

The Challenges E-Commerce Poses to the Determination of a Taxable Presence: The “Permanent Establishment” Concept Analyzed from a South African Perspective *

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Abstract: It is a principle of international tax law that a country may not tax the business profits of a non-resident enterprise unless those profits are attributed to a “permanent establishment” located in the source country. A “permanent establishment” is defined as a fixed place of business through which the enterprise is wholly or partly carried on. The “business establishment” concept is however based on the world where there had to be a physical presence of the business in order for its profits to be taxed. The requirement of a fixed place of business faces challenges when trade is conducted electronically as e-commerce makes it difficult to identifying a taxable presence in the source country. This article analyses the challenges that e-commerce poses to the “permanent establishment” concept.

1. Introduction

Before any country can levy a tax on income, a connection or tax nexus must be established between itself and that income. For example, 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 to tax as a resident of that jurisdiction. But if a business entity is not considered a resident² 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 it is situated (the source country) the right to tax its income, notwithstanding the fact that the PE has no separate legal existence.⁴

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.⁵ However, the advent of electronic commerce (e-commerce) makes it difficult to identify a taxable presence in a particular country.⁶ This article analyses the meaning of the PE concept and discusses the challenges that e-commerce poses to the PE concept. The article also provides a recommendation for the effective taxation of e-commerce transactions in a source country.

2. Defining the “PE” Concept

For South African income tax purposes a “permanent establishment” is defined in section 1 of the Income Tax Act,⁷ with reference to the definition of the concept in article 5 of the Organisation for Economic Cooperation and Development’s (OECD Model Tax Convention. Section 108(1) of South Africa’s Income Tax Act⁸ read with

* This article was originally published in Kierkegaard, S. (2008) Synergies and Conflicts in Cyberlaw. IAITL. pp.221-235

¹ David Meyerowitz *Meyerowitz on Income Tax* (2008) in par 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 Article 7(1) of the OECD Model Tax Convention on Income and on Capital (2005 Condensed Version). See also L Olivier & M Honiball *International Tax: A South African Perspective* (2008) at 420; Brian J Arnold & Michael McIntyre *International Tax Primer* 2nd ed (2002) at 73.

⁴ Article 5(1) of the OECD Model Convention. See Aarge A Skaar “Permanent Establishment: Erosion of a Tax Treaty Principle” (1999) *Series of International Taxation* 71-101.

⁵ See Judd A Sher “A Band-Aid or Surgery: It Is Time to Evaluate the Health of the Permanent Establishment Concept” (1999) 28 *Tax Management International Journal* 415

⁶ The South African Revenue Service (SARS) *Discussion Document: Electronic Commerce and South African Taxation* (2000) 5-6.

⁷ Op cit note 2.

⁸ Act 58 of 1952.

section 231 of the Constitution⁹ provide *inter alia* that as soon as the double tax agreement is ratified and has been published in the *Government Gazette*, its provisions are effective as if they had been incorporated into the Income Tax Act.¹⁰ In interpreting the term “permanent establishment”, which is a treaty term, it was held in *CIR v Dowling*,¹¹ that South Africa is bound to take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Tax Convention. Constitutionally, South African courts are also bound to apply customary international law.¹² This includes the OECD Model Tax Convention and its Commentary.¹³ Article 5(1) of the OECD Model Tax Convention defines a PE as “a fixed place of business through which the business of an enterprise is wholly or partly carried on”.¹⁴ From this definition, three elements can be identified, namely: a place of business, the place of business must be “fixed”, and the business of the enterprise must be carried on through this fixed place of business. These elements are analysed below.

2.1 Place of business

A PE will only exist if the enterprise has a physical presence in the source state.¹⁵ Under article 5(2) of the OECD Model Tax Convention, the following constitute a place of business: a place of management; a branch; an office; a factory; a workshop; and a mine, an oil or gas well, a quarry or any place of extraction of natural resources. 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.¹⁶ In the German “pipeline”¹⁷ case, it was held that it is not a requirement that the place of business be attached to the surface of the earth or that it is visible above the ground. Article 5(3) of the OECD Model Convention further provides that a construction site or an installation project constitutes a PE provided it lasts for more than 12 months. It should be noted that the above mentioned activities in themselves are not conclusive evidence of the existence of a PE. The OECD makes it clear that these have to be viewed against all the other requirements discussed below.

