

**NATIONAL UNIVERSITY OF
RWANDA
FACULTY OF LAW**

LLM-BUSINESS LAW

*RELIABILITY OF PERMANENT ESTABLISHMENT CONCEPT
IN TAXATION OF ELECTRONIC COMMERCE*

A thesis submitted in fulfillment of the academic requirements
For the Masters degree in Business Law (LLM-Business Law)

Submitted by : Specioza KABIBI

Supervisor : Dr. NTEZIRYAYO Faustin

July, 25th 2014

CERTIFICATION

I hereby declare that to, the best of my knowledge, this thesis entitled “**Reliability of the permanent establishment concept in taxation of e-commerce**”, save as specifically acknowledged in the text, is my original work, and has neither been published elsewhere nor submitted in any other University.

Signed on ---/---/2013

KABIBI SPECIOZA

DEDICATION

This thesis is dedicated to my late father

ACKNOWLEDGEMENTS

I would like to thank my supervisor, for his tireless suggestions, comments, guidance and direction; for granting me the privilege of being able to study under him and for his permanent assistance throughout the L.L.M. program.

Heartfelt thanks, respect and appreciation goes to Rwanda Revenue Authority for generously giving me an unlimited access on their library books and documents to make this research resourceful.

This work would not have been possible without my husband. To him, I express my sincere gratitude for his time, guidance, assistance and encouragement in the pursuance of my L.L.M program.

Words cannot truly express my deepest gratitude and appreciation to my mother who always gave me her love and emotional support. She has been a source of encouragement and inspiration to me throughout my life, a very special appreciation.

Sincere gratitude also goes to my late father for the myriad ways in which, throughout his life, he actively supported me in my determination to find and realize my ignite potential. Right from my childhood he addressed me as a special female bright lawyer even when I didn't know what it is to be a lawyer. This research is for, and because of him.

Lastly, but not least, I thank God the Father, the Son and the Holy Spirit for all I have achieved, it is through His guidance, will, and power; that I successfully managed to achieve whatever I have and more especially the gift of life. Special thanks go to my heavenly mother Virgin Mary and my patron saint Jude Thaddeus as well. It is through their constant intercessions; that I achieved God's grace, mercy and blessings.

ABBREVIATIONS AND ACRONYMS

AAR: Authority for Advanced Ruling

Art(s): Article(s)

ATO: Australian Taxation Office

B2B- Business to Business

B2C- Business to Consumers

C2C: Consumer to Consumer

CIT: Corporate Income Tax

DIT: Domestic Income Tax

DTAA: Double Taxation Avoidance Agreement

DTA(s): Double Taxation Agreement(s)

E-business: Electronic Business

E-commerce: Electronic Commerce

ed.,: Edition

EU- European Union

IBFD: International Bureau of Fiscal Documentation

Ibidem: Latin word meaning same book, same author and same page

ICT- Information and Communication Technology

Idem: Latin word meaning same book, same author but on different page

ie: *Id est* (Latin word meaning that is to say)

ISP(s): Internet Service Provider (s)

MAGERWA: Magasins Généraux du Rwanda (Public General Warehouses of Rwanda)

M-Commerce: Mobile Commerce

N°: Number

NSW: New South Wales

OECD- Organization for Economic Co-operation and Development

OG: Official Gazette

op.cit: *Opere citato* (already cited)

P.E: Permanent Establishment

P: Page

P2P: Peer to Peer

Para(s): Paragraph(s)

PAYE: Pay As Earn

P.E.: Permanent Establishment

pp: Pages

RRA: Rwanda Revenue Authority

Supra: Indicates reference above or previously in text

TCP/IP: Transmission Control Protocol/Internet Protocol

UK: United Kingdom

UN- United Nations

UNCITRAL- United Commission on Trade Law

US(A): United States (of America)

vs: Versus

X: Unknown author

ABSTRACT

The Advent of e-commerce has caused many to question the reliability of the Permanent Establishment concept. Features of e-commerce that include; the borderless, ubiquitous, intangible nature of Internet as well as the expected reduction of the need of certain intermediaries in the business process; allow a business to earn income without having to maintain a physical presence in the market territory. In light of these features, and considering the traditional requirement of a physical presence for a permanent establishment to be rise, it is easy to conclude with arguments calling for the abandonment of a PE concept.

While the research accepts these arguments as being valid, nevertheless, it will be argued by the researcher that the PE concept is theoretically justifiable for income that arises from international transactions conducted in an e-commerce environment. The researcher argues that if the concept of permanent establishment cannot be sustained in this new digital realm, then overall taxation of e-commerce will be complicated thus increased tax avoidance. The researcher argues that however imperfect the PE concept is, it is the *devil we know* that should be maintained.

The researcher will however, show that despite the necessity of the PE concept, there is need for understandable and comprehensible interpretations to clarify and build up its application to e-commerce. The researcher argues that the PE concept needs to be redefined because the application of the PE concept under traditional principles may be rendered problematic in light of certain e-commerce features that are essential and significant from a tax perspective. It should therefore be redefined to encompass the innovations of e-commerce and more specifically in clarifications of when is it considered that a foreign business enterprise has a physical presence.

Table of Contents

CERTIFICATE	i
DEDICATION	ii
ACKNOWLEDGEMENTS	iii
ABBREVIATIONS AND ACRONYMS	iv
ABSTRACT	vi
Table of Contents	vii
GENERAL INTRODUCTION.....	1
I. Introduction	1
II. Choice and interest of the topic	1
III. Statement of problem.....	1
V. Objectives.....	4
VI. Methodology.....	5
VII. Scope	5
VIII. Chapter outline	6
CHAPTER ONE: OVERVIEW OF E-COMMERCE TAXATION	7
1.1. Clarification of key concepts	7
1.1.1. Definition of Electronic Commerce.....	7
1.1.2. Definition of Internet	10
1.1.3. Taxation	11
1.2. E-commerce transactions and earning of income	12
1.3. Features of e-commerce that has implications in taxation.....	14
1.4. Guiding principles for e-commerce taxation	17
CHAPTER 2: INTERNATIONAL TAXATION CONCEPTS OF RESIDENCE AND SOURCE OF INCOME.....	20
2. 1. Determining taxing rights	20
2.2. International concepts of residence and source in Rwanda	21
2.2.1. Residence jurisdiction.....	22
2.2.1.1. Residence of individuals	23
2.2.1.2. Residence of companies.....	25
2.2.1. Source jurisdiction	26

2.2.1.1. Source of Income in Rwanda.....	27
CHAPTER 3: LEGAL ANALYSIS OF THE PERMANENT ESTABLISHMENT	
CONCEPT IN E-COMMERCE	32
3.1. International Double Taxation and Double Taxation Agreements	32
3.2. Significance of the determination of permanent establishment.....	35
3.3. Traditional definition of permanent establishment	36
3.3.1 Physical permanent establishment	36
3.3.1.1. A place of business	36
3.3.1.2. A place of business must be fixed.....	37
3.3.1.3. Through which business is carried on.....	39
3.3.2. Activities excluded from the Permanent Establishment Concept.....	40
3.3.3. Agency permanent establishment	41
3.3.4. Activities and core functions PE test	44
3.4. Analysis of the PE concept in e-commerce	46
3.4.1. Computer equipment.....	47
3.4.2. Permanent establishment and websites.....	48
3.4.3. Permanent establishment and Servers.....	50
3.4.4. Internet Service Provider and Dependent Agent Permanent Establishment.....	53
3.4.5. Preparatory or Auxiliary exception.....	54
3.4.6. No necessity of human intervention	55
GENERAL CONCLUSION AND RECOMMENDATIONS.....	69
BIBLIOGRAPHY.....	72

GENERAL INTRODUCTION

I. Introduction

The general introduction provides a brief background, of the choice and interest of the topic, statement of the problem, objectives and scope of the study. It further explains the methodology adopted for the study and concludes with the chapter outline.

II. Choice and interest of the topic

As all scientific works, the choice of this study was driven by the challenges posed to the Tax Administration by e-commerce in the determination of permanent establishment. Traditionally the permanent establishment concept is based on the principal that there has to be a physical presence of the business before the source country can tax its profits.

However, with the emergency of e-commerce physical presence and physical locations are no longer required in foreign markets in order to engage in significant commercial activities. This is why my interest was to determine whether the traditional ways of determining permanent establishment would be reliable in taxation of e-commerce. The study will analyze the reliability of the PE concept in the taxation of e-commerce.

III. Statement of problem

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.¹

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

¹ B. J. Arnold and M.J. McIntyer, *International tax primer*, Kluwer Law International, 2nd ed., Hague – Netherlands, 2002, p.15

residents are taxed on their worldwide income and the source nexus, by which persons are taxed on income that originates within the geographical confines of the country.²

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 resident 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 located in that jurisdiction.³

The significance of a Permanent Establishment is that, it gives the country in which it is situated the right to tax its income, notwithstanding the fact that the Permanent Establishment has no separate legal existence.⁴

However, the advent of electronic commerce (e-commerce) makes it difficult to identify a taxable presence in a particular country.⁵ This is because as indicated above the Permanent Establishment 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. With e-commerce, physical presences and locations are no longer required in order to engage in significant commercial activities. People now routinely communicate and do business with others across vast distances, in places they have not even heard of or visited.

The borderless, anonymous, digital, ubiquitous, lack of physical presence reduced physical and human intermediaries and instantaneous nature of internet and e-commerce has challenged the operation of taxation systems and many taxation concepts which

² *Ibidem*

³ Art.7(1) of OECD Model Tax Convention on Income and Capital, Paris, 2008 (Condensed Version) hereinafter referred to as OECD MC (2008), available on, <http://www.oecd.org/tax/treaties/modeltaxconventiononincomeandoncapital-condensedversionjuly2008.htm>, accessed on 20/08/2011

⁴ See, Commentary on Art. 5 (1) of OECD MC (2008)

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

largely depend on territorial and personal bases of jurisdiction⁶. It makes it difficult for revenue authorities and taxpayers to determine whether there is a permanent establishment within a particular country.

Against this background, this research will consider and examine the reliability of the PE concept in taxation of e-commerce. This will lead to an examination of the impact of the internet and e-commerce on the established taxation principles and the ability of the existing tax regimes to cope with these new realities. In particular the concept of permanent establishment will be analyzed to examine whether it is efficient or not in the taxation of e-commerce.

Traditionally, the concept of permanent establishment required some physical presence in the country seeking to impose tax. Today, however, it is no longer necessary to have a physical place of business in a country in order to sell products or services in that country. This phenomenon has raised a discussion on whether the traditional concept of permanent establishment remains workable or if a change is indeed necessary.

Indeed, it is arguable that the elements that make up the definition of permanent establishment in OECD model tax convention and in the Rwandan tax laws may not be able to be satisfied by entities engaged in buying and selling goods and services on the internet. Where the business of a non-resident enterprise includes activities conducted wholly or partly via internet, in many cases there will be little difficulty in determining whether a permanent establishment exists. As with more traditional forms of commerce, if the enterprise maintains a physical presence such as a branch or an office in Rwanda through which it conducts business, then clearly there will be a permanent establishment in Rwanda, and the profits attributable to the activities carried on through that permanent establishment, including activities conducted electronically, will be taxable in Rwanda.

⁶ R. Azam, E-commerce taxation and cyberspace law: "The integrative adaptation model" (2007) *Virginia Journal of law & Technology* available at: http://www.vjolt.net/vol12/issue3/v12i3_a1-Azam.pdf; accessed on 23rd February 2011

The situation becomes more complicated, however, where little or no physical presence is maintained in Rwanda. For example, if all of the non-residents' business in Rwanda is conducted via a website on a server that is located in Rwanda, with no other physical presence in Rwanda, the existing rules can be difficult to apply. This raises the following research questions:

- To what extent is the permanent establishment concept applicable in the taxation of e-commerce?
- Can a website be a permanent establishment?
- Can a server be a permanent establishment for an entity carrying on business through a website hosted on the server?
- Is an Internet Service Provider an agent for the purposes of establishing permanent establishment?

It is on this ground that the researcher had a curiosity of discovering whether the traditional ways of the determining permanent establishment is reliable in the taxation of e-commerce; by analyzing challenges caused by e-commerce in the determination of permanent establishment as a taxable presence in Rwanda and possible solutions.

V. Objectives

Given the complexity of determining permanent establishments in e-commerce, the broad objective of this study is to analyze whether the permanent establishment concept is applicable in the taxation of e-commerce. In fulfilling the aim of this study, the study seeks to achieve the following research objectives:

- Identify features of internet with implications for taxation of e-commerce
- Identify international taxation concepts – residence and source of income
- Analyze traditional ways of defining PE
- Analyze whether these traditional ways are reliable in taxation of e-commerce
- Analyze the challenges caused by e-commerce in the determination of PE; and
- Possible solutions to the above problems

VI. Methodology

This study is primarily a literature study. Information for the study has been obtained mainly from text books, professional subject journals, publications by foreign government departments, relevant legislations and court cases.

A review of the literature on the permanent establishment concept and taxation of electronic commerce available at the library of Rwanda revenue Authority and the National University of Rwanda was also carried out.

The Internet was also searched as a secondary source of information.

An exegetic analysis of the permanent establishment and e-commerce concepts, which included establishing the researcher's views about the text-critical, literary and historical aspects of the concepts; were also used to better understand the meaning and significance of various provisions of the used laws and legislations. These helped in making interpretation of laws and clarifications of the intentions of the legislator.

An analysis of foreign case laws was made. Facts to the case were illustrated by tables. The challenge however was, that there are no domestic case laws in Rwanda related to taxation of e-commerce.

VII. Scope

This study is limited at analyzing whether the permanent establishment concept is reliable in the taxation of e-commerce. While it is acknowledged that e-commerce has challenged principals of VAT and Custom Duties, this study will be limited to income taxation as in accordance with the CIT laws and more especially because the PE concept is more beneficial in the CIT laws.

VIII. Chapter outline

The research will commence with the general introduction of the whole work. It presents the background of the study by indicating the choice and interest of the research, statement of the problem, hypothesis, objectives and the scope of the research. It deals with the methodology that was used to collect the data. It also concludes with the chapter outline.

The first chapter deals with an overview of e-commerce and taxation. This chapter helps to give a clarification of key concepts used throughout the research. It also gives an insight of certain features of e-commerce with direct implications for the operation of taxation systems. It explores the features of e-commerce, how internet works and the e-commerce transactions. It also discusses guiding principles of e-commerce taxation.

The second chapter deals with international taxation concepts of residence and source of income. It starts with how to determine the taxing rights and the analysis of the concepts of residence and source, which are based on to determine the taxing rights.

The third chapter deals with the legal analysis of the PE concept in e-commerce. It commences with a brief clarification of international double taxation to explain the necessity of a PE concept, followed by an examination of the significance of PE in taxation, traditional definition elements of the PE concept and the analysis of PE in e-commerce when using the traditional elements of definition. It later highlights with case illustrations the examples of e-commerce taxation. It also analyses some foreign court judgments that helps in conceiving the challenges and even those which provide possible solutions to those challenges.

The research ends with the general conclusion. It discusses the summary of the findings of the study and related recommendations.

CHAPTER ONE: OVERVIEW OF E-COMMERCE TAXATION

While it is beyond the scope of this thesis to discuss the complex functioning of the e-commerce and its working, a basic understanding of certain parts is imperative in order to comprehend the tax issues raised in this thesis. This chapter considers the definition of the key words of Internet and E-commerce, features of Internet and e-commerce, how the Internet functions and the e-commerce transaction; and the guiding principles of e-commerce taxation.

1.1. Clarification of key concepts

In order to clearly understand the research study, it is necessary to briefly define essential key words that will be used throughout this research.

1.1.1. Definition of Electronic Commerce

As noted by the Inland Revenue,⁷ there is no international accepted definition of e-commerce. However, different authors have tried to define it and they all have some common points as it is shown below.

