bound to do so).[96]

8 Criticisms against the OECD's guidelines of the taxing of servers as PEs

The OECD seems to be of the view that existing international tax rules and principles are sufficient to handle emerging issues relating to the taxation of e-commerce business profits.[97] As discussed above, some countries

88 OECD *Commentary on Article* 5 para 54 5

89 Inland Revenue *Electronic Commerce: Tax Status of Websites and Servers* (press release) 2000-04-11 http://www inlandrevenue gov uk/e-commerce/ecom15 htm (accessed 05-07-2008)

90 OECD *Commentary on Article* 5 para 45 6

91 US Department of the Treasury, Office of Tax Policy *Selected Tax Policy Implications of Global Electronic Commerce* (1996) http://www ustrea gov/offices/tax-policy/library/internet pdf (accessed 04-09-2008) 25; Sher 1999 *Tax Manag Int J* 419; Duke 2005 *J Transnat'l L & Pol'y* 282-283

92 US Department of the Treasury *Selected Tax Policy* 25

93 Levine & Weintraub 2000 *Tax Manag Int J* 223

94 Levine & Weintraub 2000 *Tax Manag Int J* 223 See also Koch & Key "Taxation of Internet Transactions – a Swiss Perspective" 1999 *Tax Planning International* 16; Sher 1999 *Tax Manag Int J* 419

95 Levine & Weintraub 2000 *Tax Manag Int J* 223

96 Olivier & Honnibal *International Tax* 33

97 OECD Ministerial on Electronic Commerce *A Borderless World* (1998) http://www ottawaoecdconference org/English/conference-program/agenda pdf (accessed 04-06-2008); Gárate *Fixed Place* 72

have issued their own reports that endorse the OECD guidelines because they are trying to ensure that they will not lose out on tax revenues as a result of e-commerce. It is, however, important to note that the OECD guidelines which focus on the preservation of traditional international tax principles, such as the requirement of a physical presence (a server) in source countries, have little relevance for the world of e-commerce.[98]

At first glance, a server seems to fall within the traditional definition of PEs. However, e-commerce developments are frustrating the ability of countries to tax the profits from e-commerce as a result of traditional PE principles that emphasize the need for a physical presence within source countries. While the OECD has highlighted some circumstances under which a PE could exist for certain e-commerce transactions, a number of authors have criticised the OECD's views. Some of these criticisms are discussed below.

8 1 Difficulties in determining the location of servers

Tax authorities will find it difficult to tax the profits generated by servers located within their borders because the location of the servers and the functions performed by software code within the servers are highly malleable.[99] The OECD has also acknowledged that servers are highly mobile and flexible in nature.[100] The United States Treasury Department has noted that computer servers can be located anywhere in the world and their users are indifferent to their location. It is possible that such a server, or similar equipment, is not a sufficiently significant element in the creation of certain types of income.[101]

The location of a server can be easily moved between different countries (without affecting the underlying transaction). Servers can transfer their programs almost instantaneously to a server in a different jurisdiction if necessary.[102] Cockfield notes that servers and the software functions within a server form part of the hardware and software infrastructure of the Internet and can be shifted outside the country in which an e-commerce firm is based or where the software products are developed as well as outside of the source country where e-commerce goods and services are purchased.[103]

Mirror sites can, for instance, be established to direct customers to different servers depending on the level of traffic at any time. Actions such as these could frustrate the attempts of tax authorities to find a stable physical presence on which to base taxation under the PE concept.[104] The establishment of a PE may also be avoided by moving operations to a server in another country before the conditions of being "fixed" under the PE test are satisfied.[105]

98 Cockfield 2001 *Minn L Rev* 1189; Hoffart 2007 *Nw J of Tech & Intell Prop* para 4
99 Hellerstein "Transaction Taxes and Electronic Commerce: designing State Taxes that work in an Interstate Environment" 1997 *Nat Tax J* 593
100 OECD *Dismantling the Barriers to Global Electronic Commerce* (1997) http://www oecd org/LongAbstract/0,2546,en_2649_34223_2751231_1_1_1_1,00 html (accessed 04-06-2008)
101 US Department of the Treasury *Selected Tax Policy* 7 2 3 1
102 Cockfield 2001 *Minn LR* 1259
103 1259.
104 Pinto 2006 *Bull Int Fiscal Doc* 273
105 Skaar "Erosion of the Concept of Permanent Establishment" in *International Studies in Taxation* 316-319