2.2 The place of business must be “fixed”

For a place of business to be fixed, two components have to be met, namely: a specific geographical spot (the location test); and there must be a certain degree of permanence at each geographical spot (the duration test). The location test requires that there must be 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. The key requirement is that the business should commercially and geographically consist of a coherent whole.¹⁸

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.¹⁹ In South Africa, the courts hold the view that the word “permanent” in “permanent establishment” does not refer to mere temporary use of premises for purposes of trade. In *Transvaal Associated Hide and Skin Merchants v Collector of Taxes, Botswana*²⁰ it was decided on the facts that the taxpayer’s regular occupation of the shed at an annual rental showed that its occupation of the premises was permanent and not temporary. 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 at a regular basis.²¹

⁹ The Constitution of the Republic of South Africa of 1996.

¹⁰ Meyerowitz op cit note 1 in par 30.11; K Huxham & P Haupt *Notes on South African Income Tax* (2008) at 356.

¹¹ 1975 (4) SA 518 (A) at 524.

¹² Section 233 of the Constitution op cit note 9.

¹³ Olivier & Honiball op cit note 3 at 395.

¹⁴ Par 2 of the Commentary to article 5 of the OECD Model Convention.

¹⁵ L Olivier “The ‘Permanent Establishment’ Requirement in an International and Domestic Taxation Context: An Overview” (2002) *SALJ* 871.

¹⁶ Par 14 of the Commentary on article 5 of the OECD Model Convention.

¹⁷ Bundesfinanzhof vorn 30.10.1996, IIR 12.92, BStBI II 1997, S12.

¹⁸ Olivier & Honiball op cit note 3 at 97.

¹⁹ Cristián Gárate “The Fixed Place of Business in the Context of Electronic Commerce” in Hans-Jörgen & Mario Züger *Permanent Establishments in International Tax Law* (2003) at 46.

²⁰ 29 SATC 97 at 115.

²¹ Olivier & Honiball op cit note 3 at 99. Richard L Doernberg, Luc Hinnekens, Walter Hellerstein & Jinyan Li *Electronic Commerce and Multijurisdictional Taxation* (2001) at 206.

2.3 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.²² The phrase “carried on through” infers that the business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose.²³ A distinction has to be made between a PE “serving” an enterprise and one through which the businesses of the enterprise is carried on. To “serve” an enterprise, the activities of the PE may be the main activities of the enterprise or they may be auxiliary, substantial or insignificant.²⁴ 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. Although the presence of individuals may be required for the setting up of a PE, their ongoing presence is not required.²⁵ The presence of fully automatic 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.²⁶

2.4 Exclusions to the PE Concept

The OECD Model Convention sets out certain activities that are excluded from the PE definition.²⁷ The common feature with these activities is that 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 is of the view that the decisive criterion is whether or not the activity of a fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.²⁸ A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise cannot be regarded as doing preparatory or auxiliary activity, for such a managerial activity exceeds this level.²⁹

2.5 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.³⁰ The person making use of the authority must do so repeatedly and not merely in isolated cases.³¹ Persons (whether individuals or juristic persons) whose activities may create a PE should not be independent agents. According to the OECD, the factors which play an important role in deciding whether a person is a dependent or independent agent are: 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, if the risk is born by the agent, then that person acts independently.³²

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 rationale for the PE concept has historically rested on two main grounds. Firstly, the presence of a PE was evidence that a foreign company conducted significant business within the source country.³³ Secondly, the PE concept permitted source countries to share in tax revenues from the profits created by commercial opportunities presented by their markets.³⁴ The concept represented a form of international equity in that it provided a reasonable compromise between the interests of net-exporting nations and net-importing nations because 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.³⁵ This sharing of tax revenues also provided an incentive for residence and source countries to

²² Par 5 of the commentary on article 5(1) of the OECD Model Convention.

²³ Doernberg et al op cit note 21 at 206; See also Kesnia J Levouchkina “Relevance of Permanent Establishment for Taxation of Business Profits and Business Property” in Hans-Jürgen & Mario Züger *Permanent Establishments in International Tax Law* (2003) at 20-21.

²⁴ Skaar op cit note 4 at 112.

²⁵ Par 1(10) of the commentary on article 5 of the OECD Model Convention

²⁶ Ibid.

²⁷ Article 5(4) of the OECD Model Convention.