Electronic commerce commonly referred to as e-commerce means “the use of *internet* and the web to transact businesses.”⁸ It focuses on digitally enabled commercial transactions between and among organizations or individuals.⁹ Digitally enabled transactions include all transactions mediated by digital technology whereas commercial transactions involve the ex-change of value across organizational or individual boundaries in return for products and services.¹⁰

⁷ Inland Revenue & Customs and Excise, *Electronic Commerce: UK’s Taxation Agenda*, November 1999, para 1.3.

⁸ C.L. Keneth and G.T. Coral, *e-commerce, business, technology, society*, Pearson International Edition, 4th ed., 2008, pp 10-11

⁹ *Ibidem*

¹⁰ *Ibidem*

Electronic Commerce has also been defined as “the ability to perform transactions involving the exchange of goods and services between two or more parties using electronic tools and techniques.”¹¹

Other authors have defined electronic commerce as a “network of computer networks”¹². Whereas OECD in bid to define the term notes that;

*E-commerce is a broad concept that covers any commercial transactions involving both organizations and individuals, which are based upon the electronic processing data, including text, sound and visual images. It also refers to the effects that the electronic exchange of commercial information may have on the institutions and processes that support and govern commercial activities.*¹³

The ATO on the other hand has defined e-commerce more narrowly as “the buying and selling of goods and services on the Internet.”¹⁴ This is in line with B.J. Arnold and M. J. McIntyre¹⁵ who defined e-commerce as commercial activities conducted over internet.

According to the researcher’s analysis of all the above definitions of e-commerce, the exchange of value is an important feature to understand the limits of e-commerce. Without an exchange of value, there is no e-commerce.

Having defined e-commerce, the researcher also finds it important to make a working distinction between e-commerce and e-business because we believe it defers in different phenomena. There has been a long and hot debate between e-commerce and e-business among academicians about the meaning and limitations of e-commerce. Some argue that e-commerce encompasses the entire world of electronically based organizational

¹¹ Para.3.2.1, United States Department of Treasury, *Selected Tax Policy Implications of Global Electronic Commerce*, November 1996. Hereinafter referred to as United States department of Treasury (1996)

¹² J. H. Graham Smith, *Internet law and regulation*, 2nd ed., 1997, p. 1.

¹³ OECD, “E-commerce: Opportunities and Challenges for the Government” 1997, *The Sacher Report*, Paris, p. 11

¹⁴ D. Pinto, E-commerce and Source Based Income Taxation, Doctoral series vol. 6, IBFD, March 2002,p.2

¹⁵ B. J. Arnold and M. J. McIntyre, *op.cit.*, p.150

activities that support a firm market exchanges.¹⁶ Others argue on the other hand, that e-business encompasses the entire world of internal and external electronically based activities, including e-commerce.¹⁷

For the purpose of this research, the term e-business will be used to refer to digital enabling transactions and processes within a firm, organization or institution involving information systems under the control of a firm, organization or institution. As drawn from C. L. Keneth and G. T. Carol views, unlike e-commerce, e-business does not include commercial transactions involving an exchange of value across organizational boundaries¹⁸.

For example, a company's online inventory control mechanisms like electronic filing system (e-filing), electronic payment transactions (e-payment), Electronic Single Window (ESW), Electronic Billing Machines (EBM) etc. used by many tax administrations including Rwanda Revenue Authority are a component of e-business. E-business applications turn into e-commerce precisely when an exchange of value occurs.

There are different types of e-commerce. For the most part, different types of e-commerce are distinguished by the nature of the market relationship – who is selling to whom. The exceptions are Peer to Peer (P2P), and M-Commerce which are technology-based distinctions.¹⁹

An example of the types of e-commerce distinguished by the nature of a market relationship includes; Business to Business E-Commerce (B2B) which means online business companies, that focus on selling to other business companies or firms²⁰; On line business companies or firms selling to individual consumers usually referred to as Business to Consumer E-commerce (B2C)²¹; and Consumers selling to other consumers

¹⁶ Rayport and Jaworski, 2003, quoted by C.L Keneth and G.T Carol, *op.cit*, p. 11

¹⁷ Kalakota and Robinson, 2003, quoted by C.L Keneth and G.T Carol, *op.cit*, p. 11

¹⁸ C.L Keneth and Coral, *op.cit*, p.11

¹⁹ *Idem*, p. 20

²⁰ *Ibidem*

²¹ *Ibidem*

with the help of an online market maker commonly termed as Consumer to consumer (C2C)²².

As discussed above, Peer-to-Peer (P2P) and M-commerce²³ are technology based types of e-commerce. The former is the technology which enables internet users to share files and computer resources directly without having to go through a central web server, in e-commerce; while the second one is the use of wireless digital devices to enable transactions on the web. It involves the use of wireless networks to connect cell phones, hand held devices such as blackberries, and personal computers to the web. This is an e-commerce type that is now rampant in Rwanda especially in mobile banking, electricity buying, etc.

The definition of e-commerce shown above makes it essential to also define and clarify the notion of Internet.

1.1.2. Definition of Internet

The term internet refers to “international network” of computers joined together through a common software protocol called Transmission Control Protocol/Internet Protocol (TCP/IP).²⁴

Other authors such as J.Kraynak and J.W.Hebraken defined the Internet as “a world-wide network of interconnected computer systems and a series of several types of computer services.”²⁵

From the above definitions, the researcher can conclude that, the great genius of the internet is the simple process of joining computers or computerized databases and allowing them to talk to each other through standard protocols. Before the internet error,

²² *Idem*, p. 21

²³ *Idem*, pp 21 - 22

²⁴ B. Fitzgerald, A. Fitzgerald, E. Clark, G. Middleton and Y. F. Lim, *Internet and e-commerce law, business policy*, Thomson Reuters (professional) Australia ltd, NSW, 2011, p.6

²⁵ J. Kraynak and J. W Habraken, *Internet 6 in 1*, Que, 1997, p. 5

that data would flow through the analogue channels provided by the postal services or the telephone system, as voice, telex or facsimile (fax) communications.²⁶

Other key words to clarify are notions related with tax matters; these include taxation and taxes.

1.1.3. Taxation

The word taxation refers to the imposition or assessment of a tax or the means by which the sovereign state obtains the revenue required for its activities.²⁷

On the other hand, the taxes refer to compulsory payments levied by the government on individuals or companies to meet the expenditure, which is required for public welfare. Taxes are the enforced proportional contributions from persons and property levied by the law-making body of the State by virtue of its sovereignty for the support of the government and all public needs.²⁸

There are many types of taxes and these include Value Added Taxes (VAT), Corporate Income Tax (CIT), Pay As You Earn (PAYE), etc. Since this research is limited to Corporate Income Tax; one may define CIT as a direct tax levied on business profits received by entities.²⁹

In order to clearly understand taxation of E-commerce, it is equally important to clearly understand e-commerce transactions and how income is earned through e-commerce.

²⁶ B. Fitzgerald, A. Fitzgerald, E. Clark, G. Middleton and Y. F. Lim, *op.cit.*, p. 6

²⁷ B. A. Garner, *Black's Law Dictionary*, eighth edition, Thomson West, second reprint, 2007, p. 1500.

²⁸ T. M. Cooley, the law of taxation *cited by* Bryan A. Garner, *Black's Law Dictionary*, 8th edition, Thomson West, second reprint, 2007, p. 1498.

²⁹ Art. 37 of Law n° 16/2005 of 18/08/2005 on direct taxes on income; *Official Gazette* n° 01 of 01/01/2006, (here in after referred to as Law n° 16/2005).

1.2. E-commerce transactions and earning of income

Though it is beyond the scope of this research to analyze how e-commerce might be conducted, it is necessary to give a brief background, how it works and how income is earned.

As derived from different authors' definitions of e-commerce above, e-commerce is conducted mainly through a global computer networks. The architecture of internet with its open distributed network system of packet switching and universal communication protocol has led to worldwide networks where the individuals and organizations that comprise it are independent from one another. There is no central technical control point. Yet by means of this system, a computer situated in one location can communicate with any other computer that is also connected to the network no matter where in the world it might be located, provided the illusion that all users are on the same network.³⁰

A popular way of conducting e-commerce is by using a website. Websites are computer programs that reside on a server, which are in turn connected to the internet. These servers are commonly connected to the Internet Service Providers (ISPs) but this need not be the case as computer servers may sometimes be owned, operated and maintained by businesses directly. They possess Internet Protocol (IP) numbers that are somewhat like telephone numbers, identifying devices connected to internet. This is achieved by one computer dialing the IP number of the device or computer sought to be contacted.³¹

Generally, e-commerce conducted through Internet can be broken into the physical network infrastructure and the logical network infrastructure. The physical network infrastructure refers to the physical components (user, computers/terminals, cables, routers and servers) that allow computers to transmit information to each other where as the logical network infrastructure allows this communication possible. The logical network infrastructure 'can be thought of as the laws that govern the movement of traffic

³⁰ D. Pinto, *op.cit.*, p.3

³¹ *Ibidem*

down the network highways' and refers to the actual method by which the information is transferred from one computer to another³².

In simple terms, e-commerce conducted through the internet consists of three parties, namely the ISP, the trader and the customer. The ISP will normally maintain a server located either in or outside the relevant country although bandwidth (capacity) restrictions may mean that local servers are necessary. A server fulfills the function of being a computer that physically hosts a website and which has access to internet. The website for a trader is in many ways similar to a mail-order catalogue, providing details about the trader, his or her products, and their prices. The ISP typically charges the trader a fee for hosting the website, usually at a flat rate or on a time basis.³³

A customer, after logging on to the Internet through the ISP, selects the internet address of the trader, thereby accessing the trader's website. The customer acquires a product or service listed on this site generally by entering his or her credit card information on line. With intangible products, a transaction can be completely wholly on internet usually called on-line or direct e-commerce for example digital products such as music or software can be purchased or delivered completely on-line through internet. However, with the purchase of tangible products, physical delivery is still necessary once the site registers the order on the merchant's sales system. This is referred to as off-line or indirect e-commerce.³⁴

There are many sources of e-commerce revenues and these include advertisements and direct sales³⁵. Certain providers of information or content earn revenue from advertisements. Content providers who earn from advertising revenues place paid advertisements on websites in the same manner that newspapers or magazines place paid advertisements on their printed pages. Services are also provided on internet. A number

³² C.L Keneth and G.T Carol, *op.cit.* p.203

³³ *Idem*, pp 4-5

³⁴ *Ibidem*

³⁵ Para.5.1, United States department of Treasury (1996)

of law firms, accounting firms and other professional service providers are using the Internet as another means of selling their services to clients.³⁶

Electronic trading or the provision of goods and services via electronic interaction vary with different tax consequences. For example, a customer may access the website of the book retailer³⁷ and identifies a book that s/he wants to purchase; the customer can order, have the order accepted and pay for the book via internet. Additionally, the customer can arrange for the book to be delivered electronically to the hard drive on the personal computer. The company from which the book was purchased might be an exclusively electronic retailer who has no physical stores.

Having briefly examined how e-commerce may operate and how income is earned, the next part goes to examine the characteristics of e-commerce that has implications in taxation. E-commerce has peculiar features which distinguish it from traditional commerce and which have implications in a tax perspective.

1.3. Features of e-commerce that has implications in taxation

The first and more important feature is that e-commerce is borderless. On a bigger scale, with internet, geographical boundaries cease to have meaning; e-commerce can flow seamlessly across borders. The increasing number of transactions that transcend physical borders has become a major concern to governments around the world because of potential erosion of tax bases as well as other enforcement measures.³⁸

The borderless nature of e-commerce involves borderless commerce. It bears no correlation to, and does not recognize geographical boundaries. There is no correlation of physical location of a business and commercial activities online. For example, “as it is

³⁶ An example of a Law Company is <http://www.mbendi.co.za>

³⁷ An example is Amazon, selling books on line through <http://www.amazon.com>

³⁸ S. Basu, 'Taxation of Electronic Commerce', Commentary, 2001 (2) *The Journal of Information, Law and Technology (JILT)*, p.6. Available at [http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2001\(2\)/basu1](http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2001(2)/basu1) accessed on 11/09/2012

often difficult to determine the location of the website, it is often difficult to determine physical location [of the parties and of the transaction] for e-commerce transactions”.³⁹

The impact of this characteristic is that there is a challenge of identifying which state may properly impose jurisdiction over the parties to the transactions. This also means that compliance activities by taxation authorities in relation to e-commerce will spill over into other jurisdictions. It therefore heightens the importance of cooperation among jurisdictions to reach agreement on how to tax e-commerce. As S. Basu comments, “...*Borderless commerce will expand both business tax compliance efforts in multiple new foreign jurisdictions and nexus and jurisdictional disputes over which states or nations can impose income or transactional taxes on internet vendors*”.⁴⁰

Additionally e-commerce lacks a physical presence. Before the days of e-commerce, physical presence, physical delivery of goods, and services were a norm and was very important in a business transaction.⁴¹ Under e-commerce, the word physical is optional. Physical presence is not necessary and where goods and services are digitalized neither is physical delivery. Products like books, newspapers, software, music and magazines no longer needs to be delivered in hardcopies to the purchaser. It is just easy to deliver the same thing over a wire through internet.

In traditional commerce, a market place was a physical place in order to transact. However, Internet has liberated the market from being restricted to a physical space and makes it possible to transact from your desktop, at home, at work, from your phone, etc. using mobile commerce. This has been very challenging in the tax perspective as the physical presence could have triggered a PE under the physical PE provisions.

³⁹ J. Man, J. Swinson and D. Morrison, “e-GST” (2000), Revenue Law Journal, vol.10, available at <http://www.austlii.edu.au/au/journals/RevenueLawJl/2000/9.html> accessed on 26/08/2011

⁴⁰ S. Basu, *op.cit.*, p.6

⁴¹ D. Pinto, *op.cit.*, p. 59

Apart from that, e-commerce may also reduce physical intermediaries and human intermediaries such as brokers, distributors or representatives.⁴² Examples of these possibilities are already evident and include the ability to purchase airline tickets without the need to use a travel agent, or to purchase books or music on-line, as well as retail stock trading without brokers. Such representative presences could have triggered tax nexus under the agency provisions of PE threshold.

Another important feature of e-commerce is that in many cases internet users are anonymous.⁴³ Business is transacted on a non-face to face basis and therefore the seller and the consumer may not know each other. The identity of a person carrying out e-commerce activities may not be known by other parties to the transaction and to the parties to the transaction and in many cases cannot be reliably verified. In absence of registration process requiring the production of some evidence of identity, there can be no certainty of whether a person engaging in e-commerce is in fact who they represent themselves to be online.⁴⁴ In my opinion, the impact here is that the tax administration will hardly know the taxpayer for enforcement purposes.

More to add, the ubiquitous nature of e-commerce has also challenged taxation. The production and distribution of digital products has enabled companies to become ubiquitous in the conduct of their commercial activities. The internet has expanded to engage in new forms of commerce online.⁴⁵

The impact of this characteristic is that “with narrowing of core competencies, internet businesses will frequently have more flexibility to relocate (or initially locate) their property in jurisdictions with more favorable income tax rule and rates. It is far easier to shift the location of computer servers, headquarter employees or information technology personnel than it is to move around large factories. Thus, the emergency of virtual corporation puts pressure to tax laws –particularly in the income tax arena – to develop

⁴² *Idem*, p. 62

⁴³ B. Fitzgerald, A. Fitzgerald, E. Clark, G.Middleton and Y.F.Lim, *op.cit*, p. 852

⁴⁴ *Ibidem*

⁴⁵ *Ibidem*

new rules for apportioning the income of more mobile and dynamic businesses.⁴⁶ This also challenges the essential elements of physical PE which requires a fixed place of business.