With technological developments, central servers can be completely taken out of the transactional loop by peer-to-peer networking where users trade digital products without resorting to any centralized server location.[106] In these circumstances, it may be difficult to assert that business is being conducted through a server owned or leased by an e-commerce business resident in a country. The emergence of such networking techniques may ultimately frustrate the focus on physical aspects of the network.

It has also been noted that the location of a server often bears little relationship to the location of the essential economic activities of an enterprise that comprise the production and consumption of information.[107] In essence, the location of a server need not have any geographical connection to activities that add value and create income.[108] E-commerce makes it possible for functions to be disintegrated between servers, which makes it difficult in practice to determine whether activities are core or preparatory in nature.[109] These possibilities expose the vulnerabilities of trying to apply the PE concept to tax e-commerce transactions.

8 2 The possibility of increased tax avoidance schemes

There are income tax avoidance[110] opportunities available to taxpayers if servers constitute PEs. Tax-planning strategies can be effected by basing a server in a tax haven or low tax jurisdiction that imposes nil or minimum taxes on business profits.[111] The server's program can then be remotely uploaded, altered or repaired from a remote location. A number of tax haven and low tax jurisdictions have facilities to host servers.[112]

Cockfield notes that taxing servers as PEs will not effectively allocate taxing jurisdiction and revenues to source countries and that servers/PEs offer tax planning opportunities for multinational firms to shift income outside of residence countries.[113] For example, multinational companies can be encouraged to engage in transfer pricing strategies[114] by allocating related party profits to

[106] Talbert "Internet Telephony over Peer-to-Peer Networks" 2007 http://www articlexplosion com/articledetail php?artid=629&catid=30&title=Internet+Telephony+over+Peer+t (accessed 03-07-2008)

[107] Hellerstein 1997 *Nat Tax J* 593

[108] Cockfield "Reforming the Permanent Establishment Principle through a Quantitative Economic Presence Test" 2004 *Tax Notes Int'l* 643

[109] Cockfield "Balancing National Interests in the Taxation of Electronic Commerce Business Profits" 1999 (74) *Tulane LR* 133

[110] The term "tax avoidance" refers to the use of legal methods of arranging one's affairs so as to pay less tax See Meyerowitz *Income Tax* 2008 para 29 1; De Koker *Silke on South African Income Tax 3* (2008) para 19 1

[111] Sher 1999 *Tax Manag Int J* 425; Cockfield 2004 *Tax Notes Int'l* 643

[112] Ng "Singapore offers Tax Incentives and Advantages to E-Businesses" (2000) 21 *Tax Notes Int'l* 16; Sher 1999 *Tax Manag Int J* 425

[113] 2004 *Tax Notes Int'l* 643

[114] The term "transfer pricing" describes the process by which related entities set prices at which they transfer goods or services between each other It entails a systematic manipulation of prices in order to increase or reduce profits artificially or to cause losses and avoid taxes in a specific country See SARS *Practice Note No 7 Determination of Taxable Income of Certain Persons from International Taxation: Transfer Pricing (s 31 of the Income Tax Act No. 58 of 1962)* 6 August 1999 para 2 1; Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa *Second Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structures of South Africa* (1995) para 13b; Arnold & McIntyre *Tax Primer* 2002 53

servers located in low tax jurisdictions.[115] It is, however, worth pointing out that the profit that can be attributed to the server may not be that significant as servers do not normally take risks for instance, with respect to the sales inventory or the marketing of intangibles.