²⁸ Par 24 of the Commentary on article 5 of the Model Tax Convention.

²⁹ Ibid.

³⁰ Article 5(5) of the OECD Model Convention; R Rohatgi *Basic International Taxation* (2002) at 77.

³¹ Olivier & Honiball op cit note 3 at 105.

³² Par 37-38 of the Commentary on art 5 of the OECD Model Convention.

³³ Skaar op cit note 4 at 78-79.

³⁴ Nancy H Kaufman “Fairness and the Taxation of International Income” 29 *Law & Pol’y Int’l Bus.* (1998) at 145; Charles E McLure “Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws” 52 *Tax Law Review* (1997) 269, 361-62; David R Tillinghast “The Impact of the Internet on the Taxation of International Transactions” 50 (1996) *Bulletin for International Fiscal Documentation* at 524 – 525.

³⁵ Skaar op cit note 4 at 88-95.

cooperate in reducing international double taxation, hence promoting international trade. The emergence of e-commerce, however, upset this balance because physical locations are no longer required in foreign markets in order to engage in significant commercial activities. Below follows a discussion on the impact of e-commerce on PE concept.

3. What is E-commerce?

E-commerce is a term used to describe the wide array of commercial activities carried out by electronic means that enable trade without the confines of geographical boundaries.³⁶ This technology enables the transmission of voice, data, images and video information to take place in cyberspace by using the Internet.³⁷ The Internet provides an environment in which automated functions can undertake significant business with little or no physical activity.³⁸ 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 geographic boundaries. Because the Internet ignores international boundaries, "place" has little meaning in the networked world.³⁹ This makes it difficult to establish international norms for identifying the source of the taxpayers' income. 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.⁴⁰ 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.⁴¹ As a result, governments throughout the world are concerned that they will not receive their fair share of the revenues associated with taxing e-commerce profits.

4. Challenges E-commerce Poses to the "PE" Concept: 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. With the development of the Internet, online retailers can 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 customers⁴² thus eliminating the necessity for having the presence of intermediaries a given jurisdiction.⁴³ 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.⁴⁴ Multinational companies can centralise many of their operations including sales, marketing and customer support that previously required employees or fixed bases within source countries.⁴⁵

The Internet also encourages the re-intermediation process, which is essentially the development of new intermediaries (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.⁴⁶ With such developments multinational firms with existing PEs may begin to shift part of their business operations from the

³⁶ R Doernberg & L Hinnekens *Electronic Commerce and International Taxation* (1999) at 3; RA Westin *International Taxation of Electronic Commerce* (2000) at 2; H Suddards *E-commerce: A Guide to the Law of Electronic Business* (1999) at 257.

³⁷ C Sher "Taxation of E-commerce" (2000) 39 *Income Tax Reporter* 172; SP Melvin *Cyber Law and E-commerce Regulation: An Entrepreneurial Approach* (2005) at 52; C 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 at 426-427.

³⁸ Suddards op cit note 36 at 27; Westin op cit note 36 at 2; CW Pappas "Comparative US and EU Approaches to E-Commerce Regulation" (2003) 31 *Denver J of International Law & Policy* 325 at 326-327.

³⁹ DR Johnson & D Post "Law and Borders: The Rise of Law in Cyberspace" (1996) 48 *Stanford Law Review* at 1367 and at 1370-1371; Melvin op cit note 9 at 52.

⁴⁰ Doernberg & Hinnekens op cit note 36 at 341-343; JJB Hickey, R Mathew & C Rose *E-commerce: Law Business and Tax Planning* (2000) at 261.

⁴¹ Suddards op cit note 36 at 255; R Buys R & F Cronjé *F Cyber law: The Law of the Internet in South Africa* 2 ed (2004) at 307; See also Gárate op cit note 19 at 48.

⁴² Arnold & McIntyre op cit note 3 at 153; AW Oguttu & B Van der Merwe "Electronic Commerce: Challenging the Income Tax Base" (2005) 17 *SA Mercantile Law Journal* at 85-86.

⁴³ Andrew L Shapiro "Digital Middlemen and the Architecture of Electronic Commerce" 24 *Ohio North University Law Review* (1998) at 795.

⁴⁴ Arnold & McIntyre op cit note 3 at 153.

⁴⁵ Arthur Cockfield, "Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation" (2001) 85 *Minnesota Law Review* (2001) at 1179.

