

Determination of Permanent Establishment in E-Commerce: An Exploratory Study

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ABSTRACT

Permanent establishment has been used as a principle or threshold to determine whether a country has taxing rights on the business profits of a non-resident taxpayer. That threshold, however, has raised many questions in the context of e-commerce. Many countries are now concerned of how to determine permanent establishment in an e-commerce environment. Some view that the existing rule is insufficient to cope with e-commerce. This is because the existing tax rules were not designed in the era of e-commerce. Tax authorities are also concerned about the tax revenue loss, as there are no specific tax laws relating to permanent establishment in e-commerce. This study was conducted to solicit the perceptions of tax offices and tax practitioners on the criteria used to tax business profits in an e-commerce environment. This paper discusses how permanent establishment is determined in the conventional and e-commerce environments. The findings indicate that the existing tax threshold concerning permanent establishment is applicable in taxing e-commerce business profit, however, further amendments and changes should be incorporated to cater for e-commerce environment. The subjects also perceived that additional criteria should be included in the existing tax laws on permanent establishment to ensure tax treatment on e-commerce do not leave room for tax loss.

1.0 INTRODUCTION

Electronic Commerce (e-commerce) is defined as “commercial transactions, conducted through the processing and transmission of digitized data, in the form of text, sound as well as open network” (Singh, 2003). E-Commerce has created a new way of conducting commercial transaction, which has become an important element of business. This new way of conducting business has made the world one big marketplace.

However, as good as it may be, e-commerce has far reaching impact on administration, systems and policies of many governments including Malaysia. One of the major party and authority that has been affected by e-commerce is the tax administration. Many view that the advancement of e-commerce has made the task of taxing business become more daunting (Hong, 2002; Smith, 2002). Nonetheless, there are some experts who believe that the present tax system would be able to cope with this new (e-commerce) nature of doing business. The Organization for Economic Cooperation and Development (OECD), for example, view that there should not be any difference in taxing either conventional or e-commerce transaction (Kasipillai & Salleh, 2000). OECD believes that it is fair to tax

both the intangible and tangible transactions in accordance with the required laws and regulations.

On the contrary, there are some experts who view that the existing law is unable to cope with the advancement of e-commerce. This is because the existing law was not designed in the e-commerce era (Smith, 2002). Many countries are concerned that “substantial tax revenue could be lost as there are no specific tax laws relating to the legal authority to tax Internet commerce” (Davis & Chan, 2000). As tax is one of the essential revenue for every government and contributes to at least 80 percent of principal source of government revenue (Jones & Basu, 2002), the impact of e-commerce would be somehow worrying.

2.0 PERMANENT ESTABLISHMENT

History of PE

The concept of PE was first established to solve the double taxation problem among foreign business (Buchanan, 2001). In the early years (1845-1909), PE was used to refer to space for the conduct of a business activity. The second phase of the evolution of PE occurred in the 1920's where the League of Nations established that the income, which had the strongest economic allegiance, would represent the state to which the income is tax. Then, PE has been defined as real centers of management, mining and oil fields, factories, workshops, agencies, warehouse, offices and depots.” (Buchanan, 2001). Later, in 1928 a decision was made to define PE as a demarcation point to tax the profits from business (Cockfield, 1999). Hence, PE has been used to determine the physical nexus to tax business income, whereby tax will only be charged to profits of foreign business that have been derived from source countries if the profits came from the source countries (Cockfield, 1999). PE is a long established international tax concept used as indicator to legal authority to tax the transaction.

The importance of PE

International tax law has been using the concept of PE to determine the tax liability of a multinational company, which identify whether the company has a PE in a foreign jurisdiction to enable the jurisdiction to tax the profits arising in the jurisdiction (Moran and Kummer, 2003). The underlying concept of PE indicated that the contracting countries give up its right to charge income attributable in a country where the PE is identified (Sweet, 1998). The objective of PE is to determine the tax presence of the operation

of business in order to avoid conflict between countries. As long as the trading or business has a fixed place of business through which the business is wholly or partly carried on or a dependent agent who has, and habitually exercise, authority to conclude contracts in the name of the non-resident, then the operations will be deemed to have a PE in the said jurisdiction (Singh, 2003).