It should be acknowledged however, that there are a number of non-tax business reasons that will necessitate e-commerce businesses to own or lease servers in the countries where their consumers are located. For example, mirror servers are often placed in target markets in order to speed up download times. Nevertheless, an e-commerce company could still maintain its main server in a tax haven jurisdiction to perform business activities, and use servers in target markets to perform mere auxiliary or preparatory activities that do not amount to a PE. The source country servers could, for example, simply advertise on a web page and then temporarily store on the server any orders that would be relayed to the main server in the tax haven. Alternatively, an e-commerce company can own a tax haven-based server and simply host its web page on servers located in source countries. The e-commerce company will not attract source country income taxation because merely hosting a web page on a foreign-owned server does not place the server at the disposal of the resident company.[116] In fact, e-commerce businesses sometimes employ server arrays that permit a website and its functions to be dispersed over many servers located in multiple jurisdictions. The server array may be used to direct congested Internet traffic to different servers or applications.[117] The Australian Taxation Office[118] has noted that e-commerce transactions can be separated into different functions which, by themselves, can be considered auxiliary or preparatory in nature, but when linked via the Internet, create "a viable business that is not subject to tax in any jurisdiction."[119]

8 3 Administrative Challenges

Tax authorities will face many difficulties in taxing profits attributable to the software functions of servers. Calculating the income attributable to the server or website would require tax authorities to go through each case and thousands of lines of computer code (if a country applies the self assessment system, this burden would fall on the taxpayer).[120] This is not administratively feasible, as tax authorities would somehow have to determine the amount of added value provided through server functions. An OECD Electronic Commerce Tax Study Group[121] noted that taxing servers "would present insurmountable tax compliance and administration issues." The highly intangible, flexible, and mobile nature of computer code would also make tax

115 Cockfield 1999 *Tulane LR* 148
116 OECD *Commentary on Article* 5 para 42 10
117 Cockfield 2001 *Minn L Rev* 1259
118 *Tax and the Internet – Volume 1* (1997) See also Australian Taxation Office *Tax and the Internet: Second Report* (1999) 5 3 47-5 3 72 http://www ato gov au/content asp?doc=/content/Businesses/ecommerce_tati2 htm (09-07-2008)
119 Para 7 5 4
120 Cockfield 2001 *Minn LR* 1250
121 Dunahoo "E-Commerce Tax Study Group responds to OECD Request" 2000 *Worldwide Tax Daily* 11-18

administration difficult. Multinational businesses may have to incur significant compliance costs, since they would have to file tax returns and fulfil other reporting obligations in every jurisdiction where their servers are located.[122] As national tax authorities' attempt to extend their taxing jurisdictions over alleged server profits, this may lead to international double taxation in the absence of a double tax treaty between the countries concerned.

9 Is the "source basis of taxation" on which the PE concept is based relevant in the e-commerce context?

Some writers have argued that the rationale for the source basis of taxation upon which the PE concept is based has lost its relevance in the e-commerce context.[123] It is submitted that theoretically, the source basis of taxation is still justifiable for income arising from international transactions conducted in an e-commerce environment. The rationale for the source basis of taxation is that taxpayers can be expected to share the costs of the infrastructure and the running of the country which enables the production of income, its maintenance and investments, and its use through consumption.[124] In essence, this basis of taxation is justified by pointing to the benefits that state services provide to taxpayers who interact with the country. McLure argues that in a traditional context, physical presence is needed to establish a tax nexus for the source basis of taxation, because an enterprise has to be physically present in the country to make use of the infrastructure in the country in order to run its businesses.[125] The question that arises is whether this basis of taxation is justifiable in the e-commerce context where businesses can earn profits from interacting with a source country without having to maintain a physical presence in that country. With e-commerce, the entire value of what is sold is normally created in the residence country. Thus, from an economic perspective, the source country's only contribution is often its customer base or market. In this context, it could therefore be argued that the source country provides little or no benefit relevant to the production of income which would justify source-based taxation in the e-commerce era.[126] However, Skaar argues that even if a business does not have a physical presence in the source country, it nevertheless benefits substantially from the source country's infrastructure and therefore should make a contribution to the source country.[127]