⁴⁶ Ibid.

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.⁴⁷

5. Challenges E-commerce Poses 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 irrelevant as Internet technologies can fully automate the order filling, contract negotiating, and payment processing that was traditionally performed by dependent agents.⁴⁸ This makes it difficult to find a PE based on its traditional formulation under the OECD Model.⁴⁹ It is indeed illogical to conclude that individuals are necessary to have a PE when no individuals are in fact necessary to generate the income for e-commerce transactions.⁵⁰ Furthermore, independent agents can be hired if necessary at a fraction of the cost to accomplish many dependent agent functions.⁵¹

6. How the OECD Deals with the Challenges E-commerce Poses to the PE Concept

In order to protect source countries tax bases the OECD came up with certain guidelines with regard to the application of the PE concept in context of e-commerce. The guidelines apply traditional principles in determining whether a website or a server qualifies as a PE (a fixed places of business through which the business of the enterprise is carried on or a dependent agency presence).

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 accessed.⁵² Websites consist of the software and electronic data stored on the server that allows an enterprise to interact directly with its customers.⁵³ 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”⁵⁴ Arnold and McIntyre⁵⁵ also note that a website is a “virtual office”. As intangible property, it does not provide a regular link between the place of business and a specific physical geographical point and so it cannot qualify as a PE.⁵⁶

6.2 Can a Server Constitute a PE?

A server, on the other hand, is automated equipment on which an Internet web site is stored and through which the website is accessible.⁵⁷ Paragraph 42.2 of the OECD Commentary on article 5 provides that, since the server is a piece of equipment that has a physical location, that location may constitute a fixed place of business of the enterprise that operates that server. Further that, if a server is used regularly for enterprise business it may constitute a PE if it is at the disposal of the enterprise for that purpose.⁵⁸ When an enterprise conducts its business through a website that is hosted⁵⁹ on the server of an Internet Service Provider (ISP), such hosting arrangements do not result in the server and its location controlled by and at the disposal of the enterprise even though the website

⁴⁷ Ibid.

⁴⁸ Ibid.

⁴⁹ Dale Pinot “The Need to Reconceptualise the Permanent Establishment Threshold” 60 *Bulletin for International Fiscal Documentation* (2006) at 266.

⁵⁰ Ibid.

⁵¹ Olivier & Honiball op cit note 3 at 104-105.

⁵² Ibid.

⁵³ Buys & Cronje op cit note 41 at 303.

⁵⁴ Par 42.2 of the OECD Commentary on article 5

⁵⁵ Arnold & McIntyre op cit note 41 at 153-154.

⁵⁶ Buys & Cronje op cit note 41 at 303; Gárate op cit note 19 at 54.

⁵⁷ Buys & Cronje op cit note 41 at 303.

⁵⁸ Par 42.3 of the Commentary on article 5 of the OECD Model Convention; see also Buys & Cronje op cite note 41 at 303; Arnold & McIntyre op cit note 3 at 153.

⁵⁹ Par 42.3 of the Commentary on article 5 of the OECD Model Convention.

of the enterprise is hosted on a specific server at a specific location.⁶⁰ 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.⁶¹ However if the enterprise owns (or leases) and operates the server on which the web site is stored and used, then the place where that server is located could constitute a permanent establishment as the server and its location is 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.⁶² What is relevant is not the possibility of the server being moved, 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 place for a sufficient period of time so as to become fixed within the meaning of article 5(1) of the OECD Model Convention.⁶³

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 there is no PE.⁶⁴ The presence of the personnel is not necessary to consider 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.⁶⁵

Paragraph 42.7 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 (e.g. a display of a catalogue of certain products), relaying of information through a mirror server for security and efficiency purposes, gathering market data for the enterprise and supplying such information.⁶⁶ 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.⁶⁷

From the above it can be concluded that a PE based on a "fixed place of business" will only be deemed to be present when the enterprise is carrying on business through a web site 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 Internet Service Provider (ISP) constitute a Dependent Agent PE?