Many e-commerce transactions simply involve a customer selecting an item from an online catalogue of tangible goods electronically through the supplier's website. However the internet has also enabled commercial dealings in digital products for example sound recordings, software and videos which are downloaded directly onto the customer's computer or mobile device for example an iPad, iPod or Smartphone.⁴⁷

In a complementary development, the internet also places a premium on intangible values such as brand names and customer information, leading to more tax planning and litigations over the value and location of such intangibles.

The instant nature of the internet has also brought new forms of commerce, new ways of doing business and new ways of deriving income which tend to have a very small physical print. This requires taxation authorities to reconfigure new relevant ways of assessing tax compliance.

Despite these challenging features of e-commerce, like traditional and any other kind of commerce, e-commerce must respect guiding principles of taxation. These are analyzed in the next section.

1.4. Guiding principles for e-commerce taxation

Modern tax systems are guided by the core principles which remain essential even to the taxation of e-commerce. In particular, the OECD's committee on fiscal affairs has developed broad taxation principles for e-commerce, which were endorsed by OECD and non-OECD countries at the 1998 Ottawa Ministerial Conference. Generally, these do not differ from general principles of taxation of conventional forms of taxation. They have

⁴⁶ *idem*, p. 853

⁴⁷ *Ibidem*

been accepted world wide as providing the basis for taxation and being implemented by OECD members. The OECD taxation framework conditions set out the taxation principles that should apply to e-commerce.⁴⁸

Like taxation of traditional commerce, taxation of e-commerce should seek to be neutral and equitable between forms of e-commerce and between conventional and electronic forms of commerce.⁴⁹ The taxation of e-commerce should seek to be technologically neutral so that no particular form of commerce is advantaged or disadvantaged. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.⁵⁰

Taxation of e-commerce should also be efficient. This means that compliance costs for taxpayers and administrative costs for tax authorities should be minimized as far as possible.⁵¹

Certainty and simplicity, are also guiding principles of taxation of e-commerce. The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax should be accounted.⁵²

Taxation of e-commerce should be effective and fair. It should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimized while keeping counter-acting measures proportionate to the risks involved.⁵³

⁴⁸ OECD, *Electronic commerce: Taxation Framework Conditions*, A report by the committee on Fiscal Affaires, presented to the OECD Ministerial conference *A Borderless World –Realizing the Potential of electronic commerce* 8th October 1998, hereinafter referred to as OECD (1998)

⁴⁹ B. Fitzgerald, A. Fitzgerald, E. Clark, G. Middleton and Y.F. Lim, *op.cit.*, p. 857

⁵⁰ *Idem*, p. 856

⁵¹ *Idem*, p. 857

⁵² *Ibidem*

⁵³ *Ibidem*

Flexibility is another important guiding principle of taxation of e-commerce. The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.⁵⁴

The above framework is not at odds with the views held by the Rwanda Revenue Authority but the researcher is of the view that care should be taken to ensure that the existing Rwandan tax base is not eroded by international decisions favoring nations with sophisticated and developed economies.

Having done an overview of e-commerce taxation by understanding the key concepts, features of e-commerce challenging taxation, and the guiding principles of taxation; it is now easy to analyze the international concepts of residence and source which facilitates to determine a country's taxing right.

⁵⁴ *Ibidem*

CHAPTER 2: INTERNATIONAL TAXATION CONCEPTS OF RESIDENCE AND SOURCE OF INCOME

The essence of international taxation is the issue of whether and to what extent a country has the right to tax an individual or a company.⁵⁵ The traditional model for international taxation of global commerce is based upon the concepts of residence of a taxpayer and source of income. Residence-based tax is a type of tax system, which taxes residents of the country on their worldwide income having no regard to the source of the income. The source of income is where the economic activity creating the income occurs. The clarity between these two principles lies at the heart of the e-commerce debate due to the complex, intangible, and multi-jurisdictional nature of e-commerce⁵⁶. It is on this note that this chapter focuses on the determination of taxing rights and the international concepts of residence and source jurisdictions.

2. 1. Determining taxing rights

The principles in common use around the world to determine the extent of a country's taxing right are residence and source.⁵⁷ The principle of sovereign territoriality provides autonomy and ultimate law making and law enforcing authority to countries or states within their geographical borders and over their citizens abroad. States or countries have sovereign rights to charge and collect taxes related to their territories a term commonly termed as "fiscal sovereignty".

For practical administration and enforcement reasons, a country only asserts taxing authority over persons or property that are sufficiently connected with it to enable it impose authority over their persons or property. This is primarily based on the personal status of that person such as residence, domicile, citizenship, etc., a context mostly termed as "natural nexus" between tax base and a particular territory.⁵⁸

⁵⁵ A. Miller and L. Oats, *Principles of International taxation*, 2nd edition, Tottel publishing, 2009, p.20

⁵⁶ *Ibidem*

⁵⁷ *Idem*, p.21

⁵⁸ *Ibidem*

The primary purpose of international taxation concepts has been from its inception to resolve problems arising from the fact that taxable corporations and individuals conduct their business across international borders and thus occupy more than one fiscal jurisdiction. This later provides a solution of a burning issue of whether and to what extent should a country have a right to tax an individual or a company.

In the context of taxation of cross-border transactions, the government is broadly concerned about the activities in its country of residents and activities of its residents in foreign countries. These two aspects give rise to the two fundamental platforms of a country's international law, commonly known as the source jurisdiction of taxation and the residence jurisdiction of taxation.⁵⁹

2.2. International concepts of residence and source in Rwanda

Rwanda's international tax arrangements revolve around the basic concepts of the residence of the taxpayer and the source of their income. In general, residents of Rwanda are taxed on the worldwide income while non-residents are taxed only on income considered to have a source in Rwanda.⁶⁰

To avoid double taxation, Rwanda has entered into Double Taxation Agreements (DTAs) with some countries for example the Republic of South Africa,⁶¹ the Kingdom of Belgium,⁶² and the Republic of Mauritius.⁶³ Most DTAs are bilateral although there is also an East African DTA⁶⁴ which will bind all the East African member countries. The

⁵⁹K. Holmes, *International tax policy and double tax treaties, An introduction to Principle and Application*, IBFD publications, 2007, p. 19

⁶⁰Art. 9 of Law n° 16/2005

⁶¹ Presidential Order n° 36/2009 of 14/7/2009 ratifying the agreement on the avoidance of double taxation and embezzlement of taxes on income signed at Kigali in Rwanda, on 05 December 2002 between the Republic of Rwanda and the Republic of South Africa; O.G n° 35 of 31/08/2009 hereinafter referred to as DTAA Rwanda & South Africa

⁶²Presidential Order n° 57/01 of 04/10/2010 ratifying the convention signed in Kigali, Rwanda on 16th April 2007, between the Republic of Rwanda and the Kingdom of Belgium for the avoidance of Double Taxation and prevention of tax fraud and fiscal evasion with respect to taxes on income and capital; OG n° 41 of 11/10/2010 hereinafter referred to as DTAA Rwanda & Belgium.

⁶³This have been recently terminated from 1st January 2013

⁶⁴ The East African DTA is meant to bind all East African Countries. However, Rwanda and Burundi has not yet ratified it. Rwanda has taken some steps to ratify but it is still on parliament level.

articles of the DTAs mainly deal with issues such as residence, range of taxes covered, permanent establishment, business profits, etc. By signing, ratifying and the publication of the DTA, Rwanda undertakes to apply its taxation laws to the other signatory in accordance with the terms of agreements negotiated. Rwanda meets its obligations under the DTA by incorporating them directly into domestic law.

According to the Rwandan Constitution,⁶⁵ when there are inconsistencies between the domestic law and the ratified DTA, like all other treaties, the latter prevails. *“Upon their publication in the Official Gazette, international treaties and agreements which have been conclusively adopted in accordance with the provisions of law shall be more binding than organic laws and ordinary laws except in the case of non compliance by one of the parties.”*⁶⁶

To clearly understand the said concepts, an examination of residence and source jurisdiction is shown in the following subsections.

2.2.1. Residence jurisdiction

The residence jurisdiction involves the taxation of the country’s resident individuals and corporations on income arising from the state of residence and even that arising in foreign countries. The income is taxed because of a nexus between the country and, not the activity but the person that earns the income. The resident taxpayer is taxed on its worldwide income because:

- the taxpayer draws the benefit of the government’s public goods and services to facilitate the economic activity that produces its income from all sources that is from both within and outside the country;⁶⁷

⁶⁵Constitution of the Republic of Rwanda of 04 June 2003 (*Official Gazette* special number of 4 June 2003) as it has been amended by Amendment n° 01 of 2nd December 2003 (*O.G* special number n° special of 2nd December 2003) Amendment n° 02 of 8 December 2005 (*O.G* n° special of 8 December 2005) Amendment of 13/8/2008 (*O.G.* n° special of 13 August 2008) hereby abbreviated as Rwandan Constitution;

⁶⁶Art.190 of the Rwandan constitution

⁶⁷A. Miller and L. Oats, *op.cit.*, p.21

- the resident taxpayer typically obtains a greater level of public goods and services from the government than a non resident taxpayer.⁶⁸

To exercise residence jurisdiction, a country must provide rules that classify individuals and legal entities either as residents or non-residents. The rules determining the residence of individuals and legal entities are discussed below.

Under this approach, nexus is established on the basis of personal connection of the taxpayer to the taxing jurisdiction. So long as there is a sufficient connection with the jurisdiction, all the income of the entity will be taxed in that jurisdiction.

The determination of an individuals or company's residence⁶⁹ must be made for each relevant year of assessment.

2.2.1.1. Residence of individuals

Like taxation of traditional commerce, the ideal test of residence is very essential in taxation of e-commerce because the tax consequences of residents and non-residents are very different. V. Thuronyi⁷⁰ identifies the following three principal approaches to determine individual residence for taxation.

a) According to time spent in a particular country

Most countries determine tax residence according to the number of days spent in a country in a given period or consecutive periods. Some countries use a calendar year where as others use the fiscal year. For example, UK uses a fiscal year which runs from

⁶⁸ *Ibidem*

⁶⁹The term *residence* comes from a common English word to *reside*. The word *reside* is a familiar English word and is defined in the Oxford English Dictionary as meaning “to dwell permanently or for a considerable time to have ones settled or usual abode, to live in a particular place (Kirkbride J. and Abimbola A. Olowofoyeku, *The Law and Theory of Income Tax*, second edition, 2002, LAP, p.24)

⁷⁰V. Thuronyi, *International Aspects of Income tax in Tax Law Design and Drafting*, Vol 2, IMF 1998, available at <http://www.imf.org/external/pubs/nfi/1998/tlaw/eng/ch18.pdf> accessed on 08/05/2013

5th April to the following 5th April.⁷¹ In Rwanda, however, an individual who stays in Rwanda for more than 183 days in any 12-month period, either continuously or intermittently, is resident in Rwanda for the tax period in which the 12 month period ends.⁷²

b) According to a person's connection with a particular country

This considers tax residence as a personal attribute. In Rwanda, an individual is also considered a resident if he or she has a permanent residence in Rwanda; has a habitual abode in Rwanda; or is a Rwandan representing Rwanda abroad.⁷³ The researcher's observation is that it has been impossible, however, to legislate fully what would be considered as one's permanent residence or habitual abode.

c) According to residence rules adopted for other civil law purposes

Using this approach, a person may determine that anyone with citizenship status, or perhaps the right to work there, should be considered a tax resident. This is simpler than having different rules for different purposes, although in practice, the only major state that uses this test is the USA, which bases its residence test to a US citizenship.⁷⁴

Residence of individuals has also been challenged by e-commerce. For example, in the context of e-commerce, the 183-day test becomes untenable. The geographical location of a person has been of historical importance in affecting where that person is a resident. However, physical location becomes almost meaningless on the internet when technology exists that enables an individual to carry out activities in another jurisdiction while never actually physically leaving his geographical location even for a single day.

⁷¹ A. Miller and L. Oats, *op.cit.*, p. 32

⁷² Art. 3 of Law n° 16/2005

⁷³ Art. 3 of Law n° 16/2005

⁷⁴ A. Miller and L. Oats, *op.cit.*, p. 30

2.2.1.2. Residence of companies

There are two approaches of determining tax residences of companies. These include the legal approach and the economic approach. Under the legal approach, tax residence is determined according to the country of incorporation / registry in the commercial register.⁷⁵ This is always termed as the place of incorporation test as it concerns with the legal form of incorporation process.⁷⁶

Under the economic or commercial connection approach, tax residence is determined according to place of management; principal business location or tax residence of shareholders (not widely used).⁷⁷ This is termed as place of management test.

Rwanda uses both approaches. The Rwandan law stipulates that a company is considered as a resident in Rwanda during a tax period if it is a company or an association established according to Rwandan laws; or has its place of effective management in Rwanda at any time during that tax period; or is a Rwanda government company.⁷⁸

Residence of Companies has also been challenged by e-commerce. With the borderless nature of e-commerce, it is quite easy for a company to have effective tax residences in more than one country, and as a result, there can be an ambiguity of which country has the primary jurisdiction in the taxation of the company's profits.

Much as dual residences and multiple residences may rise, residence may also be hard to determine. For instance, virtual corporation can easily relocate their assets or businesses compared to traditional businesses. Changing the location of computer servers, are relatively easy than changing the location of a factory. Companies can more easily move to favorable tax regimes and tax havens or keep moving from one place to another without permanently settling in one place.

⁷⁵ *Idem*, p. 44

⁷⁶ *Ibidem*

⁷⁷ *Idem*, p. 52

⁷⁸ Art. 3.3 of Law n° 16/2005

The source jurisdiction examined in the following subsection; can however be applied especially where the residence jurisdiction seems much challenged.

2.2.1. Source jurisdiction

The source jurisdiction of taxation means that the country taxes non-resident individuals, and corporations on income arising to them domestically. In principle, this captures the income derived by the non-residents from the sale or use of goods, services or other resources to customers in another country.⁷⁹

The source jurisdiction is also termed as “territorial approach”. This is because it entitles the “source” country to tax the income of non-residents that is earned within its borders.⁸⁰

Under this approach, nexus is established with the income stream. That is, if the source of income is regarded to be within the jurisdiction, the income is taxed by this jurisdiction.⁸¹

In simple terms, the policy reason for taxing income that has a source in the country stems from the benefit theory of taxation. The country taxes income of which it is the source because of a nexus between it and the activities that produce the income. This means that there is an identifiable and tangible connection between the country and the income earning activity.⁸²

The main argument advanced by countries using source- based taxation is that it has to tax income arising or having source within its jurisdiction if it has provided public goods

⁷⁹ A. Miller and L. Oats, *op.cit*, p. 20

⁸⁰ Raymond Yu, E-commerce: Relevance of Source and Residence Rules, October 2001, p.8, *available at*, http://raymondyu.net/pub/papers/ecom_sr.pdf accessed on 01/07/2013

⁸¹ *Ibidem*

⁸² Shereya Rao, Nexus matters; India’s Right to Tax; *available at* http://www.nishithdesai.com/file/pdf/research/research_articles/Nexus%20Matters%20-%20India%27s%20Right%20to%20Tax.pdf; *accessed on 07/03/2013*

like infrastructures etc. for the benefit of the non-residents to enable the taxpayer to undertake its economic activity which generated the income.⁸³

The rationale behind the source basis of taxation implies that the non-resident taxpayer needs to have some sort of presence in the country in order to be able to take advantage of the public goods and services offered by the government.⁸⁴

This explains why, in principle a non -resident business taxpayer should be having a permanent establishment in the country before the said country may impose tax on the non- resident's business income sourced in the country.

2.2.1.1. Source of Income in Rwanda

The issue of source of income is essential in Rwanda; as in accordance with Rwandan tax laws, it will only tax non-residents when they have income derived from Rwanda.⁸⁵

Although the Rwandan income tax law does not define the term *source*, the determination of the actual source of income may be derived from article 4 of law n° 16/2005 pre-cited. The stipulations of this article indicate that income from sources of Rwanda includes, income from services provided in Rwanda employment executed from Rwanda, crafts person, musician or a player from his or her performances in Rwanda, activities carried on by a non-resident through a permanent establishment in Rwanda; sale of movable, immovable and any other assets owned by a permanent establishment in Rwanda, and any other activities carried on in Rwanda, etc.