It should also be noted that source states do provide significant benefits to companies even in the absence of a physical presence. For instance, they benefit from the legal systems that enforce payment for transactions, uphold intellectual property rights and maintain a pro-competition and conducive

[122] Cockfield "Tax Compliance Issues for U S Companies with International Electronic Commerce Transactions" 2000 *Tax Notes Int'l* 223; Sher 1999 *Tax Manag Int J* 425

[123] McLure "Source-based Taxation and Alternatives to the Concept of Permanent Establishment" 2000 *World Tax Conference Report* para 6 5

[124] Olivier & Honiball *International Tax* 52

[125] 2000 *World Tax Conference Report* para 6 5

[126] Pinto 2006 *Bull Int Fiscal Doc* 267

[127] *Permanent Establishment* 559-560

business environment.[128] In fact, the sale of digitised goods (such as music and computer games) is not feasible in countries that do not have a suitable telecommunications infrastructure or whose population lacks competence in computers. The provision of these benefits therefore warrants the source basis for taxing income in the e-commerce era.[129] Furthermore, source countries have to provide waste disposal for packaging materials, consumer protection laws, and an infrastructure on which delivery vehicles can travel when physical delivery of electronic products has to take place.[130] Based on the above, it is arguable that the rationale for source-based taxation of income is still relevant in the e-commerce era.

Although source-based taxation remains theoretically valid in today's globalised world, the PE principle which is enshrined in the source basis of taxation needs to be reconceptualised in light of the changes brought about by e-commerce.[131] The current definition of PE in the OECD Model applies in a context where international business activities are carried out at a fixed place or by representatives in a jurisdiction. In traditional commerce, reliance on the PE principle can be applied with relative coherence and certainty. However, e-commerce allows substantial business activities to take place in a source state without physical or human intermediaries, making it difficult to find a PE based on its traditional formulation under the OECD Model Convention.[132]

It is submitted that the attempt by the OECD to transpose real world international tax principles (the need for a physical presence in foreign markets) into the virtual world (a server as a PE) is not the effective solution for resolving the fiscal challenges that arise when e-commerce enterprises "trade with" a foreign country (there is no taxable presence) as opposed to "trading in" a foreign country (there is a taxable presence ie a PE). A number of commentators have pointed out the drawbacks of applying traditional concepts to the brave new world of cyberspace. Johnson and Post note that the regulation of cyberspace must be different from the regulation of real space because cyberspace does not have territorial boundaries, but exists simultaneously in multiple jurisdictions.[133] Regulators should not only focus on physicality – in this case, a physical aspect of the network – while ignoring the more ethereal aspects of cyberspace.[134] The current methods of amending or "patching" the old legislation to deal with the new electronic developments should be changed and new international principles adopted that take these developments into consideration.[135]

Skaar argues that since a PE is merely a piece of evidence of economic allegiance, and not the reason for source-based taxation, it has to be changed.[136]

[128] Pinto 2006 *Bull Int Fiscal Doc* 268
[129] 268.
[130] 268.
[131] Pinot 2006 *Bull Int Fiscal Doc* 279
[132] Pinto 2006 *Bull Int Fiscal Doc* 266; Cockfield 2001 *Minn L Rev* 1206
[133] 1996 *Stan L Rev* 1367
[134] 1367
[135] American Bar Association "Report of the Task Force on International Tax Reform" 2006 *The Tax Lawyer* 658; Sher 1999 *Tax Manag Int J* 425
[136] *Permanent Establishment* 573

In support of this view, Doernburg and others also argue that the PE concept is merely a

> " … threshold that business activities in the source country must have reached in order to entitle that country to tax the pertinent income. It is not unreasonable for this threshold to be adjusted for changes in the nature of business and in the way business is carried on". [137]

10 Views on how to tax e-commerce effectively

Commentators have come up with various views about how to tax the income of electronic transactions in source countries. Hinnekens came up with the "virtual PE approach".[138] This approach creates a tax nexus in the source country even if there is no fixed place of business. The tax nexus operates as a PE "fiction" by allowing tax jurisdiction on the basis of a virtual PE in the source country. This approach is based on deleting the requirement for the existence of a fixed place of business in the source country from the current formulation of source under the PE principle. Skaar also refers to this approach.[139] However, Pinto is of the view that this approach creates difficulties in attributing profits to a virtual PE.[140] Furthermore, it may only be feasible in the case of active business profits because its implementation is difficult in the case of passive income.