An ISP is a company that supplies connections to the Internet, usually for a monthly fee.⁶⁸ It is common for ISP's 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 carries on e-commerce through the web sites hosted on servers owned and operated by these ISP. According to the OECD Commentary,⁶⁹ the ISP does not constitute a dependent agent of the enterprise to which the website belongs, because it does not normally have authority to conclude contracts in the name of these enterprises. ISP's are normally independent agents acting in the ordinary course of their own business which entails hosting web sites of many different enterprises.⁷⁰

7. Other Countries' Responses to the OECD's Guidelines

In response to the OECD guidelines on the taxation of PEs, the Australian Tax Office noted that a website located on a server that is fixed in time and location, and through which business is carried on may constitute a permanent establishment.⁷¹

⁶⁰ Ibid; see also Gárate op cit note 19 at 54.

⁶¹ Par 42.3 of the Commentary on article 5 of the OECD Model Convention; Buys & Cronje op cit note 41 at 303; Suddards op cit note 36 at 262; Doernberg et al op cit note 21 at 210.

⁶² Par 42.4 of the Commentary on article 5 of the OECD Model Convention; see also Arnold & McIntyre op cit note 3 at 153.

⁶³ Par 42.4 of the Commentary on 5 of the OECD Model Convention.

⁶⁴ Par 42.6 of the Commentary on article 5 of the OECD Model Convention; see also Buys & Cronje op cit note 41 at 303.

⁶⁵ Par 42.5 and 42.6 of the OECD Commentary on article 5.

⁶⁶ Par 42.7 of the Commentary on article 5 of the OECD Model Convention.

⁶⁷ Par 42.8 of the Commentary on article 5 of the OECD Model Convention; See also Buys & Cronje op cit note 41 at 303.

⁶⁸ Ibid.

⁶⁹ Par 42.10 of the Commentary on article 5 of the OECD Model Convention.

⁷⁰ Arnold & McIntyre op cit note 3 at 153.

⁷¹ Australian Tax Office *Tax and the Internet: Discussion Report of the ATO Electronic Commerce Project* (1997) at 7.2.1.5. Available at ><http://www.ato.au/indexlist.asp?placement=AS/TS+k=internet+d=internet+1=1> last accessed 16 July 2008.

Canada's Tax Administration noted that "whether a file server fits the definition of a permanent establishment 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."⁷²

It is however worth noting that the German tax authorities are of view that "for the time being" a server will not be considered a permanent establishment under the definition in the OECD model tax treaty because the activities associated with the server are preparatory in nature.⁷³

The United Kingdom's Observation to article 5 is that it "takes the view that a server used by an e-tailer, either alone or together with websites, could not as such constitute a PE".⁷⁴ The United Kingdom's Inland Revenue has also indicated that servers will not constitute a permanent establishment for United Kingdom tax purposes.⁷⁵

Spain and Portugal have expressed a number of reservations on the OECD Report "Clarification of Permanent Establishments definition in E-commerce". Their Observation to article 5 of the OECD Model Convention is that "since the OECD continues the study of e-commerce taxation, these states will not necessarily take into consideration the OECD's guidelines until the OECD has come to a final conclusion on the matter."⁷⁶

As stated above, although South Africa is not an OECD Member country, it has been awarded observer status.⁷⁷ Non-OECD member countries, like South Africa⁷⁸ can also indicate a reservation to any articles in the OECD Model Convention.⁷⁹ Since South Africa has not indicated such a reservation, it can be assumed that South African courts are bound to follow the OECD interpretation of taxing servers as PEs in the e-commerce context.

8. The Challenges E-commerce Poses to the Taxation 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.⁸⁰ And as pointed out above, some countries have issued their own reports that endorse the OECD's because they are trying to ensure they will not lose out on tax revenues as a result of e-commerce. It is however important to note that the OECD's guidelines that focus on the preservation of traditional international tax principles such as the requirement for a physical presence (a server) in source countries, have little relevance to the world of e-commerce.⁸¹ 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.

8.1 The Challenge of Locating 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.⁸² The OECD has also acknowledged that servers are highly mobile and flexible in nature.⁸³ 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

⁷² Herb 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) at 6.3.2.4. Available at ><http://www.ccradrc.gc.ca/tax/business/ecom/index-e.html>< last accessed 13 July 2008.

⁷³ Regional Finance Office of Karlsruhe, Decree 11 Nov 1998, IStR 1999, pg 439; see also Friedrich EF Hey "German Tax Authorities Rule That Server Does Not Constitute PE" 19 *Tax Notes International* (1999) at 635- 635.

⁷⁴ Par 54.5 of the Commentary on article 5 of the OECD Model Convention.