Critical analysis of this article shows that before determining the source of income of Rwanda, the *originating cause* of the income and *location* of the originating cause must

⁸³ D. Pinto, *op.cit.*, p.19.

⁸⁴ Bijal Ajinkya; Residential Refresher Course on International taxation –current and emergency issues; available at;

http://www.nishithdesai.com/file/pdf/research/research_articles/Source%20Versus%20Residence%20-%20An%20Indian%20Perspective.pdf accessed on 07/03/2013

⁸⁵ Art. 9 of Law n° 16/2005

first be established. This is because; this article reflects that the source of the income is where the originating cause is located.

The analysis of the above said article 4 of law n° 16/2005, however, shows that it is silent on what could be the source of income where the income had multiple originating causes. Some authors has established that in case of multiple originating causes, the dominant cause of the income arising must be determined and therefore, the source of the income will be where the dominant source of the income is located.⁸⁶

Like other concepts, source jurisdiction has also been challenged by e-commerce. As the physical location of an activity becomes less important in e-commerce, it becomes more difficult to determine where an activity has taken place and hence it becomes harder to determine the source of income. For example, what is the source of a sales income if the customer acquired the goods by navigating through and clicking the website?

The source-based tax system has inadequacies in the e-commerce environment. The reasons for the inadequacies are:

- The true source of the income has been obscured as the elements of a transaction can be performed in many jurisdictions, thus becoming difficult to determine source and dominant source.
- It has become easier and more economically feasible to transfer valued added elements of businesses, which account for a significant portion of the profits of the enterprise, out of the source jurisdiction.⁸⁷

In this regard, it is interesting to note the viewpoints of the United States Department of

⁸⁶ R. Buys., *Cyberlaw @ SA: the Law of Internet in South Africa* (2000) Pretoria: Van Schaik Publications, hereinafter referred to as Buys, 2000, p. 250

⁸⁷ *Idem*, p. 234

Treasury and the Australian Taxation Office as they both speculate on the demise of the source basis of taxation, and suggest that the advent of e-commerce will accelerate a trend towards preferring residence-based taxation to source-based taxation.

The United States Department of Treasury takes the following view:

*'The growth of new communication technologies and electronic commerce will likely require that principles of residence-based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible to apply traditional source concepts to link an item of income with a specific geographical location. Therefore, source-based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere...'*⁸⁸

However, certain commentators have questioned the United States' preference for residency concepts over source concepts.⁸⁹ In their view, the United States is predominantly an exporter of goods and services and will benefit from a taxation system based on residency concepts. It has been suggested that the United States policy 'primarily seeks to protect the interests of American companies and United States revenue.'⁹⁰ This is because as exporters the US residents will earn their income when based in the US territorial borders.

In a similar vein, the Australian Taxation Office takes the following view:

"The Internet provides an environment where automated functions, by their very nature, may be able to undertake a significant amount of business activity in a source jurisdiction with little or no physical activity or participation in the economic life in any jurisdiction anywhere. This highlights the inappropriateness

⁸⁸ Para 7.1.5, United States Department of Treasury (1996).

⁸⁹ Joint Committee of Public Accounts And Audit "Internet Commerce – To Buy Or Not To Buy", 1998, Australia, p.3. Hereinafter referred to as Joint Committee of Public Accounts and Audit (1998)

⁹⁰ *Ibidem*

*in an Internet environment of allocating taxing rights on a concept based on geographical fixedness ...*⁹¹

The Australian Taxation Office further states that:

*Australia's source rules are challenged by electronic commerce. Universal access to a web site, automation, and high mobility mean that most electronic commerce activities may generate considerable revenue without necessarily being located in close proximity to the market and without significant use of any infrastructure anywhere. For highly mobile activities (e.g. high value services), source rules are based on location that are more likely to facilitate tax planning. The need to apply source rules to different types of income on a case by case, factual approach will create considerable difficulties in an Internet environment with a large number and variety of interfaces, activities, and modes of delivery.*⁹²

The OECD also identifies source rules as a general problem area:

*The Internet is expected to pose challenges to the operation of the domestic source rules of all member countries. The ability of members to apply domestic source rules to Internet businesses could become crucial if most Internet businesses eventually migrated to low tax jurisdictions, which are generally expected to fall outside tax treaty networks. Potential jurisdictional and enforcement issues for source rules will be common to all OECD members and are likely to benefit from a coordinated approach*⁹³

In the determination of the country's taxing rights, it is also essential to discuss the permanent establishment concept. This is because it helps the permitted countries to share tax revenues in cases where two or more different countries have either source rights or residency rights to the company's profits. In other words, it helps to identify who has a

⁹¹ Australian Taxation Office *Tax and the Internet - Second Report (1999)*, para 7.2.17 hereinafter referred to as Australian Taxation Office (1999)

⁹² Paras 7.2.9. and 7.2.10, Australian Taxation Office (1999).

⁹³ OECD, 1998, para 119.

legal taxing right in case the taxpayer is a resident in one country and has sourced an income in another country or in case a taxpayer has sourced income in many countries or where the taxpayer is a resident in many countries. This is why the following chapter examines the PE concept in general and later in relation to e-commerce.

CHAPTER 3: LEGAL ANALYSIS OF THE PERMANENT ESTABLISHMENT CONCEPT IN E-COMMERCE

As previously discussed, the permanent establishment concept is an essential issue with regard to taxation of e-commerce. The purpose of this chapter is to analyze the concept of permanent establishment in the context of e-commerce. To achieve this, the constitutive sections analyses the significance of permanent establishment, the traditional definition of permanent establishment, analysis of the PE concept to e-commerce, typical examples of e-commerce transactions and examines case laws involving e-commerce in need to provide solutions to certain challenges posed.

However, before analyzing the PE concept, it is necessary to briefly talk about double taxation agreements in order to clearly understand the permanent establishment concept.

3.1. International Double Taxation and Double Taxation Agreements

As discussed in the previous chapter; countries tax on the basis of both residence status of the taxpayer and source of income. Consequently, foreign income earned by a resident of a country may be taxed by both the country of source and the country of residence. This is commonly termed as International Double Taxation.

International double taxation has been defined as “the imposition of comparable income taxes by two or more sovereign countries on the same item of income (including capital gains) of the same taxable person for the same taxable period”.⁹⁴ The legal definition of International Double Taxation however is different from the broader economic concept of double taxation. In the broader economic concept, International double taxation occurs whenever there is a multiple taxation of same items of economic income⁹⁵. However, under the legal definition, taxation of one subsidiary company by one country and the taxation of a parent company on the dividend from that subsidiary by another country is

⁹⁴ B. J. Arnold, M. J. McIntyre, *op.cit.*, p.29

⁹⁵ *Ibidem*

not international double taxation⁹⁶. This is because the two companies are separate legal entities.

International Double Taxation can rise from a variety of causes. The following three types of double taxation arise from conflicts over tax jurisdiction. These include:

The first type of double taxation is commonly called *Source-Source conflicts*. This is where two or more countries assert the right to tax the same income of a taxpayer because they all claim the income is sourced in their country.⁹⁷

Another type of double taxation is where two or more countries assert the right to tax the same income of a taxpayer because they claim the taxpayer is a resident of their countries. In most cases it happens when the tax payer is a dual-resident taxpayer. This type of double taxation is termed as *Residence-Residence conflicts*.⁹⁸

A *residence-source conflict* is another type of double taxation. Here one country asserts the right to tax foreign-source income of a taxpayer because the taxpayer is a resident of that country, and another country asserts the right to tax the same income because the source of the income is in that other country.⁹⁹

In a bid to eliminate double taxation caused by the above conflicts, most countries have developed means of mitigating the conflict, either through their own individual tax codes (exemption and credit method), or through their bi-lateral or multi lateral tax treaties with other countries. These treaties are called Double Tax Avoidance Agreements (DTAAs).

However, as a general rule, most international treaties give the residence country an unlimited right to impose tax on the world wide profits of resident companies, and limit

⁹⁶ *Ibidem*

⁹⁷ *Idem*, p. 27

⁹⁸ *Ibidem*

⁹⁹ *Ibidem*

or eliminate the source country's right to tax.¹⁰⁰ Persons subject to the residence jurisdiction of a country generally are taxable on worldwide income, that is, the person is typically taxable on both domestic sourced income and foreign sourced income.¹⁰¹

To avoid double taxation, in a situation where an enterprise is a resident in one country with income originating in another, most DTAA's will provide that the profits to qualify as having arisen in the source country, they must have been earned through a permanent establishment created by a non-resident company in that jurisdiction. If no permanent establishment is found, the source country may tax the profits¹⁰².

Thus, the capability to tax profits from e-commerce rests on the ability to find that an enterprise conducting business over the internet either has the place of residence in a given jurisdiction, or derived its profits from business carried on within designated country where it has a PE, or both.

The most significant provision included in international tax treaties is listing and excluding activities which leads to determine permanent establishment in a given country.

However, with the emergency of electronic commerce, finding such a listed activity that leads the tax administration to get a taxable activity or presence within a country is very difficult. An analysis of typical e-commerce activities demonstrates the difficulty of actually applying such permanent establishment concept to the internet. Thus, the question of permanent establishment becomes a crucial issue with regard to e-commerce.

Although the PE concept has been challenged by e-commerce, the concept remains vital in taxation due to its significance.

¹⁰⁰ United States Department of Treasury (1996), *op.cit.*, para.7.1.4

¹⁰¹ B. J. Arnold and M.J. McIntyre; *op.cit.*,p.15

¹⁰² *Idem.*, P, 28

3.2. Significance of the determination of permanent establishment

Historically, the concept of PE answered an international necessity for a quantitative criterion for ascertaining the taxability or non-taxability of foreign commercial activity in the source state.

The rationale for the PE concept has historically rested on two main grounds.¹⁰³ The concept provided a sufficient evidence that foreign companies business within the source country was substantial enough to justify the imposition of fiscal compliance burdens on the foreign company in that state. This clearly means that the PE concept will define whether a foreign enterprise has sufficient nexus with the state to warrant the enterprise being subject to local CIT. Under nexus rules, it is determined by whether a foreign enterprise or its agents actually conduct core business income-producing activities in the state and historically it has been accepted that the conduct of such business requires foreign enterprises to have some physical presence in the state by way of labour and/or property.¹⁰⁴

The permanent establishment concept also permitted source countries to share in tax revenues from the profits created by commercial opportunities presented by their markets. 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.¹⁰⁵

Having examined the Double Taxation Agreements and significance of PE; it becomes approachable to examine the legal definition and traditional elements of the permanent establishment concept.

¹⁰³ C.Finnerty, P. Merks, M.Petriccione, R. Russo, *Fundamentals of International Tax Planning*, IBFD, 2007, p.48.

¹⁰⁴ eComTaxpert Group, Taxation of Electronic Commerce in India, Mumbai-Silicon Valley, June 2002, p.19 of 84 (confidential)

¹⁰⁵ P.Sri Sudha; Electronic Commerce and service PE in the International Tax Law; p.1455 available at http://220.227.161.86/29310cajournal_mar2013-27.pdf accessed on 10th June 2013.

3.3. Traditional definition of permanent establishment

In order to understand the permanent establishment concept in taxation of e-commerce, a clear understanding of the traditional definition of PE is necessary. An overview of the main aspects of the definition will be provided here. Particular aspects of the definition warrant a further analysis and this will be undertaken later when analyzing the PE concept in e-commerce.

For Rwandan income tax purposes, a “permanent establishment” is defined in article 5 of law n° 16/2005 of 18/08/2006 on direct taxes. This definition is similar to Article 5(1) of the OECD Model Tax Convention which defines a permanent establishment as “a fixed place of business through which the business of an enterprise is wholly or partly carried on”¹⁰⁶. From this definition, three essential elements can be identified, as it will be analyzed.

Analysis of this definition provides different manners in which the business can have enough ties to cause a permanent establishment to exist. These include; physical PE test, Agency PE test and activities & core functions PE test.

3.3.1 Physical permanent establishment

The first way in which to establish a business tie that give rise to a PE is the physical PE test. According to the physical permanent establishment, a permanent establishment exists only if three basic elements are satisfied. These include, a *place of business* that is *fixed* through which business of enterprise is wholly or partially *carried on*.

3.3.1.1. A place of business

Generally, the term place of business covers premises, facilities, or installations used to carrying on business of the enterprise. This means that a permanent establishment will only exist if the enterprise has a physical presence in the source state. Under article 5 of

¹⁰⁶ OECD MC (2008), *op.cit.*, Art., 5(1)

the Law n° 16/2005 already cited, a place of business constitutes; an administrative branch, factory, workshop, mine, quarry or any other place for the exploitation of natural resources, and a building site or a place where construction or assembly works are carried out. According to the strict interpretation of this article, one can argue that only a physical presence of the business is considered a PE.

The OECD Model Tax Convention, however, adds that, a place of business may exist where no premises are available or required for carrying on business.¹⁰⁷ Even a certain amount of space can constitute a place of business.¹⁰⁸ As we will however found out in this research, the commentaries on the OECD MC accepts that even where there is no physical presence of a business, a PE can exist.

Similarly, the federal tax court of the Republic of German, specifically in the “pipeline”¹⁰⁹ case, 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.

3.3.1.2. A place of business must be fixed

In its ordinary and plain meaning, the word ‘fixed’, as per the Dictionary, means – (a) definitely and permanently placed or assigned (b) stationary or unchanging in relative position and (c) definite, permanent & lasting.¹¹⁰

According to the OECD commentary, the term ‘fixed’ means established at a distinct place with certain degree of permanence. As to what constitutes a reasonable period of time to a given necessary degree of permanence depends upon the nature of business of

¹⁰⁷ Commentary on Art. 5(1) of the OECD M C, p.81

¹⁰⁸ C.Finnerty, P. Merks, M.Petriccione, R. Russo, *op.cit.*, p. 40

¹⁰⁹ German Tax Supreme Court, Bundesfinanzhof vorn (BFH) 30.10.1996, III R 12/92, Betriebs-Berater (BStBl) 1997. Hereinafter abbreviated as “ the pipeline case), p. 138.

¹¹⁰ A.S. Hornby, Oxford Advanced Learners Dictionary, International Student’s Edition, new 8th ed., 2010, p. 563.

the enterprise in the backdrop of facts of each case. Obviously, ‘permanent’ in the context of ‘fixed place of business’ does not mean for ever nor can it be merely temporary.¹¹¹

For a place of business to be fixed, two components have to be met, namely: specific geographical spot (the location test) and a certain degree of permanence at each geographical spot (the duration test).¹¹²

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 ground¹¹³. In applying this test, the context of the business has to be understood first.

Under the duration test, a certain degree of permanence is required in order for a permanent establishment to exist. The business should not be temporary in nature.¹¹⁴ This is evidenced in the case law of *Transvaal Associated Hide and Skin Merchants vs. Collector of Taxes, Botswana*¹¹⁵. Here, it was decided 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. Additionally, 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.

It should however be noted that, the mere presence of a non-resident at a particular location does not necessarily make that location a ‘place of business’. In other words, it means that there should be a relationship between the place and the business of the

¹¹¹B. Fitzgerald, A. Fitzgerald, E. Clark, G. Middleton and Y. F. Lim; *op.cit.*, p. 868

¹¹² *Idem*, pp 867-868

¹¹³ D. Pinto, *op.cit.*, p.73

¹¹⁴G. Cristián, *The Fixed Place of Business in the Context of Electronic Commerce*, IBFD, 2003, p.4.