Problem associated with Permanent Establishment (PE)

One of the tax issues that have raised concern to many countries is the issue of PE. According to Merrill (2001) "... a fundamental question in applying national income tax systems is whether a legal entity has enough presence in a foreign jurisdiction to justify net income taxation by that jurisdiction". PE identified two main elements in its manifesto of establishing permanence, namely, fixed place of business and physical presence. However, the nature of e-commerce of being borderless creates ambiguity in the application of PE, which has made the determinant of physical presence difficult to identify (Hong, 2002). Tax collection has become increasingly complicated due to the effect of borderless business transactions, which in a way contradicts with the principle of territorial basis of taxing income (Hong, 2002).

The purpose of PE was to determine a particular point when a foreign entity had established a sufficient tax presence to qualify for the tax obligations in a particular jurisdiction. Consequently, the focal point of using nexus as basis to determine the PE of a business has been disturbed by the conduct of e-commerce, which has sideline the used of a link to identify the physical nexus of a business. The Indian eCom Tax expert Group viewed that although developing countries would gain immensely from the growth of e-commerce, it also believed that 'the imposition of entry barriers such as improper taxation of e-commerce may ultimately harm developing countries.' (The eCom Taxpert Group, 2002). In addition, many opined that e-commerce raises the difficult issue of charging income based on the physical presence (Cockfield, 1999; Merrill, 2001) which would lead to the difficulty in the application of tax rules and principle (Horn, 2003). Experts believe that e-commerce which has broken the rule of territorial scope would affect the tax collection (Hong, 2002; Kasipillai and Salleh, 2000).

The purpose of this paper is to present the findings of a small scale study conducted to solicit the opinion of tax experts on the issue of PE in e-commerce environment. This study focuses on how PE is determined in the conventional and e-commerce as well as the application of present tax system in regards to PE.

Worldwide interpretation of PE

In the era of e-commerce, many countries realized that it is important to revise their existing tax law especially related to PE. Few countries have developed their own interpretation of PE while other has taken a stand to follow the OECD Model. Following are examples of PE interpretation highlighted by few countries.

Based on the Mexican Income Tax Law (ITL), PE is defined as 'a place of business in which part or all of an entrepreneurial activity is developing is deemed PE. Branches, agencies, offices, factories, workshops, installation, mines, quarries and other places of exploration, extraction or exploitation of natural resources shall inter alia be deemed PE' (Amante and Pena, 1999). Therefore, any entrepreneurial activity established through such scope would be considered as revenues attributable to such PE (Amante and Pena, 1999).

In the UK, servers and websites are not considered as having enough presence to establish a PE (Meril, 2001). Australian Tax Office and Canada, have taken a decision to use OECD interpretation of PE.

Germany, however, has referred to the Pipeline case in their interpretation of PE related to automatic equipment. In this case, it has been concluded by Second Chamber of German Supreme Tax Court that 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 (Sally, 2002).

Progressively, Inland Revenue Authority Singapore (IRAS) has produce a guideline (Income Tax Guide on E-commerce) to assist business in understanding the income tax treatment for e-commerce transactions. The guideline highlights various ways of treating income sourced in Singapore in which she has the right to tax (IRAS, 2001). It provides understanding of how the current tax law and principles would apply to tax e-commerce income. It described various situations of business operations conducted through websites within or outside Singapore and its tax obligations. In regards to PE, the extent of business activities in Singapore checked through in order to determine the tax liability of a business although the server is located in Singapore. It also concluded that a server alone would not be considered as having a PE.

OECD Model in its Article 5 defined PE as 'fixed place of business which the business of an enterprise is wholly or partly carried on' (Moran and Kummer, 2003). The OECD Model allows a jurisdiction to impose net income tax on a business only if its activities in the jurisdiction rise to the level of PE

(Merill, 2001). OECD concluded that a website does not constitute a PE and a server would only be considered PE if it qualifies to establish a fixed place of business (Scally, 2002). PE would not exist where the e-commerce operation carried preparatory or auxiliary activities (Singh, 2003).