⁷⁵ Press Release, Inland Revenue "Electronic Commerce: Tax Status of Web Sites and Servers" (April 11, 2000). Available at ><http://www.inlandrevenue.gov.uk/e-commerce/ecom15.htm>< last accessed 5 July 2008.

⁷⁶ Par 45.6 of the Commentary on article 5 of the OECD Model Convention.

⁷⁷ Olivier & Honiball op cit note 3 at 9.

⁷⁸ Olivier & Honiball op cit note 3 at 83.

⁷⁹ Ibid.

⁸⁰ OECD Ministerial on Electronic Commerce: Ottawa Canada (October 1998) "A Borderless World". Available at ><http://www.ottawaoecdconference.org/English/conference-program/agenda.pdf><, last accessed on 4 June 2008; see also [the comments by Gárate](#) op cit note 20 at 72.

⁸¹ Cockfield op cit note 57 at 1189.

⁸² Walter Hellerstein "Transaction Taxes and Electronic Commerce: Designing State Taxes That Work in an Interstate Environment" 50 *National Tax Journal* (1997) at 593

⁸³ OECD "Dismantling the Barriers to Global Electronic Commerce" (Turku, Finland, November 1997). Available at >http://www.oecd.org/LongAbstract/0,2546,en_2649_34223_2751231_1_1_1_1,00.html<, last accessed on 4 June 2008.

the creation of certain types of income.”⁸⁴ The location of a server can also be easily moved (without affecting the underlying transaction) between different countries. Servers can transfer their programs almost instantaneously to a server in a different jurisdiction if necessary.⁸⁵ 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.⁸⁶ The finding of the existence 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.⁸⁷

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.⁸⁸ In these circumstances, it may be difficult to assert that business is being conducted through a server owned or leased by the resident-based e-commerce business. 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 activity that e-commerce comprises – the production and consumption of information.⁸⁹ E-commerce makes it possible for functions to be disintegrated between servers, which practically makes it difficult to determine whether activities are core or preparatory in nature.⁹⁰ These possibilities expose the vulnerabilities of trying to apply the PE principle to tax e-commerce transactions.

8.2 The Possibility of Increased Tax Arbitrage

Tax-planning strategies can be effected by basing a company’s main server in a tax haven or low tax jurisdiction that imposes nil or minimum taxes on business profits.⁹¹ This server can then perform the company’s core business activities and then the source country servers are used to perform mere auxiliary or preparatory activities (for instance, advertising on a web page) that do not amount to a PE. The Australian Taxation Office⁹² 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.” An e-commerce company could also 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.⁹³

If servers constitute PEs, multinational companies will be encouraged to engage in transfer pricing strategies⁹⁴ by allocating related party profits to servers located in low tax jurisdictions. This can be done by ensuring that programs within the server that is located in a low tax jurisdiction enable the completion of virtually all aspects of the business transaction from advertising, order-taking, and conclusion of the contract.⁹⁵

⁸⁴ United States Department of the Treasury, Office of Tax Policy “Selected Tax Policy Implications of Global Electronic Commerce” (22 November 1996) at 7.2.3.1. Available at >www.ustrea.gov/taxpolicy/internet.html> Last accessed 30 June 2008.

⁸⁵ Cockfield 2001 op cit note 45 at 1259.

⁸⁶ Pinto op cit not 49 at 273.

⁸⁷ Skaar op cit note 4 at 319.

⁸⁸ In peer-to-peer networking, users do not have to resort to any centralized server. Users can access directories over a centralized server, but can then trade digital products among each others' personal computers. See Michael Talbert “Internet telephony over Peer-to-Peer Networks”. Available at www.articlexplosion.com/articledetail.php?artid=629&catid=30&title=Internet+Telephony+over+Peer+t... > last accessed 3 July 2008.

⁸⁹ Hellerstein op cit note 82 at 593

⁹⁰ Arthur Cockfield “Balancing National Interests in the Taxation of Electronic Commerce Business Profits” 74 *Tulane Law Review* (1999) at 133.

⁹¹ For example, Bermuda, markets itself as an e-commerce centre for businesses. See “Globalization and Tax” *The Economist* (Jan 29 2000) at 16. See also Linda Ng “Singapore Offers Tax Incentives and Advantages to E-Businesses” 21 *Tax Notes International* (2000) at 16.