¹¹⁵ *Transvaal Associated Hide & Skin Merchants v Collector of Taxes Botswana*, 29 SATC, 97, available at , available at: http://www.elaws.gov.bw/rep_export.php?id=917&type=pdf, accessed on 12th April 2011

enterprise, *i.e.*, does the place of business support the business activity or does the business activity simply occur at the place of business?¹¹⁶

3.3.1.3. 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. The phrase “through which business is carried on” infers that the fixed place of business must be functional to the carrying on of the business of the non-resident¹¹⁷. This further means that the business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose.

To clearly understand this, a distinction has to be made between a permanent establishment “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. Although the business of the enterprise needs to be carried on through the permanent establishment, this does not necessarily mean that a permanent establishment will only exist if individuals are present.

Although the presence of individuals may be required for the setting up of a permanent establishment, their ongoing presence is not required.¹¹⁸ The presence of fully automatic equipment operated and maintained by the enterprise in the host country may constitute a permanent establishment. However, if the non-resident enterprise merely sets up the machines and then leases them to other enterprises, a permanent establishment does not exist, because that machine is not functional in carrying on the non-resident’s business.

¹¹⁶Golf in Dubai vs DIT, F.No. AAR/770/2008 dated 13th October 2008; *available on*, <http://www.itatonline.org/dlmonitor/download.php?t=f&i=112> accessed on 12th April 2011

¹¹⁷ C.Finnerty, P. Merks, M.Petriccione, R. Russo, *op.cit*, p.41.

¹¹⁸ Para 1(10) of the commentary on Art.5 of the OECD MC

3.3.2. Activities excluded from the Permanent Establishment Concept

The Rwandan law and the OECD Model Tax Convention, sets out certain activities that are excluded from the permanent establishment definition.¹¹⁹ 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 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.¹²⁰

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.¹²¹

The researcher however finds this not efficient. For example, a warehouse according to article 5 of OECD MC or article 5 of law no 16/2005 pre-cited, is considered as either preparatory or auxiliary. Although this might be valid because warehouses mostly stores goods when waiting for customs processes for example SDV warehouses are used to keep goods for SDV when they await customs procedures clearances; there is a time when an enterprise makes business through warehousing. A good example is MAGERWA where its sole business is to keep safe goods of clients when they are still under Customs regime. They earn revenues from the act of keeping goods under Customs regime.

¹¹⁹ Art. 5 of Law n° 16/2005

¹²⁰ Para 24 of the Commentary on Art.5 of the OECD MC

¹²¹ *Ibidem*

3.3.3. Agency permanent establishment

The second way in which to establish a business tie that cause a PE is an agency PE test. Agency PE exists when four basic elements exist. All this elements applies to dependent agents exercising their authority to contract. The elements include:

- 1) *a dependent agent*
- 2) *acts on behalf of an enterprise in a foreign State*
- 3) *has an authority to conclude contracts in that foreign state in the name of the enterprise*
- 4) *habitually exercises such authority.*¹²²

The agency permanent establishment will result, if a non-resident employs a dependent agent having contracting ability in the taxing jurisdiction. It is usually a common practice for people who start business in another country to use agents to secure sales rather than to set up a new shop or business premises staffed by the firm's own employees.¹²³

Although an enterprise may not have a fixed place of business in a host state, a permanent establishment 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. This is also evident in Rwandan tax law.¹²⁴ Persons however, whether individuals or juristic whose activities may create a permanent establishment, should not be independent agents.

According to the OECD, the essential factor which plays an important role in deciding whether a person is a dependent or independent agent is the amount of freedom the person entering into contracts on behalf of the enterprise has. If the person operates under detailed instructions and control, this indicates a dependent status; and, if the risk is borne by the agent, then that person acts independently.¹²⁵

¹²² Commentary on Art. 5(1) of the OECD MC, p.78

¹²³ A. Miller and L. Oats, *op.cit.*, p. 121

¹²⁴ Art. 5 para.4 of law n° 16/2005

¹²⁵ Para 37-38 of the Commentary on Art. 5 of the OECD MC

Essentially, to fulfill this requirement the agent cannot be self-employed and perform similar activities for more than one business.¹²⁶ This is relatively straight forward as applied to software agents, since the software agent likely would not be self employed elsewhere and would not perform similar activities for other businesses. As a result, software agents would likely fulfill this basic element.

The requirement to fall out the agency permanent establishment category is that an enterprise's representative in the source state must be a broker, a general commission agent or any other agent of an independent status who acts in the course of its business.¹²⁷ Holmes K. continued to suggest that for an agent to be considered of an independent status, s/he should be both legally and economically independent of its principal.¹²⁸

Holmes K. goes on to differentiate the two modes of independence. He explains that legal independence means that the principal has no control over, or power to interfere in day-to-day business of the agent. Legal independence would normally be evidenced by the existence of a contract between the agent and the principal.¹²⁹ According to him, economic independence, on the other hand, means that the agent conducts its own exclusive business where it bears the entrepreneurial risk of the business, that is, there is no merging of the business interests of the principal and the agent.¹³⁰

Article 5(7) of the UN Model of DTA offers further clarification. It specifies that (...) *when the activities of ...an agent of independent status are devoted wholly or most wholly on behalf of an enterprise,(...) he will not be considered as an agent of independent status(...)*¹³¹.

¹²⁶ Art. 7(1) of the OECD Model Tax Treaty (2003)

¹²⁷ K.Holmes, *op.cit.* p. 161

¹²⁸ *Ibidem*

¹²⁹ *Idem*, p.162

¹³⁰ *Ibidem*

¹³¹ United Nations of Economic and Social Affairs, UN Model Double Taxation Convention between Developed and Developing Countries, New York, UN (2001); Art. 5(7)

This means that an independent agent should not be acting in his ordinary course of business. It also means that since s/he is wholly devoted to the business of the other, s/he is not independent in actual sense and thus constitute to a permanent establishment.

Another essential required element to fulfill an agency PE is whether the agent *acts on behalf of an enterprise in a foreign State*. This element is relatively easy to ascertain in the traditional concept. The main question of fact is whether the agent is acting on behalf of the principle. Determining whether the software agent complies with its requirement is simple in that a software agent is specifically programmed to act for the benefit of the principle. This is because it is always presumed that by carrying out the directions of the principal via a program, the agent acts for the benefit of the principal.

Another essential required element to fulfill an agency P.E is whether the agent has an authority to conclude contracts in that foreign state in the name of the enterprise. The basic question posed in this element of agency permanent establishment is *whether the agent is acting as intended or as reasonably expected by the principal*. Computer agents are easily applied than human agents in this element because computer agents are easily programmed to act in a certain manner and so they act as the principal intends or reasonably expects them to act. Whatever the computer agent does, is what it has been programmed to do by the principle, thus it acts according to the intention of the principle¹³².

Another question posed in the agent permanent establishment is whether the agent *habitually exercises such authority*. This element is primarily the requirement of regularity or frequency¹³³ and excludes incidental acts. A computer agent should be held on the same standard as a human agent of this element, as their functions and jobs are substantially identical, and as such the software agent fulfills this element in the same

¹³² SCHAEFER B. "International Taxation of Electronic Commerce Income: A Proposal to Utilize Software Agents for Source-based Taxation" (1999) Nov *Santa Clara Computer and High Technology Law Journal* 120-121, hereinafter abbreviated as (Schaefer (1999), available at, <http://digitalcommons.law.scu.edu/cgi/viewcontent.cgi?article=1256&context=chtlj&sei-redir=1&referer>

¹³³ *Idem*, p. 112-139

way as a human agent. In conclusion it appears that the second element is uncertain where as other elements are relatively simple to determine.

From the above, therefore for a physical or agency permanent establishment to be there, 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 permanent establishment.

However, with the above- analyzed elements, it is in many cases unclear whether software agents or computers may be deemed to conduct business as it has led to many challenges as it will later be discussed in this chapter.

3.3.4. Activities and core functions PE test

This is perhaps the most widely applied test. Under the activities test, certain activities result in a permanent establishment while others clearly will not. The activities test depends on the core functions of an enterprise. The determination of what constitutes core functions for an enterprise depends upon the nature of the business carried on by that enterprise¹³⁴. This requires that the functions performed at that place be significant as well as an 'essential' or 'core' part of the business activity of the enterprise¹³⁵.

Where the server functions form an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, there would be a permanent establishment.

The determination of what constitutes core functions for an enterprise depends upon the nature of the business carried on by that enterprise.¹³⁶ This requires that the functions performed at that place be significant as well as an 'essential' or 'core' part of the business activity of the enterprise. Obviously, if the functions performed are essential or core, this

¹³⁴ OECD clarification of the Application of the permanent establishment Definition in e-commerce (2000) para. 42.9.

¹³⁵ *Ibidem*

¹³⁶ *Ibidem*

will mean that they are not auxiliary or preparatory so as to be excluded from constituting a PE.

Where the server functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment there would be a permanent establishment.

Article 5(4) of the OECD Model Tax Convention and paragraph 3 of article 5 of Rwandan n° 16/2005 excludes preparatory and / or auxiliary activities from the definition of a PE. The article also gives a list of other excluded activities. These include: the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise, maintenance of a fixed place of business solely for the purpose of purchasing merchandise, and maintenance of a place of business solely for the purpose of collecting information for the enterprise. The researcher however argues that even though the OECD Model included the above listed activities among those excluded from the definition of PE, critical analysis of the said list shows that they still remain to be either preparatory or auxiliary activities.

This exclusion is likely to be important in an e-commerce context, as many activities, including the advertising of goods and services, could fall within the ambit of excluded activities under article 5(4) of the OECD Model Tax Convention.

This also comes to emphasize that if the activities or core functions of the enterprise are auxiliary or preparatory; then a PE cannot arise as they are expressly excluded from what constitutes a PE.

Having clearly understood the legal definition and traditional elements of the permanent establishment concept, the following section analyses the application of the said elements in e-commerce.

3.4. Analysis of the PE concept in e-commerce

As previously analyzed, the nature of e-commerce has implications on the application of the P.E concept. It is arguable that the nature of e-commerce may challenge the elements that make up the definition of P.E which was mostly focusing on the traditional modes of commerce. This section tries to analyze the application of a PE traditional definition in e-commerce context.

To clearly understand the legal issues; the researcher takes an example of where a person (customer) is able to access the website of X, which could be located on a server that could either be owned by X or, alternatively the website could be hosted by a computer server maintained by an ISP. In either case, the location of the server could be in Rwanda, where X is based or in a foreign country where customers are located, or even in the third country, which could be chosen by X for commercial reasons.

This example raises a number of difficult questions in relation to the application of PE concept to websites, servers, and representative presences such as human agents or ISPs. Some of these questions include the following: Can a website be a PE? Can a server be a PE? Can an ISP be regarded as an agent PE? In answering these questions, a number of aspects have to be considered and though some are interrelated, subsequent analysis will be conducted for computer equipments, websites, servers, ISPs and other relevant issues.

Considering the previous analyzed essential elements extracted from article 5 of the OECD Model Tax Convention which is equivalent to the Rwandan article 5 of law n^o 16/2005 of 18/08/2005 on direct taxes on income, this section will analyze whether computer equipments, websites, servers, ISPs and other relevant issues fulfills them to qualify as PE.

3.4.1. Computer equipment

Under many domestic tax laws, a taxpayer that owns and uses real property or equipment to engage in substantial business activities in the country would have sufficient nexus with that country to be taxable there, save for special exemptions.¹³⁷

The fact that the computer equipment used to conduct substantial business is a computer or computer peripheral may make no difference since it is also a real property. The use of a server for example, to conduct business activities in the country should be sufficient to create a taxable presence in that country under at least some circumstances. What those circumstances are would depend on domestic legislation of particular countries.¹³⁸

To determine whether a computer equipment operated by a company constitute a permanent establishment in the country where it is situated, a distinction must be made between the computer equipment which may be set up at a location so as to constitute a permanent establishment; and the software and data which is used by or stored on that computer equipment.¹³⁹ This is because computer equipments meant to store data is more equivalent to a warehouse activity which is excluded from PE according both article 5 of OECD MC and article 16/2005 of the Rwandan pre-cited law.

The distinction is important in that it recognizes the traditional notion of the fixed place of business. The permanence test looks at whether the computer has actually been moved or cannot be moved. Therefore, computer equipments at a given location may constitute a permanent establishment if it meets requirements of being fixed.¹⁴⁰

The presence of computer equipment in a country can constitute a PE if it is fixed at some location for some period. The fact that it can be moved from one place to another or the fact that the computer is movable does not mean that it is not fixed unless it is

¹³⁷ B. J. Arnold and M. J. McIntyre, *op.cit.*, p. 155

¹³⁸ B. J. Arnold and M. J. McIntyre, *op.cit.*, p. 155

¹³⁹ Para.42.2 of the OECD clarification on the application of the permanent establishment definition of e-commerce, 2000

¹⁴⁰ OECD clarification on the application of the permanent establishment definition in e-commerce, 2000, para.42.4

actually moved. In addition, the business of an enterprise must be conducted where the equipment is located for that location to be a PE of the enterprise.¹⁴¹

3.4.2. Permanent establishment and websites

A website is essentially a location on the World Wide Web. It is a collection of linked computer files located on the hard drive of a server that is connected directly to the internet. It contains a home page, which is the first document users see when a web address is accessed. Websites consist of the software and electronic data stored on the server that allows an enterprise to interact directly with its customers.¹⁴²

An important issue in the income taxation of e-commerce is the treatment of substantial business conducted by a foreign taxpayer through a website that appears on computer screens located in that country. A website allows the enterprise to interact with its customers in ways that are strongly analogous to the interactions that typically occur through the bricks and mortar office. Sales through a website constitute an important part of e-commerce.¹⁴³

More to add, a website gives remote sellers direct access to all consumers in a country who have access to the internet. Potential customers can log onto the remote seller's website, select products for purchase from an online catalogue, and consummate the sale online by filling out the form and charging the purchase to third personal credit card.¹⁴⁴ If these electronic sales are viewed as made through the PE the electronic sales are taxable in the source country. If this virtual office is not treated as a PE, however the income derived from the electronic sales will escape taxation in the source country and escape taxation elsewhere as well.

¹⁴¹ B. J. Arnold and M. J. McIntyre, *op.cit.*, p. 156

¹⁴² *Idem*, p. 151

¹⁴³ *Idem*, p 154

¹⁴⁴ *Ibidem*

As discussed earlier, for a PE to exist, the essential element of the place of business must exist. It is therefore legally required that for a website to be regarded as a PE, a place of business must exist.

Paragraph 4 of the commentary of article 5 of OECD model convention requires that a place of business should be a physical location such as a premise, facilities or installations. Since a website is a combination of software and electronic data, it would not involve a tangible property and therefore the most likely conclusion is that it cannot constitute a place of business. This is because it 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'.¹⁴⁵ As an intangible property and not physical, therefore 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 permanent establishment.¹⁴⁶

However, this seems to be inefficient, because if the website holds information for a business, and sells this information by executing orders and arranging for shipments, then it has all the characteristics of a permanent establishment, because it is worth a boutique or an office that affirms a fixed place of business. This is why some OECD countries like Portugal and Spain disagreed with the above OECD view and considered treating a website as a PE¹⁴⁷. Portugal's and Spain's view is in line with the researcher's view because when you consider the activities or core function approach, the website can be treated as a PE when it is used to perform the functions of a traditional office especially because it does the function of the virtual office.

This functional approach would promote equal treatment of the e-commerce and more traditional commerce and would avoid the competitive problems that would result from

¹⁴⁵ OECD Committee on Fiscal Affairs, *Model income tax convention on income and on capital*, condensed version, July 2008, p. 97.

¹⁴⁶ *Ibidem*

¹⁴⁷ B. J. Arnold and J. M. Mclyntre, *op.cit.*, p. 154

giving a preference to one form of business over another. Taxation of websites as PE's moreover would reduce the opportunities that taxpayers would have to avoid all taxes.