Malaysia has not been in the forefront in producing any guideline in regards to tax issues arising from e-commerce. Unlike Singapore, which has come out with a Singapore base situation to deal with e-commerce tax obligations, Malaysia has adopted common platform with countries such as Australia and Canada by referring to the OECD Model Tax (Kasipillai, 2002) where the existence of PE is identify when a place of business is located in Malaysia, continuity of activity in Malaysia and or there is right of use of the facilities in Malaysia (Singh, 2003). A non resident enterprise will deemed to establish a PE if it has either a fixed place of business through which the business is wholly or partly carried on or a dependent agent who has and habitually exercises, authority to conclude contracts in the name of the non-resident.

Sparse study has been done in the area of taxation on e-commerce. Davis and Chan (2000) studied on the potential tax problems related to Internet commerce. They identify five main potential problems created by Internet commerce, which include double taxation, tax free, tax avoidance, tax evasion and tax administration. Their study found that tax avoidance is the most probable problem created by Internet trading. So far, there is no study done with regards to permanent establishment context in Malaysia environment.

3.0 METHODOLOGY

A small-scale study was carried out to investigate tax implications related to permanent establishment in e-commerce. Several tax experts from renowned accounting firms and IRB officers were approached for the purpose of data collection. Twenty tax experts participated in the study. The study solicited opinion from the experts through an interview to gauge their perception on permanent establishment in e-commerce. Initially, contact was made through Human Resource Department of the accounting firms and IRB. The Human Resource Officers assisted in identifying the experts who could participate in the study. The experts were chosen by the human resource officers based on their expertise in tax matters who can provide information required for the study. Once the name of experts was obtained, appointment was made directly with them for the interview.

A set of structured questionnaire was used to collect data for the study. The questionnaire contains open

and closed ended questions. Open-ended questions aim to tap subject opinion of the existing practice in determining permanent establishment for e-commerce. The closed ended questions used five point likert scales. In order to maintain the anonymity of the respondents in this paper, the respondents are quoted by reference to the number that is number 1 to 20 (i.e. expert no.1 to expert no.20)

Judgment sampling (which is non probability sampling designed) was used as sampling technique to chose the size of the sample. According to Sekaran (2003), judgment sampling “involves the choice of subjects who are most advantageously laced or in the best position to provide the information required” He suggested that judgment sampling is used when a limited number of people can provide the information required for the study. Therefore, this study adopted this technique as only a small number of people have the information that is sought by the study. The data collected from the interview were interpreted by developing themes to analyze the perceptions of the respondents. Through the themes, the key concept was used to explain the findings of the study. The quantitative findings are discussed along with the qualitative findings.

4.0 FINDINGS

In examining the determination of permanent establishment in conventional business with that of e-commerce, this paper analyzed the issue by addressing the key concept with regards to permanent establishment.

Interpretation of PE

The findings reveal mixed perceptions on the interpretation of the PE definition as defined by OECD. It was found that 85 percent (n=17) of the subjects agree with the definition of PE (that PE is fixed place of business where the business of an enterprise is wholly or partly conducted). However, 15 percent (n=3) of the subjects disagree with the definition. Below are the comments made by the experts who disagree with the existing interpretation of PE.

Expert's no. 5: “present definition of PE is too wide”.

Experts no. 12: “concept of PE should be based on the treaty used by the respective jurisdiction not strictly adhered to the OECD concept of interpretation of PE”

Experts no. 17: “PE is used to determine place of business, therefore, real business is where the management and control

is operate, which means where board of directors meeting to make decision and policy related to the business is conducted”.

Other experts also indicated their interpretation of PE. According to them fixed place of business must indicate degree of permanence as to the location in question irrespective of whether the equipment used is owned or leased by the persons doing the business. Some also interpreted PE to be where the substantial place of business and contracts are concluded. One expert viewed PE to include agency that habitually exercise power on behalf of the principle to negotiate and conclude contracts on behalf of the principal. Others view PE to be the place of business with physical and place where the business is carried out. In sum, the experts interpreted PE as containing three elements namely; place of business, degree of permanence and carrying out business.

Existing practice

The experts were asked several open ended questions on this matter. The questions were asked to gather the opinion of the experts in regards to sources of authority used to identify PE for the conventional and e-commerce taxpayer. The finding revealed several sources of authority as basis used by experts to assist them in determining PE. Below are the various sources identified by the experts.