⁹² Australian Tax Office Report (1997) op cit note 86 at 7.5.4; See also Australian Taxation Office “Tax and the Internet: Second Report” (1999) at 5.3.31-5.3.72 (1999). Available at >http://www.ato.gov.au/content.asp?doc=/content/Businesses/ecommerce_tati2.htm< last accessed on 9 July 2008.

⁹³ Par 42.10 of the Commentary on article 5 of the OECD Model Convention.

⁹⁴ 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 reduce profits or increase profits artificially or cause losses and avoid taxes in a specific country. See Arnold & McIntyre op cit note 3 at 53

⁹⁵ Cockfield (1999) op cit note 90 at 148.

8.4 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 case by case and thousands of lines of computer code.⁹⁶ 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 Group⁹⁷ 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 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.⁹⁸ As national tax authorities' attempt to extend their taxing jurisdictions over alleged server profits, this may lead to international double taxation.

9. The Need for a New Threshold for Taxing E-commerce

From the above, commentators argue that the PE principle needs to be reconceptualised in light of the changes brought about by e-commerce.⁹⁹ 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 either physical or human intermediaries, making it difficult to find a PE based on its traditional formulation under the OECD Model.¹⁰⁰

A number of commentators have pointed out the drawbacks of applying traditional concepts to brave the new world of cyberspace. Johnson and Post¹⁰¹ 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. Regulators should not only focus on physicality - in this case, a physical aspect of the network - while ignoring the more ethereal aspects of cyberspace.¹⁰² 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 the new developments into consideration.¹⁰³ Skaar¹⁰⁴ notes that "rather than protecting the tax base in the source state, the permanent establishment principle today has become instrumental in ensuring avoidance of source state taxation for some economically important business operations ... The future is likely to prove that the Permanent establishment principle has lost its force for new and mobile industries An enterprise's economic connection to the soil, its permanent establishment, is no longer a reliable evidence of economic allegiance". Skaar¹⁰⁵ 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. In support of this view, Doernburg and others¹⁰⁶ 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".

Writers on this issue have suggested some possible approaches to resolving these problems.¹⁰⁷ In this authors' view the most visible way for resolving this problem is by levying a withholding tax on e-commerce transactions. Citing the challenges in the characteristics of e-commerce, Avi-Yonah¹⁰⁸ has also proposed that, the best way to tax e-commerce would be to introduce a withholding tax at the corporate tax rate for the source

⁹⁶ Cockfield (2001) op cit note 45 at 1250.

⁹⁷ Carol A Dunahoo "E-Commerce Tax Study Group Responds to OECD Request" (2000) *Worldwide Tax Daily* 11-18.

⁹⁸ Arthur Cockfield "Tax Compliance Issues for U.S. Companies with International Electronic Commerce Transactions", 20 *Tax Notes International* (2000) 223.

⁹⁹ Pinot op cit note 49 at 279.

¹⁰⁰ Pinto op cit note 49 at 266; Cockfield (2001) op cit note 45 at 1206.

¹⁰¹ Johnson & Post op cit note 39 at 1367.

¹⁰² Ibid.

¹⁰³ American Bar Association "Report of the Task Force on International Tax Reform" (2006) 59 *The Tax Lawyer* at 658.

¹⁰⁴ Skaar at op cit note 4 at 559 and at 573.

¹⁰⁵ Skaar op cit note 4 at 573.

¹⁰⁶ Doernberg et al op cit note 21 at 79.

¹⁰⁷ For instance, the "base erosion approach" that is propounded by Richard Doernberg "Electronic Commerce and International Tax Sharing" 16 *Tax Notes International* (1998) at 1013. This approach maintains the use of the PE principle. Then there is the "virtual PE approach" that is advocated by L Hinnekens "Looking for an Appropriate Jurisdictional Framework for Source State Taxation of international Electronic Commerce in the Twenty-first century" 26 *Intertax* (1998) at 179. This approach creates a tax nexus as a PE "fiction" by allowing tax jurisdiction on the basis of a virtual PE in the source country.