One has to remember however that being a virtual office only, should not be the only reason to make a website a PE. Even if the website was treated as a virtual office or fixed place of business, the exception of a preparatory or auxiliary functions would be applicable. A website that simply operated as an electronic catalogue would not be a PE, just as having a traditional catalogue in a country would not constitute a PE in that country for that remote seller.¹⁴⁸

3.4.3. Permanent establishment and Servers

A server is automated equipment on which an Internet web site is stored and through which the website is accessible. 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.¹⁴⁹

Furthermore, if a server is used regularly for enterprise business, it may constitute a permanent establishment if it is at the disposal of the enterprise for that purpose.

When an enterprise conducts its business through a website that is hosted 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 of the enterprise is hosted on a specific server at a specific location. 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.¹⁵⁰

¹⁴⁸ *Idem*, p.155

¹⁴⁹ A. Lymer and J. Hasseldine, *The International Taxation system*, Kluwer Academic Publishers, 2002, p.63

¹⁵⁰ B. Fitzgerald, A. Fitzgerald, E. Clark, G. Middleton, and F.Y. Lim, *op.cit.*,p. 870

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. What is relevant is not the possibility of the server being moved, but whether it is in fact moved.¹⁵¹

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. Even if the enterprise has control over the server at a fixed place of business, the meaning of permanent establishment still requires that the business of the enterprise should be wholly or partly carried on through the place where the server is located.¹⁵²

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 permanent establishment. 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.¹⁵³

Paragraph 42.7 of the OECD Commentary on article 5, further provides that a server will only be considered a permanent establishment 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 permanent establishment.¹⁵⁴ 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

¹⁵¹ *Ibidem*

¹⁵² *Idem*, p. 871

¹⁵³ *Idem*, p. 870

¹⁵⁴ *Idem*, p. 871

server for security and efficiency purposes, gathering market data for the enterprise and supplying such information.¹⁵⁵

However, if such functions go beyond preparatory or auxiliary activities in that they form the main or core function of the enterprise and an important and significant part of its business activities, then a permanent establishment will be deemed to exist.¹⁵⁶

Additionally, a computer server that is substantial in nature could be regarded as a place of business, as it is a tangible piece of equipment.¹⁵⁷ The reference to *substantial* machinery and equipment arises because paragraph 2 of the commentary to article 5 OECD Model Convention refers to machinery and equipments giving rise to a place of business only in *certain instances*.

From the above, it can be concluded that a permanent establishment 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 and at a fixed location, In addition to that, the business of the enterprise must not be of a preparatory or auxiliary nature. However, according to the researcher’s analysis, very few enterprises carry on business through their own servers and consequently they would not be taxable.

The OECD view has also been criticized by developed countries in that, if websites are to be considered as permanent establishments, then more revenues will be located to e-commerce importing countries through broader view of the nexus for e-commerce purposes and so exporting countries will not gain anything.

¹⁵⁵ P.Sri Sudha; *op.cit.*, p.1456

¹⁵⁶ *Ibidem*

¹⁵⁷ D. Pinto, *op.cit.*, p.104

3.4.4. Internet Service Provider and Dependent Agent Permanent Establishment

An Internet Service Provider (ISP) is a company that supplies connections to the Internet usually for a monthly fee. 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 carries on e-commerce through the web sites hosted on servers owned and operated by these ISPs.¹⁵⁸

According to paragraph 42.10 of the OECD Commentary, 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.¹⁵⁹ ISPs are normally independent agents acting in the ordinary course of their own business which entails hosting web sites of many different enterprises.¹⁶⁰

In some cases, nevertheless, the business of an ISP may be trapped in the business of its principal that it would be treated as a dependent agent and possibly a permanent establishment. For example, if a foreign corporation set up a separate corporation in a country to act as its ISP on an exclusive basis, the ISP would lose the status of an independent agent and be treated as a dependent agent.¹⁶¹

Characterizing an ISP as a dependent agent does not necessarily result in it becoming a permanent establishment of its principal. This is because under tax treaties basing on OECD Model Tax Convention, a dependent agent is a permanent establishment only if it has and habitually exercises the authority to conclude contracts on behalf of its principal. Whereas the tax treaties based on the UN Model Tax Treaty considers a dependent agent as a permanent establishment if the agent has the power to conclude contracts or has a stock of goods out of which it fills orders for its principal.¹⁶²

¹⁵⁸ K. Holmes, *op.cit.*, p. 168

¹⁵⁹ A.Lymer and J.Hasseldine, *op.cit.*, pp.97-99.

¹⁶⁰ *Idem*, p.98.

¹⁶¹ B. J. Arnold, M. J. McIntyre, *op.cit.*, p.156

¹⁶² *Idem*, p.157

An ISP may not escape tax on its own income simply because it is not the permanent establishment of its customers. In a typical case, it would have computer equipment in the country, which it is using to perform the core functions of its business. Under the circumstances, it would have a permanent establishment in the country and would not qualify for the exemption extended to preparatory and auxiliary activities.¹⁶³

3.4.5. Preparatory or Auxiliary exception

Even if it is concluded that business activities are carried out through infrastructure such as computer servers, as shown above, these activities must constitute *business activities* and accordingly must not be activities which may be regarded as preparatory or auxiliary, as these are excluded from the definition of PE.

An indicative list of activities generally considered preparatory or auxiliary includes: providing a communications link; advertising goods or services; relaying information through a mirror server for security & efficiency purposes and gathering market data for the enterprise or supplying information.¹⁶⁴

Whether these or other activities should be characterized as 'auxiliary' or 'preparatory' in nature needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment.¹⁶⁵ Thus, online advertising and the provision of an online catalogue or the provision of online information to prospective customers by an e-tailor does not create a permanent establishment.

Paragraph 42.9 of the OECD clarification of the Application of the Permanent Establishment definition in e-commerce (2000) defines an e-tailor as an enterprise that carries on business of selling products through the internet.¹⁶⁶

¹⁶³ *Ibidem*

¹⁶⁴ *Ibidem*

¹⁶⁵ *Ibidem*

¹⁶⁶ OECD clarification of the Application of the permanent establishment Definition in e-commerce (2000) para. 42.9.

However, online adverts for an online advertising agency or the online research activities of an online market analyst are likely to constitute core activities and this contributes to establishing a permanent establishment.¹⁶⁷ Therefore, the core functions performed on the equipment, may give rise to a permanent establishment but only if the equipment constitutes a fixed place of business.¹⁶⁸

3.4.6. No necessity of human intervention

A final issue to be examined that needs to be considered in the hypothetical example is whether a PE could arise on the basis of agency when there is no human intervention. The first requirement for an agency PE to arise is that the agent must be a person defined in article 3(1) (a) of the OECD Model Convention as including an individual, a company or any other body of persons.

Applying this scenario, to the website and to the computer server becomes challengeable. This is because neither a website nor computer equipments can be a person as per the said article. This is in line even in the necessity of concluding contracts because websites and computer servers cannot conclude contracts on behalf of the enterprise. In conclusion therefore no agency PE could arise from a website or a computer server according to the above said article 3(1) of OECD Model Convention.

A part from the website and computer server however, an ISP, which is a software agent would seem to satisfy the requirements of agency PE as discussed earlier. This means that a permanent establishment may exist even in the absence of any human personnel at the 'fixed' location. Where personnel are not required to carry on the business in the location in which the equipment is located, their absence does not necessarily mean that a business does not operate wholly or mainly in that jurisdiction.

¹⁶⁷ *Idem*, Para.42.7

¹⁶⁸ B. Fitzgerald, A. Fitzgerald, E. Clark, Middleton G., and Lim F.Y., *op.cit.*,p. 870

The OECD further explains that this conclusion applies likewise to e-commerce as it does to other activities where automatic equipment is used. This position supports the German 'pipeline' case in which the Second Chamber of the German Supreme Tax Court¹⁶⁹ held that an oil pipeline in Germany, owned by a Dutch company, created a permanent establishment despite the absence of employees.

In Germany, the fiscal court of Schleswig-Holstein was the first court to rule on the question whether a server without human intervention is a permanent establishment.¹⁷⁰ A German telecommunications agency had provided its Swiss customers with information, at a fee, through a server installed in Switzerland. The server, which was owned by the company, was installed in rented premises and was not staffed. The court concluded that the server was a permanent establishment and that the profit attributable to it had therefore to be taxed in Switzerland.¹⁷¹

Having analyzed the application of the PE definition in e-commerce, the following section brings out the typical examples of taxation of e-commerce transactions.

3.5: Examples of taxation of e-commerce transactions

The following section provides examples of how taxation is applied to some typical e-commerce transactions.¹⁷² Standard e-commerce models are extracted from these examples to illustrate the effects of e-commerce on residence and income sources.

¹⁶⁹ The "pipeline" case, *op.cit.*

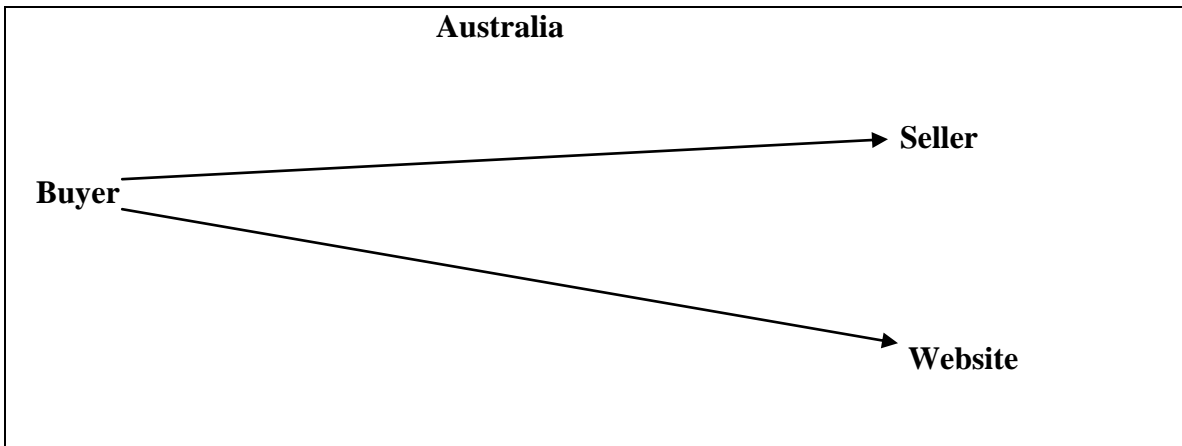
¹⁷⁰ Schleswig-Holstein Tax Court judgment of 6 September 2001, Aktenzeichen II 1224/97 – EFG 2001, 1535 = SWI 2002; hereinafter abbreviated as, Schleswig-Holstein Tax Court judgment of 6 September 2001, Aktenzeichen II 1224/97, *available at*, <http://www.mondaq.com/x/16168/Corporate+Tax/251+Lower+Court+Sees+Server+as+Permanent+Establishment> accessed on 03/05/2013

¹⁷¹ *Ibidem*

¹⁷² In implementing the Ottawa Taxation Framework Conditions, the OECD analyzed 28 categories of typical e-commerce transactions. The OECD's analysis and conclusions as to how these transactions would be regarded under the Articles of the OECD Model contained in the report, tax treaty characterization issues arising from e-commerce – Report to working party No 1 of the OECD committee on Fiscal Affairs (OECD Technical Advisory Group on Treaty Characterization of Electronic Commerce payments, 1 February 2001): <http://www.oecd.org/dataoecd/46/34/1923396.pdf> accessed on 20/08/2012

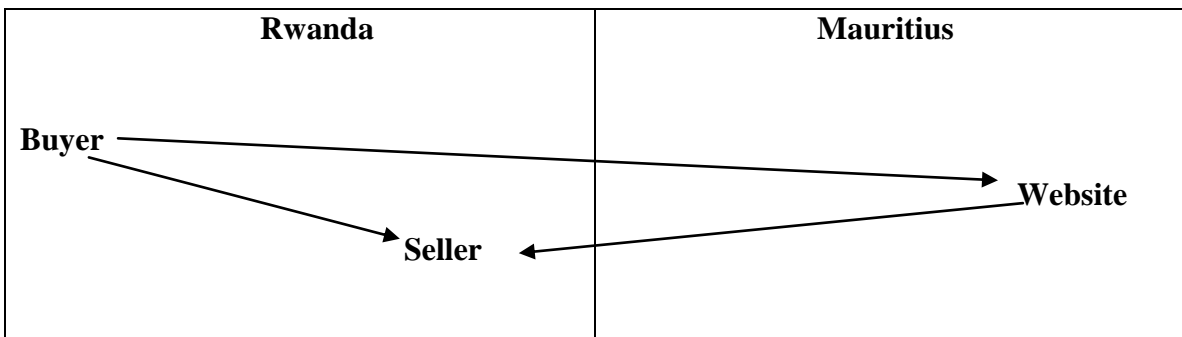
Example 1:

A buyer purchases goods or services from a seller via the seller’s website, with all parties being located in Australia. The seller’s website is either owned by the seller or is hosted by an Australian –based Internet Service Provider. The buyer pays by using either credit or through direct debit facility¹⁷³. This is diagrammatically illustrated as follows:



As already discussed, a website alone cannot be a permanent establishment, so it is necessary to relocate where the server is located in Australia. Since both the seller and buyer are residents of Australia, Australian tax laws will apply. In addition, the source of income is in Australia¹⁷⁴.

Example 2:



¹⁷³ B. Fitzgerald, A. Fitzgerald, E. Clark, G. Middleton and Y. F. Lim, *op.cit.*, pp 887-889

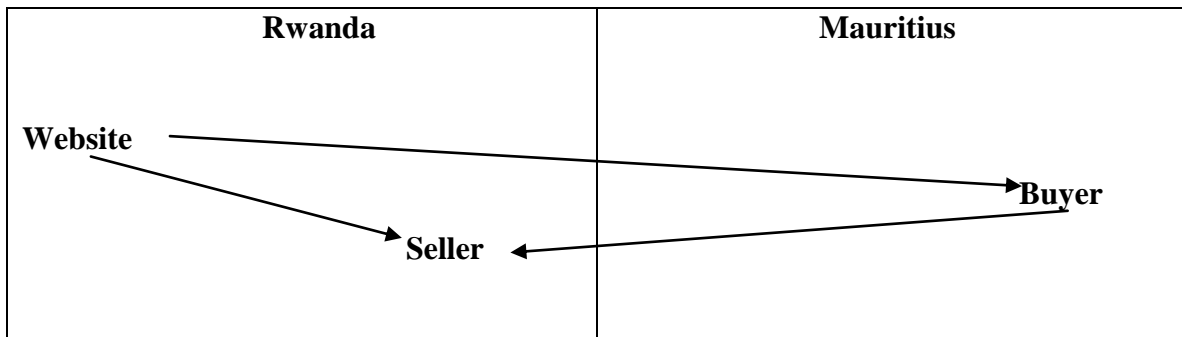
¹⁷⁴ *Ibidem*

In this example, all parties are situated in Rwanda except the website and server, which is in Mauritius. The buyer purchases goods or services from the seller's website, which operates from an ISP in the Mauritius. As in example 1, the buyer pays by using either credit or through a direct debit facility.

Since the website and server are located in Mauritius, it is arguable that under the DTA between Rwanda and Mauritius,¹⁷⁵ if the transactions so happened during the DTAs existence, a permanent establishment exists in Mauritius. This means that the business is subject to tax in Mauritius. Assuming that the transactions did happen after the termination of the DTA with Mauritius, the business would be subject to tax in both Mauritius where the permanent establishment exists and in Rwanda where both the seller and buyer are residents. A credit for any paid Mauritius tax would need to be given under the Rwandan domestic law.¹⁷⁶

Example 3:

In this example, the seller and the website are situated in Rwanda while the buyer is in Mauritius. The buyer purchases goods or services from the seller's website, which operates from an ISP in Rwanda. The buyer also pays using either credit or through a direct debit facility.