Hoffart proposes the "markets proxy" approach.[141] He argues that the history of the PE concept shows that it is not only based on the location of the value of production. He points out that the early League of Nations documents on this principle did not use the term "creation of value" but rather "origin of wealth", which means that "all stages which are involved up to the point of wealth coming to fruition, that is all the stages up to the point when the physical production has reached a complete economic destination can be acquired as wealth".[142] In his view, the PE concept should not be discarded since historically the terminology used in its development is sufficiently broad to allow the possibility that market access was a consideration at the time the rules were ordained.[143] The authors of this article do not support this interpretation as there is no evidence in the successive OECD *Commentaries* that this interpretation was the intended view of the original drafters of the OECD Model Convention.

Other commentators have argued that the PE concept, which requires that profits should be attributed to the location where value is created, is obsolete and that the appropriate test should not focus solely on wealth-creating activities, but should also consider place of consumption.[144] This view is strongly

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137 *Multijurisdictional Taxation* 79
138 "Looking for an appropriate Jurisdictional Framework for Source State Taxation of International Electronic Commerce in the Twenty-First Century" 1998 *Intertax* 179
139 *Permanent Establishment* 573
140 2006 *Bull Int Fiscal Doc* 277
141 2007 *Nw J of Tech & Intell Prop* para 31-41
142 Para 31-41
143 Para 31-41.
144 Para 15-16; McLure 1997 *Tax L Rev* 269

advocated by Cockfield.[145] Doernburg also supports this view and, in his "base erosion approach", proposes a low withholding tax on the income of electronic businesses in source countries.[146] It could thus be said that this approach effectively implies that the taxation of income in electronic transactions would be based on the ultimate destination (country of consumption) and closely resembles a consumption tax like Value Added Tax. One could also argue that adopting a consumption tax system would be contrary to the rationale of an international income taxation system, since income tax is usually associated with production rather than consumption. In response to these arguments, Avi-Yonah[147] is of the opinion that "the issue of which tax base to choose (income or consumption) is different from the question of which jurisdiction should get the revenues (production or consumption)."[148] Indeed, it is not illogical to allocate income tax revenues to countries in which consumption takes place since it is also acceptable to allocate an origin-based VAT to the production country.[149]

In agreement with the above, it is our view that since e-commerce allows enterprises to trade in source countries without a PE, an alternative to the PE threshold for determining source country tax nexus should be applied. We suggest that that can be achieved by levying a withholding tax on the income of electronic enterprises. This view is also supported by Avi-Yonah,[150] who states that due to the challenges in the characteristics of e-commerce, the best way to tax e-commerce would be to introduce a withholding tax at the corporate tax rate for the source income taxation of e-commerce transactions.

However, it is worth noting that withholding tax systems have been criticised for not being tax neutral, as they only apply to cross-border sales of goods and services that involve foreign sellers and not local sellers.[151] An inherent drawback of withholding taxes is that they are often imposed on gross receipts, which means that deductions may not be claimed. This could cause distortions where it is reasonably certain that the substantial part of the gross receipts consists of nett income. Withholding taxes can also be viewed as tariffs, especially if they are not creditable in residence countries. Furthermore, taxpayers would incur the compliance costs associated with filing returns to obtain a refund of the amounts withheld, and tax authorities would incur administrative costs to ensure that the system is enforceable.[152] Charging withholding taxes on e-commerce would make a country uncompetitive internationally, considering that withholding taxes are levied on gross income. There could also be some tax treaty constraints since neither the United Nations Model Tax Treaty nor the OECD Model Convention currently contain a provision that caters for withholding taxes on active business

[145] "Designing Tax Policy for the Digital Biosphere: how the Internet is changing Tax Laws" 2000 *Connecticut LR* 333
[146] "Electronic Commerce and International Tax Sharing" 1998 *Tax Notes Int'l* 1013
[147] "International Taxation of Electronic Commerce" 1997 *Tax L Rev* 507
[148] 539
[149] Pinto 2006 *Bull Int Fiscal Doc* 279
[150] 1997 *Tax L Rev* 507
[151] Pinto 2006 *Bull Int Fiscal Doc* 278
[152] 277

income from source countries. Articles 10, 11 and 12 of the OECD Model Convention only cover withholding taxes with regards to passive income such as dividends, interest and royalties respectively.