¹⁰⁸ Reuven S Avi-Yonah "International Taxation of Electronic Commerce" 52 *Tax Law Review*. (1997) at 507.

taxation of e-commerce transactions. Doernberg¹⁰⁹ has also advocated for the introduction of a low rate of withholding tax on e-commerce. Pinto¹¹⁰ suggests that a withholding tax should be applied by source countries on active income at a uniform rate to all international electronic commerce transactions generating withholding income, which would be refundable if the total gross sales of a business in a source country for the relevant period remain below a *de minimis* threshold. The advantages of this approach are that the system is operationally possible with the use of new technologies to assist with the collection, distribution and refund of the taxes withheld. The system also avoids issues regarding the characterisation of income that could become more complicated in the e-commerce context.¹¹¹

It is however worth noting that withholding tax systems have been criticised for not being tax neutral, as they apply only to cross-border sales of goods and services that involve foreign sellers and not local sellers.¹¹² It is also worth noting that withholding taxes based on gross receipts could be distorted where it is reasonably certain that the substantial part of the gross receipts consist of net income. 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.¹¹³ Although the withholding tax approach may be criticised, from both from a conceptual and a practical perspective, withholding tax mechanisms appear to be the most feasible approaches that countries could resort to in order to accommodate the taxation of e-commerce transactions.¹¹⁴ A classic example is India. In 1999, Indian's Authority for Advance Rulings relied on withholding taxes in taxing e-commerce under United States/India tax treaty.¹¹⁵ It is submitted that using a withholding tax approach provides a more stable and appropriate basis for the source-based taxation of international electronic commerce transactions than the current international tax system.

10. 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 amount received by or accrued by foreign entertainers and sportsmen from South Africa.¹¹⁶ 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.¹¹⁷ With regard to passive income, the Income Tax Act levies a withholding tax on royalties.¹¹⁸ 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. The anonymous nature of e-commerce can however 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.¹¹⁹ Indeed the South African Green Paper on E-commerce¹²⁰ recommended that since e-commerce blurs the actual trading capabilities of electronic enterprises, it was necessary to come up with mechanisms of identifying parties on websites. As a result of the Green Paper, in 2002, the Electronic Communications and Transactions Act¹²¹ was enacted. This Act contains certain provisions which, if complied with and effectively enforced, may alleviate some of the identification problems posed by e-commerce. For instance, section 23 requires a disclosure of the time and place of communication, despatch, and receipt of information. Sections 24 and 25 deal with the attribution of data messages to the originator. Section 38 provides that the authentication of the products or services of service providers. Sections 27 and 30 contain provisions relating to cryptography so as to ensure the authenticity, integrity and reliability of Internet data. Sections 42 and 43 require the display of information about the supplier of electronic goods and services on the website. Sections

¹⁰⁹ Doernberg op cit note 107 at 1016-17.

¹¹⁰ Pinto op cit note 49 at 277.

¹¹¹ Ibid.

¹¹² Pinot op cit note 49 at 278.

¹¹³ Pinto op cit note 49 at 277.

¹¹⁴ Ibid.

¹¹⁵ Decision issued by the Indian's Authority for Advance Rulings (AAR), No. 30 of 1999 (238 ITR 296). See also India, Ministry of Finance "Report of the High Powered Committee on E-Commerce and Taxation" (2001). Available at <www.laws4india.com/indiantaxlaws/notification/ecomcontent.asp> last accessed 2 July 2008; S Pandit & S Goradia "Indian AAR Issues Landmark Ruling on E-Commerce Taxation under US- India Tax treaty" 19 *Tax Notes International* (1999) at 11.

¹¹⁶ Sections 47A-47K of the Income Tax Act.

¹¹⁷ Section 35A of the Income Tax Act.

¹¹⁸ S 35 of the Income Tax Act.

¹¹⁹ Barry Spitz & Giles Clarke *Offshore Service* (March 2002) Issue 66 at LEX/26; Olivier & Honiball op cit note 3 at 176.

¹²⁰ Department of Communications *Green Paper on E-commerce: Making it Your Business* (2000) at 10-14.

¹²¹ Act 25 of 2002.

80 and 81 deal with the appointment of cyber inspectors who have the power to inspect any website activity and information.

If a withholding tax on e-commerce is introduced in South Africa, a provision could be inserted in the Income Tax Act provided that the provisions of the ECTA would be relied on to identify the parties to the transaction and in order to ensure the collection of the withholding tax.

11. Conclusion

From the above, it can be concluded that the OECD's guidelines that tax business profits on the basis of location of servers as PEs in a source country are unsatisfactory and unsuitable basis for attributing a tax nexus for e-commerce purposes. In this authors' view the most visible way for resolving this problem is by levying a withholding tax on e-commerce transactions.