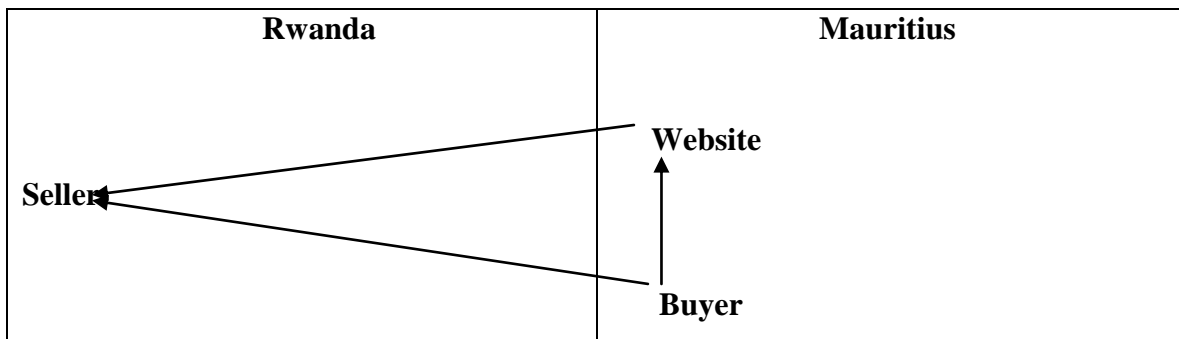
¹⁷⁵ Art. 5 and 7.2 of Rwanda-Mauritius DTAA;

¹⁷⁶ Art. 6 of Law n°16/2005

The seller and server are both based in Rwanda, which means that the permanent establishment is also in Rwanda. Consequently, Rwandan tax laws apply. Again as it is the case in example 1, the source of income, is in Rwanda¹⁷⁷. Thus, income tax is applicable according to Rwandan tax laws.

Example 4:

The seller is in Rwanda, the buyer is in Mauritius and the website and server are in Mauritius. The buyer purchases goods or services from the seller’s website, which operates from an ISP in Mauritius. As in previous examples, the buyer pays by using either a credit card or direct debit facility.



The scenario is similar to example 2. The server is located in Mauritius, so it is arguable under the DTA between Rwanda and Mauritius, if transactions so happened during its existence, that a permanent establishment exists in Mauritius. Assuming there was no DTA between Rwanda and Mauritius (in case the transactions so happened after its termination); Rwanda would also have a taxing right as the seller is a resident of Rwanda. However, a credit for Mauritius paid tax would need to be given when calculating the total taxes to be paid by the Rwandan resident.

The challenges of e-commerce taxation however have been addressed by many courts which have given some solutions to different challenging issues. Some case laws are analyzed in the following section.

¹⁷⁷ Art 4 of law n°16/2005

3.6: Case law and e-commerce taxation

The first landmark case on permanent establishment was the German Pipeline Case. In the German 'pipeline' case, the Second Chamber of the German Supreme Tax Court¹⁷⁸ held that an oil pipeline in Germany, owned by a Dutch company, created a permanent establishment despite the absence of employees.

The Dutch company supplied crude oil and oil products to German customers through the underground pipeline, which ran through the Netherlands and Germany. The German customers received oil at delivery stations in Germany, which they owned and operated.

The Dutch company regulated the flow of oil through the pipeline by remote control from a computer in the Netherlands. The Dutch company had no employees or dependent contractors in Germany. Maintenance and repair on the pipeline in Germany were performed exclusively through independent contractors.

The question examined by the German Federal Tax Court was whether the pipeline of the non-resident (Netherlands) company constituted a permanent establishment for the purposes of German domestic law and under the German-Netherlands DTA (1959).¹⁷⁹

The German court defined a permanent establishment as any fixed place of business or assets that serves the business activities of the taxpayer. The court held that the pipeline constituted a fixed place of business in Germany. With respect to the requirement that the pipeline must serve the taxpayer's business, the court stated that a fixed place of business serves a business activity when a taxable person exploits it for a certain period of time for business purposes. The Court affirmed that considering the Dutch company's business, the pipeline network served as a basis for the company's main business activity. The employment of personnel in Germany was not necessary for the existence of a fixed place

¹⁷⁸ The "pipeline" case, *op.cit*

¹⁷⁹ K. Holmes, *op.cit.*, p. 165

of business, which served as a basis of business activities instead mechanical and automatic installations are sufficient¹⁸⁰.

Westin R.A¹⁸¹ has indicated that this case has two important implications for electronic commerce:

Firstly, it shows the willingness of a court to apply the permanent establishment concept expansively to technology that was not anticipated when the permanent establishment concept was adopted. In this sense, the German ‘Pipeline case’ is crucial for electronic commerce. It demonstrates how the German courts resolved a case applying the concept of permanent establishment expansively to technology that did not exist when the concept was originally drafted¹⁸².

Secondly, it implicitly gives a message that a telecommunications company or an Internet Service Provider, whose only contact is automated equipment such as telephone lines or a server, has a permanent establishment overseas¹⁸³.

By analogy to the pipeline case, telephone lines or servers could constitute a fixed place of business through which the main line of an Internet Service Provider or a telecommunications company, namely the transfer of electronic signals, is carried on, thereby constituting a permanent establishment wherever the telephone lines or servers are located.¹⁸⁴

As a result, this dynamic interpretation increased the risk that a server, a web site, an ISP or telecommunication companies that use electronic equipment or servers could qualify as having a permanent establishment in tax jurisdictions. This direction would probably lead to taxation around the world of tax telecommunication companies and internet service providers.

¹⁸⁰ *Ibidem*

¹⁸¹ R. A. Westin, *The Taxation of E-commerce*, The Hague: Kluwer Law International, 2000; p.353-355

¹⁸² *Ibidem*

¹⁸³ *Ibidem*

¹⁸⁴ *Ibidem*

It is our view, that although this dynamic interpretation offers Tax Administration Agencies an opportunity to tax telecommunications companies and Internet service providers, it also offers them an additional bullet in their quiver with which Tax Administration Agencies has a jurisdiction to tax them.

This seemed obvious that prudent tax planning would dictate that servers be located outside Germany if possible, at least until a German authority carved out an exception for servers.¹⁸⁵ If the web site operator owned a server in Germany on which its web site was located, it is possible that, based on this decision, the enterprise would have a permanent establishment.¹⁸⁶

However, according to W.J. Craig,¹⁸⁷ care should be taken to ensure there is a uniform approach to interpreting permanent establishment as redefined to avoid local anomalies. For example, in the decision of the 'pipeline' case, the pipeline crossing Germany but owned by a Dutch company may be deemed to be sufficient to constitute a permanent establishment under German domestic law; however, this is not sufficient under the revised OECD model Tax Convention.

Another landmark case and the first German tax court to address the much discussed issue of whether a computer server can constitute a permanent establishment is the Schleswig-Holstein Tax Court judgment of 6 September 2001¹⁸⁸. The judge has decided this question in the affirmative.

The server in question was owned by the taxpayer and installed on leased premises. It operated automatically, *i.e.*, without an on-site personnel. The server was connected with Germany by a dedicated line owned by an affiliated company. Informational content was

¹⁸⁵ *Ibidem*

¹⁸⁶ *Ibidem*

¹⁸⁷ W. J. Craig, *The Taxation of E-commerce: A Fiscal Regulation* 'of the Internet, 2001, London; (here in after abbreviated as Craig, 2001) p.27

¹⁸⁸ Schleswig-Holstein Tax Court judgment of 6 September 2001, Aktenzeichen II 1224/97

fed into the server via the dedicated line and distributed to Swiss customers, who retrieved it for a fee using their television sets.¹⁸⁹

While the statement of facts is not entirely clear, it seems that the affiliate company, not the taxpayer, was responsible for generating the content. Hence, the taxpayer's only economic function was to distribute the content via its fully automatic server. The sums paid by Swiss customers were collected by Swiss Telecom and forwarded to the taxpayer, less a collection charge. The taxpayer in turn deducted a charge for its services and forwarded the balance to its affiliate.¹⁹⁰

Unfortunately, the judgment contains no figures, so it is not possible to determine the relative shares of gross proceeds earned by the taxpayer and its affiliate.

Citing the Federal Tax Court's 1996 underground oil pipeline case, the court had little difficulty finding that the presence of personnel was not a necessary requirement for a permanent establishment.¹⁹¹

Most of the decisions deal with whether the server was part of a preparatory or auxiliary activity. As already discussed, activities of a preparatory or auxiliary nature do not constitute a permanent establishment.¹⁹² The court refused to analogize the server, in which information was stored until retrieved by customers, to a facility "used solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise". The court's rather technical reasoning was that information was not comparable to merchandise because information could not be capitalized on the taxpayer's balance sheet¹⁹³.

¹⁸⁹*Ibidem*

¹⁹⁰*Ibidem*

¹⁹¹*Ibidem*

¹⁹²OECD clarification of the Application of the permanent establishment Definition in e-commerce (2000) para 42.9

¹⁹³Alexander Loh, KPMG Frankfurt; Lower Court Sees Server as Permanent Establishment; *available at*: <http://www.highbeam.com/doc/1G1-86144166.html> accessed on 03/05/2013

In this case, the court held that the computer server was a permanent establishment to which apparently substantial amounts of income should be attributed. Such income was exempt from German tax under the German-Swiss tax treaty where as the tax authorities contended that the taxpayer had no permanent establishment in Switzerland, hence that its entire income was taxable in Germany.¹⁹⁴

Germany's December 1999 regulations on the taxation of permanent establishments are silent on the issue of when permanent establishments exist in connection with e-commerce. A directive issued by the Karlsruhe Regional Tax Office dated 11 November 1998 takes the position that computer servers are fixed places of business, but generally do not create permanent establishments because their installation represents an activity of a preparatory or auxiliary character. This was the stance taken by the tax authorities in the instant case.¹⁹⁵

This lower court's judgment however, was appealed to the Federal Tax Court¹⁹⁶ in Docket no. I R 86/01

In addition to the above, there is one other Indian interesting case that has come to court exploring the precise way in which a country interprets the permanent establishment principles in e-commerce. This is the Indian Galileo case.¹⁹⁷

In this case, Galileo International Inc., a resident of the USA, was engaged in the provision of services to hotels and airlines pertaining to reservations and booking through its Computerized Reservation System. For this purpose, it maintains and operates a huge master computer system consisting of 18 mainframe computers with its main server located in USA. This main computer is connected to the airline servers' to/from which data is continuously sent and obtained. All the input processing and output is managed, processed and stored by the taxpayer through the Master Computer System in USA. The

¹⁹⁴ *Ibidem*

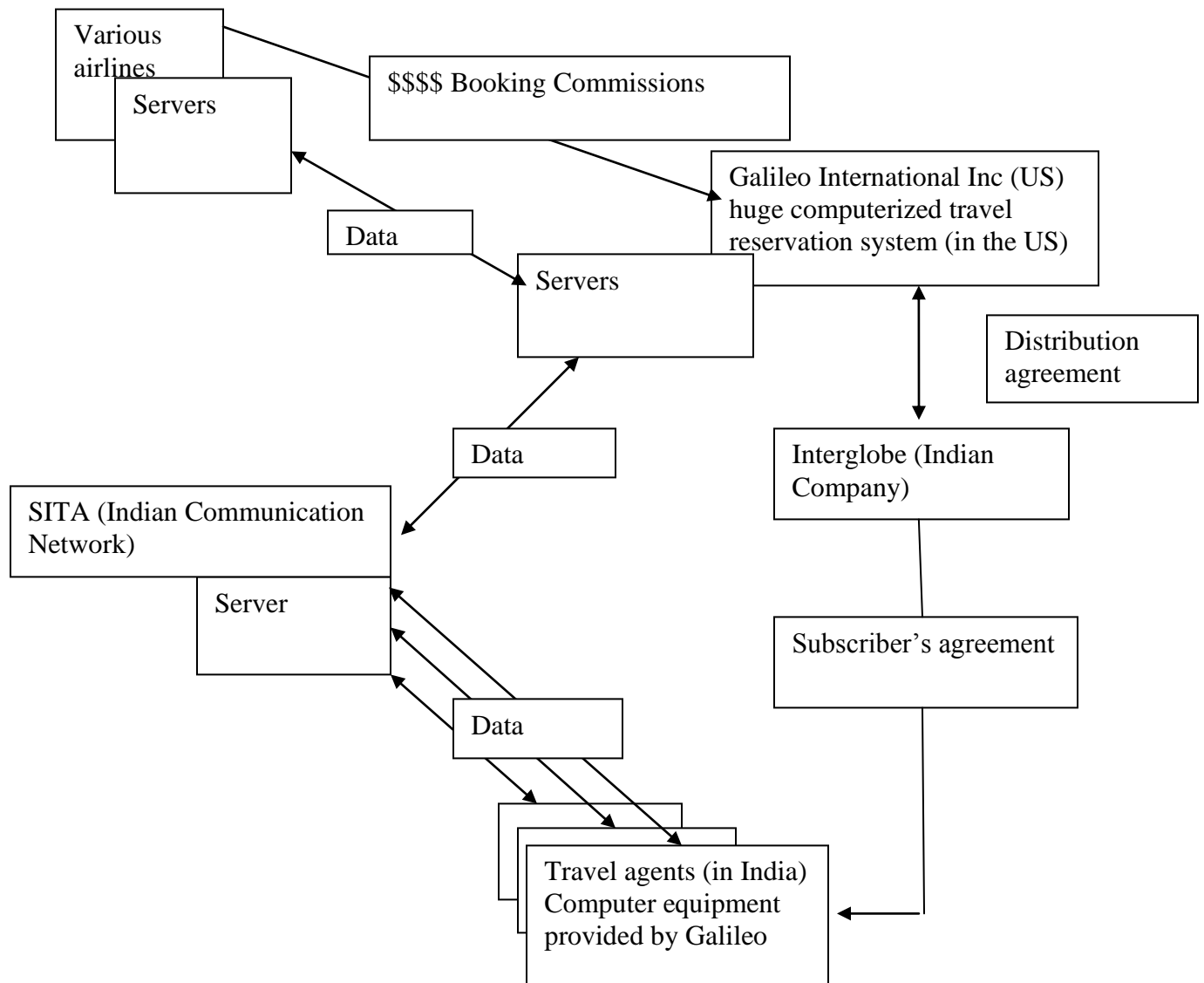
¹⁹⁵ *Ibidem*

¹⁹⁶ *Ibidem*

¹⁹⁷ India-Galileo International Inc v Deputy Commissioner of Income Tax, 30 November 2007 (Decision) (2008) 19 SOT 257 (Delhi) available at: <http://www.indiankanoon.org/doc/56225> accessed on 03/05/2013

taxpayer has entered into agreements with various airlines to provide them with the Computerized Reservation System services. The taxpayer earns booking fees from Airlines. In order to market and distribute the Computerized Reservation System services to the travel agents, the taxpayer appoints distributors and pays distribution fees to them for their services. In India the taxpayer has entered into a distribution agreement with Interglobe Enterprises Pvt. Ltd., an unrelated party to market and distribute Computerized Reservation System services to the travel agents in India.¹⁹⁸

The facts may be diagrammatically illustrated as follows:



¹⁹⁸ NAKAYAMA A., The permanent establishment concept under tax treaties and its implications for multinational companies, Dissertation, University of London, MA 2011-2012, p.22. Available on, http://sas-space.sas.ac.uk/4723/1/Aiko_Nakayama_MA_Taxation_dissertation.pdf. Accessed on 20th April 2013

Galileo Inc. claimed that it had no permanent establishment in India¹⁹⁹. Its computers communicated with the SITA computers, for which service Galileo paid SITA a fee and thus there was no direct communication between Galileo and the Indian travel agents. The airlines paid Galileo its booking commissions outside India. Galileo had, through Interglobe, provided the travel agents with the necessary computer equipment.

One issue in this case concerned whether or not the computer equipment used by the independent travel agents' could constitute a permanent establishment of Galileo in India.