To alleviate the disadvantages of levying withholding taxes on e-commerce, Pinto suggests certain mechanisms as to how such a withholding tax would operate.[153] The authors of this article support these suggestions. Pinto suggests that a withholding tax should be applied by source countries at a uniform rate to all international electronic commerce transactions.[154] The tax should be a "refundable withholding tax" on e-commerce on total gross e-commerce sales above a *de minimis* threshold. The withholding tax would be levied on all goods and services provided electronically with the exception of passive dividend and interest income which would continue to be treated under existing rules.[155] In a treaty context, this income is generally taxed by the residence state but dividends and interest may be taxed on a withholding basis by source countries that withhold tax on such income. Subject to the exception from withholding for passive dividend and interest income, if a seller's total gross sales in a jurisdiction remain below a *de minimis* threshold, the seller would not be subject to tax in the source country, but would file a return to obtain a refund of withheld amounts. If a seller's total gross sales into a jurisdiction exceed the *de minimis* threshold, the seller would be subject to source-country taxation and the amounts withheld would not be refundable. To alleviate the disadvantages that result from the fact that withholding taxes are based on gross receipts, Pinto suggests that filing of returns in source countries based on a taxpayer's net income (gross income less expenses) can be permitted.[156] He suggests further that the tax withheld should be levied at a low rate and that it should be creditable in residence countries in order to prevent it being viewed as a tariff.

Although the workings of the above withholding tax mechanism would imply that taxpayers would incur the compliance costs associated with filing returns to obtain a refund of the amounts withheld and that tax administrators would incur the administrative costs to ensure that the system is enforceable, it is our view that the system is workable. First, the system is operationally possible, in that the use of new technologies would assist in the collection, distribution and refund of taxes withheld under this approach. Secondly, the system avoids the difficulties regarding the characterisation of income that could be more problematic in an e-commerce context.[157] Pinto also notes that since the system can be unilaterally enacted by countries, it would not require a revision of the extensive and entrenched bilateral double taxation treaty network that exists between countries.

Thus, although the withholding tax approach may be criticised from both a conceptual and a practical perspective, the withholding tax mechanism (in line with Pinto's suggestions) appears to be the most feasible approach that

153 2006 *Bull Int Fiscal Doc* 277-278
154 277-278
155 277
156 278
157 278.

countries could resort to in order to accommodate the taxation of the income of e-commerce transactions.[158] A classic example of a country that has applied withholding taxes in taxing the income of electronic transactions is India. In 1999, India's Authority for Advance Rulings relied on withholding taxes in taxing e-commerce under the United States-India tax treaty.[159]

11 Is the withholding tax approach feasible in South Africa?

In South Africa, the levying of withholding taxes is applied where there are difficulties in taxing income derived by non-residents from South Africa. For instance, with respect to active income, the Income Tax Act imposes a withholding tax on all amounts received or accrued by foreign entertainers and sportsmen from South Africa.[160] The Act also imposes a withholding tax on any capital gains derived by a non-resident from the alienation of property that is situated in South Africa.[161] With regard to passive income, the Income Tax Act levies a withholding tax on royalties.[162] It could thus be said that the workings of these withholding taxes could be referred to in coming up with a withholding tax on e-commerce. However, the anonymous nature of e-commerce would make it difficult to levy a withholding tax on e-commerce. The levying of this tax requires the identification of the resident taxpayer, who must withhold the tax from the purchase price paid to the non-resident and pay it over to the tax authorities.[163]

In the *Green Paper on E-Commerce*[164] it was noted that the legal framework in South Africa is currently insufficient to deal with e-commerce issues. Because e-commerce blurs the actual trading capabilities of electronic enterprises, it was necessary to come up with mechanisms of identifying parties on websites. This would include standard on-line contact information which must be required of enterprises using a website, such as the trading name of the business, the physical as well as postal address of the business, an e-mail address, telephone or other contact information, and the statutory registration number of the enterprise.[165]

As a result of this document, the Electronic Communications and Transactions Act 25 of 2002 ("ECTA") was enacted. ECTA contains certain

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[158] 278.