Galileo argued that the travel agents merely input data which was sent to Galileo's server for processing. The acceptance of the booking was made by the airlines to Galileo's main server. The details displayed on the travel agents' screens did not constitute an offer of the sale of a ticket, but merely an 'invitation to treat,' that is, an opportunity for the travel agent to make a request to purchase.²⁰⁰

However, the Income Tax Appellant Tribunal decided that the computer equipment present at the travel agents' premises constituted a permanent establishment of Gallileo. The logic used was that Galileo's central reservation system was partially present in the travel agents' equipment. In many cases, Galileo had provided connectivity to its main server.²⁰¹

In the same observation as the Income Tax Appellant Tribunal, the researcher argues that computers/hardware installed at the travel agents' premises gave rise to the taxpayer's first essential element of permanent establishment which is the fixed place of business. The second element of *through which business is conducted* was also in existence as it was evidenced by the activities performed through those computers of reserving and booking tickets. .

¹⁹⁹ A. Miller and L. Oats; *op.cit.*, p. 388

²⁰⁰ *Ibidem*

²⁰¹ *Ibidem*

The researcher also argues that since the activities of reserving and booking tickets operated through the computers do not fall among the permanent establishment excluded activities of preparatory or auxiliary, then no way the claim of Galileo would be validated.

In confirmation of the researcher's argument the Income Tax Appellant Tribunal ruled that the activities performed were not "merely advertising" and merely preparatory or auxiliary in relation to Galileo's trade. Instead, by connecting through to Galileo's server, the travel agents were capable of reserving and booking a ticket rather than merely telling the customer of the terms on offer. This contributed directly on the earning of revenue.²⁰²

The Income Tax Appellant Tribunal ruled that without the express permission of Interglobe, acting for Galileo, the travel agents could not access the main server. The travel agents were not permitted to move the computer equipment, even within their own premises, this degree of ownership and control of the computer equipment operated by the travel agents rendered it a fixed place through which the business of Galileo was partly carried on.

According to the researcher's analysis, this means that Interglobe was completely dependent on the taxpayer in respect of rendering services to the subscribers. They were not independent agents as claimed by the taxpayer. Thus that part of the income, which earns its revenue by rendering services to the subscribers, is carried on solely by the taxpayer. Even though the distributor may have other business activities, in respect of their Computerized Reservation System business, it acts only for the taxpayer and not for any other person.

Unfortunately however, after delivering an extremely lengthy judgment on this point, which confirmed a fixed place permanent establishment and a dependant agent permanent establishment, the Indian Income Tax Appellant Tribunal then held that the profits attributable to that portion of the business operations represented by the travel

²⁰² *Ibidem*

agents' involvement was the minor part of the total profits as most of the processes was done by Galileo's server in the US. After allowing as a taxable deduction the amount of the fee paid by Galileo to Interglobe, the Court concluded that Galileo had nothing to pay.²⁰³

This case is a nice illustration of *computer equipment as permanent establishment debate*, the issues are fascinating but in the end, if the PE consists only of the computer equipment, the profits generated by the equipment alone are unlikely to be significant.²⁰⁴

²⁰³ *Idem*, p. 389

²⁰⁴ *Ibidem*

GENERAL CONCLUSION AND RECOMMENDATIONS

The permanent establishment concept has been a mainstay of international tax law for more than 70 years and has shown remarkable resiliency and international acceptance as an international income tax principle. Notwithstanding the inevitable disputes about what constitutes a permanent establishment, the permanent establishment concept has served the international community well. One of the reasons that explain the permanent establishment's success is the flexibility of the concept.

However, the physical presence requirement of the traditional permanent establishment concept has been challenged by the significant emerging commercial practices of e-commerce. Since electronic commerce has the ability to produce income with little or no physical presence, the most certain effect to fear is an unequal division of tax revenues between residence states and source states.

As a result, there is a fear throughout the world that without the change of the said traditional elements applied in determining the permanent establishment, different states will not receive their fair share of the revenues associated with taxing e-commerce profits.

It is from this ground that some people advocated that, the permanent establishment concept is not a viable option, given the fast growing significance of electronic commerce and the impact of its special characteristics discussed, which was not considered when the current rules for international income taxation were designed. Thus, they argue that most of the components of electronic commerce do not appear to fit within the existing taxation principles regarding permanent establishment.

One of these advocates, is The Indian Ministry of Finance²⁰⁵ who is of the view that, “...*the committee therefore supports the view that the concept should be abandoned*

²⁰⁵ Indian Ministry of Finance report of the High Powered Committee on e-commerce and Taxation (2001) pp 11-12

and a serious attempt should be made within the OECD or the UN to find an alternative to the concept of PE.”

The researcher, however, is not of the same view. This is because as the ATO clearly puts it, it should be noted that even before the advent of the Internet, and the rapid development of electronic commerce, it was recognized that there may be significant shortfalls with the operation of the traditional permanent establishment concept in the modern environment.²⁰⁶

Therefore, the researcher advocates that, while the permanent establishment concept is by no means not perfect and that it generates its own interpretation problems, it is the 'devil we know' and may be worth preserving.

The researcher's view instead argues for a redefinition of the permanent establishment principle that takes into account the innovations brought about by e-commerce. The researcher recommends that there should be a further evolution of the permanent establishment concept to take into account modern commercial practices such as e-commerce that permit non-resident companies to generate significant revenues in foreign markets without the need for a physical presence. Thus, there is no need to abandon the permanent establishment concept but instead redefine it to encompass all the modern commercial practices brought by e-commerce.

Additionally, those who advocate that e-commerce will require changes in taxing rules also think that it is premature to consider such changes at this point with electronic commerce still in its infancy. They advocate for a wait-and-see approach to this matter. However, it is our opinion that, this is an unreasonable response to the challenges created by electronic commerce on the current system of international income taxation as e-commerce will continue to grow as time goes, and new business and commercial practices will continue to change with time.

²⁰⁶ Australian Taxation Office, Tax and the internet, first report ,1999, pp105-106

Following the above analysis, the question of whether the traditional concept of permanent establishment is still viable in the era of e-commerce is still challenging. Having fully examined the existing concept of permanent establishment, the researcher recognizes that when the PE was introduced, the possibility of e-commerce transactions was not envisaged. Nonetheless, the taxation based on physical presence remains the appropriate threshold for CIT.

It is also argued that though e-commerce reduces physical presences, the theoretical and practical construction of the internet and e-commerce have equivalent similarities though not identical of such elements making up a PE concept. Websites, servers and ISPs can constitute a PE in some circumstances as discussed.

The researcher argues that it remains appropriate to limit the right to income taxation to those jurisdictions that serve as the origin of that income. The researcher therefore thinks that the concept of PE should continue to determine a jurisdiction's taxation rights. The permanent establishment concept is therefore essential and however much imperfect it is in electronic commerce, it is a devil we know, that we should continue to use.

However, the researcher also believes that there is a need for clear interpretations to clarify and build up its application to e-commerce. Analysis shows, that some elements of PE should be redefined and completed to encompass the innovations of e-commerce.

Additionally, as indicated throughout the research, with the introduction of new technologies, the recognition of a permanent establishment concept has become challenging and so there is need to redefine the notions of place of business, location, and permanency in order to be applicable to the new digital reality. The researcher believes that if the concept of permanent establishment cannot be sustained in this new digital realm, then overall taxation of e-commerce will be complicated, thus increased tax avoidance.

BIBLIOGRAPHY

LEGISLATIONS AND MODEL LAWS

1. Constitution of the Republic of Rwanda of 04 June 2003 (Official Gazette special number of 4 June 2003) as it has been amended by Amendment n° 01 of 2nd December 2003 (O.G special number n° special of 2nd December 2003) Amendment n° 02 of 8 December 2005 (O.G n° special of 8 December 2005) Amendment of 13/8/2008 (O.G. n° special of 13 August 2008)
2. Law n° 16/2005 of 18/08/2005 on direct taxes on income, O.G n° 1 of 1st January 2006
3. OECD Model Tax Convention on Income and on Capital, Paris, 2008 (Condensed version)
4. United Nations of Economic and Social Affairs, UN Model Double Taxation Convention between Developed and Developing Countries, New York, UN (2001)

BOOKS

1. ANOLD, B. J. et al *International tax primer*, Kluwer Law International, 2nd ed., Hague –Netherlands, 2002.
2. BUYS, R., *Cyberlaw @ SA: the Law of Internet in South Africa*, Pretoria: Van Schaik Publications, hereinafter referred to as Buys, 2000.
3. CARR, I., *International Trade Law*, Routledge Cavendish, London and New York, Forth Edition, 2010.
4. CRAIG, W.J., *The Taxation of E-commerce: A Fiscal Regulation 'of the Internet*, 2001, London; (here in after abbreviated as Craig, 2001).
5. CRISTIÁN, G., *The Fixed Place of Business in the Context of Electronic Commerce*, IBFD, 2003.

6. FINNERTY, C., et al ., *Fundamentals of International Tax Planning*, IBFD, 2007.
7. FITZGERALD, B., et al ., *Internet and e-commerce law, business policy*, Thomson Reuters (professional) Australia ltd, NSW, 2011.
8. GARNER, B.A., *Black's Law Dictionary*, eighth edition, Thomson West, second reprint, 2007.
9. GRAHAM SMITH ,J.H., *Internet law and regulation*, 2nd ed., 1997.
10. HOLMES, K., *International tax policy and double tax treaties, An introduction to Principle and Application*, IBFD publications, 2007.
11. HORNBY, A.S., *Oxford Advanced Learners Dictionary*, International Student's Edition,2007.
12. KENETH, C.L et al., *E-commerce, business, technology, society*, Pearson International Edition, Fourth edition, 2008.
13. KRAYNAK J., and W HABRAKEN W. J, *Internet 6 in 1*, Que, 1997
14. LYMER, A. and HASSELDINE, J., *The International Taxation System*, Kluwer Academic Publishers, Boston/London, 2002.
15. MILLER, A. and OATS L., *Principles of International Taxation*, Tottel publishing, 2nd Edition, 2009.
16. PINTO, D., *E-commerce and Source Based Income Taxation*, Doctoral series vol. 6, IBFD, March 2002.
17. PINTO P., *International Bureau of Fiscal Documentation*, Amsterdam, IBFD, 2003.

18. WESTIN, R.A., *The Taxation of E-commerce*, The Hague: Kluwer Law International, 2000.

ELECTRONIC SOURCES:

1. BASU S., 'Taxation of Electronic Commerce', Commentary, 2001 (2) *The Journal of Information, Law and Technology (JILT)*, Available at [http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2001\(2\)/basu1](http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2001(2)/basu1) accessed on 11/09/2012
2. BIJAL AJINKYA, Residential Refresher Course on International taxation –current and emergency issues; available at; http://www.nishithdesai.com/file/pdf/research/research_articles/Source%20Versus%20Residence%20-%20An%20Indian%20Perspective.pdf accessed on 07/03/2013
3. MAN J., SWINSON J. AND MORRISON D., “e-GST” (2000), *Revenue Law Journal*, vol.10, available at <http://www.austlii.edu.au/au/journals/RevenueLawJl/2000/9.html>, accessed on 26/08/2011
4. OECD Committee on Fiscal Affairs, *Model income tax convention on income and on capital*, condensed version, July 2008, available on, <http://www.oecd.org/tax/treaties/modeltaxconventiononincomeandoncapital-condensedversionjuly2008.htm>, accessed on 20/08/2011
5. OECD Technical Advisory Group on Treaty Characterization of Electronic Commerce payments, 1 February 2001: available on, <http://www.oecd.org/dataoecd/46/34/1923396.pdf>, accessed on 20/08/2012
6. RAYMOND Yu, E-commerce: Relevance of Source and Residence Rules, October 2001, p.8, available at, http://raymondyu.net/pub/papers/ecom_sr.pdf, accessed on 01/07/2013

7. SCHAEFER B. "International Taxation of Electronic Commerce Income: A Proposal to Utilize Software Agents for Source-based Taxation" (1999) *Nov Santa Clara Computer and High Technology Law Journal* 112-139, hereinafter abbreviated as (Schaefer (1999)), available at, <http://digitalcommons.law.scu.edu/cgi/viewcontent.cgi?article=1256&context=chtlj&sei-redir=1&referer>

8. SHEREYA Rao, Nexus matters; India's Right to Tax; available at http://www.nishithdesai.com/file/pdf/research/research_articles/Nexus%20Matters%20-%20India%27s%20Right%20to%20Tax.pdf; accessed on 07/03/2013

9. THURONYI V., *International Aspects of Income tax in Tax Law Design and Drafting*, Vol 2, IMF 1998, available at <http://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch18.pdf> accessed on 08/05/2013

10. X., E-commerce and the taxation doctrine of permanent establishment in the United States and China; available at, http://www.law.fsu.edu/journals/transnational/vol14_2/duke.pdf

CASE LAWS:

1. German Supreme Tax Court 1997 Decision of October 30, 1996. 11 R 12/92, 138 (pipeline case)
2. *Golf in Dubai vs DIT*, F.N^o. AAR/770/2008 dated 13 October 2008, available at, <http://www.itatonline.org/dlmonitor/download.php?t=f&i=112> accessed on 12th April 2011
3. *India-Galileo International Inc v Deputy Commissioner of Income Tax*, 30 November 2007 (Decision) [2008] 19 SOT 257 (Delhi), available at: <http://www.indiankanoon.org/doc/56225> accessed on 03/05/2013.
4. Schleswig-Holstein Tax Court judgment of 6 September 2001, Aktenzeichen II 1224/97

5. Transvaal Associated Hide & Skin Merchants vs Collector of Income Tax, Botswana 29, SATC 97 (1967), *available at*:

http://www.elaws.gov.bw/rep_export.php?id=917&type=pdf, accessed on 12th April 2011

TAXATION RULINGS:

1. Australian Tax Office (ATO) Taxation ruling TR 2001/13, income tax: interpreting Australia's Double Tax Agreements, *available on*,

<http://law.ato.gov.au/atolaw/view.htm?rank=find&criteria=AND~Bills~basic~exact&target=E%20EA&style=html&docid=TXR/TR200113/NAT/ATO/00001&recStart=21&PiT=99991231235958&recnum=31&tot=72&pn=ALL:::EA>

2. ATO Taxation ruling TR 2002/5, income tax: Permanent establishment, a place carrying on a business; *available at*,

<http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR20025/NAT/ATO/00001>, accessed on 11th April 2011

DESERATIONS AND THESIS

1. NAICKER KERSHNEE, The Taxation Of E-Commerce: An Examination of the Impact and challenges posed by electronic commerce on the existing tax regime, Master's Thesis, University of Natal, Pietermaritzburg, 2003

http://researchspace.ukzn.ac.za/xmlui/bitstream/handle/10413/5704/Naicke_Kershnee_2003.pdf?sequence=1

2. WATAKO V. M., Application of Kenyan VAT Law to E-Commerce, Master's Thesis, University of Nairobi, April 2012

<http://erepository.uonbi.ac.ke/bitstream/handle/123456789/8377/Cover%20Page.pdf?sequence=1>

3. NAKAYAMA AIKO, The permanent establishment concept under tax treaties and its implications for multinational companies, Dissertation, University of London, MA 2011-2012.

http://sas-space.sas.ac.uk/4723/1/Aiko_Nakayama_MA_Taxation_dissertation.pdf.

COMMISSIONS, STUDY AND REPORTS

1. Australian Taxation Office, tax and the internet - first report (1997)
2. Australian Taxation Office, tax and the internet - second report (1999)
3. Joint Committee of Public Accounts and Audit, internet commerce -to buy or not to buy” Australia, (1998).
4. United States Department of Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* (1996)
5. OECD, Electronic commerce: Taxation Framework Conditions, A report by the committee on Fiscal Affairs, presented to the OECD Ministerial conference A Borderless World –Realizing the Potential of electronic commerce 8th October 1998, hereinafter referred to as OECD (1998).