[159] Ministry of Finance (India) *Report of the High Powered Committee on E-Commerce and Taxation* (2001) www Iaws4india com/indiantaxlaws/notification/ecomcontent asp (accessed 02-07-2008) See also the decision involving the US-India treaty which was issued by the Indian Authority for Advance Rulings (AAR), No 30 of 1999 (238 ITR 296) and Pandit & Goradia "Indian AAR issues Landmark Ruling on E-Commerce Taxation under US-India Tax Treaty" 1999 *Tax Notes Int'l* 11

[160] S 47A-47K

[161] S 35A

[162] S 35 However, it is worth noting that it was announced in the 2007 National Budget that a dividend withholding tax at a rate of 10% would be introduced with effect from 1 October 2008, which would be applicable to both resident and non-resident companies *Budget Speech* (2007) http://www sars gove za/home asp?pid=4346 (25-04-2007) Also see Olivier & Honiball *International Tax* 520

[163] Spitz & Clarke *Offshore Service* (2002) Issue 66 at LEX/26; Olivier & Honiball *International Tax* 176

[164] Department of Communications *Green Paper on E-commerce* 10-14; Groenewald & Lehlokoe "Towards an Electronic Commerce Policy for South Africa" http://www isoc org/inet99/proceedings/1g/1g_4 htm (accessed 01-10-2008)

[165] Department of Communications *Green Paper on E-commerce* 37

provisions which, if complied with and effectively enforced, may alleviate some of the identification problems posed by e-commerce.[166]

If a withholding tax on e-commerce is introduced in South Africa (in line with the above suggestions), a provision could be inserted in the Income Tax Act to the effect that the provisions of ECTA could be relied on to identify the parties to the transaction in order to ensure the collection of the withholding tax.

12 Conclusion

It can be concluded that the OECD's guidelines which provide for the taxation of electronic businesses on the basis of the location of servers as PEs cannot be relied on to tax the income of electronic transactions effectively. This is because e-commerce creates the possibility that businesses may trade in source countries without a PE.

From the above, it is the authors' view that the withholding tax approach provides a more stable and appropriate basis for the source-based income taxation of international electronic commerce transactions. This approach takes into consideration the fact that substantial business profits are earned from source countries without the need to maintain a physical presence therein.

SUMMARY

When two countries have entered into a double taxation agreement, the profits of an enterprise of a contracting state are taxable only in that state. The other contracting state cannot tax those profits unless the enterprise carries on business in that state through a permanent establishment (PE) situated therein. The existence of a PE in the form of a "fixed place of business" or a "dependent agent" presupposes the existence of a tax presence.

The effective application of the PE concept, however, faces challenges when trade is conducted electronically. This is because with e-commerce, physical locations are not always required in foreign markets in order to engage in significant commercial activities. This article discusses the meaning of the PE concept, analyses the challenges e-commerce poses to this concept, and contains a recommendation for the effective taxation of income that electronic enterprises derive from foreign jurisdictions.

[166] For instance, s 23 requires a disclosure of the time and place of communication, despatch, and receipt of information Ss 24 and 25 deal with the attribution of data messages to the originator S 38 provides for the authentication of the products or services of service providers Ss 27 and 30 contain provisions relating to cryptography so as to ensure the authenticity, integrity and reliability of Internet data Ss 42 and 43 require the display of information about the supplier of electronic goods and services on the website Ss 80 and 81 deal with the appointment of cyber inspectors who have the power to inspect any website activity and information