Conventional

The study found three categories of sources used to determine PE. They are; Modus Operandi, Income

Tax Act 1967 and the Double Tax Agreement. For example,

Expert no.1 said, “whether the non resident has a business presence and the definition contained in the treaties of the specific countries are the two determinants used to establish PE of a non tax payer”.

In addition, Expert no.18 said that PE is determined “where the business operations from which the profit in substance arises, which means where the contract test, operation test or whether the trading is being conducted by dependent agent or branch or any physical presence would be the determinants of PE in taxing business.

Some said that Income Tax Act 1967 is used as basis in determining PE status of non-residents.

E-commerce

With regards to the application of PE concept to be used as determinant of e-commerce, the experts referred to various sources as basis in determining PE statues of non-resident taxpayer. OECD model of tax convention related to PE, Double Tax Agreement (DTA) and related provisions as prescribed in the Income Tax Act 1967 are the main sources of authority used as reference by the experts.

Application of PE in e-commerce environment

As shown in Table 1, experts were asked several closed ended questions regarding PE in an e-commerce environment. Table 1 reveals the descriptive findings of the data gathered from the tax experts.

Table 1: Permanent Establishment in e-commerce environment

	Strongly Agree	Agree	Disagree	Strongly Disagree	Neutral
Definition of PE applicable for the conventional and e-commerce	4 (23.5%)	9 (52.9%)	1 (5.9%)	-	3 (17.6%)
PE is necessary for a country to have right profit of business	6 (30.0%)	12 (60.0%)	-	-	2 (10.0%)
PE is a source principle which essentially constitute the scope of charge of business income which is suitable to be used to charge e-commerce	3 (15.0%)	9 (45.0%)	-	2 (10.0%)	6 (30.0%)
Definition of PE need amendment to suit e-commerce	5 (26.3%)	10 (52.6%)	-	1 (5.3%)	3 (15.8%)
In Present principle, trade and business is identifiable thru physical location which will lead to tax loss in e-commerce	5 (25.0%)	11 (55.0%)	-	3 (15.0%)	1 (5.0%)
In present principle of PE will expose e-commerce business tax liabilities of more than one jurisdiction	2 (10.5%)	6 (31.6%)	-	1 (5.3%)	10 (52.6%)
Non resident who own a computer server to conduct business has PE in that jurisdiction	1 (5.6%)	8 (44.4%)	1 (5.6%)	2 (11.1%)	6 (33.3%)

n= less than 20 because some of the experts did not give comments

The findings revealed that more than half (n=13) agreed that the definition of PE is applicable to be used for both medium of doing business (conventional and e-commerce). Only a minimal number of experts do not agree of PE being applicable for both medium of doing business. The results indicated that majority of the experts (n=18) agreed that PE is necessary for a country to have right to tax profits of a business conducted in a jurisdiction. More than half (n=12) agreed that PE is a principle, which is essential to charge business income for e-commerce. However, the results also indicated that eight experts agreed that the present principle of PE will expose e-commerce tax liabilities to more than one jurisdiction while only one disagreed. The findings also revealed more than two third agreed that based on the present principle, trade and business in Malaysia is identifiable through physical location of the business, however, since the physical location of business is not easily identifiable in e-commerce, the principle will lead to tax loss due to the transaction not being taxed in certain jurisdiction.

Although the experts agreed that the present PE definition is still applicable and suitable to be used in charging taxable e-commerce income, majority (n=16) of the experts also highlight that the definition of PE need further review, therefore should be amended to suit e-commerce business since the nature of doing business electronically includes cross border transactions. This is probably because the experts foresee that the present definition, although still applicable, would to some extent cause tax complications such as tax loss and expose taxable income to more than one jurisdiction. As shown in Table 1, nine of the experts agreed that the present principle of PE would expose e-commerce business to tax liabilities of more than one jurisdiction and sixteen of the experts agreed that the present principle will lead to tax loss. The experts also agreed that (n=9) non residents who own a computer server to conduct business has PE in that jurisdiction although a small number disagree (n=3).

Nevertheless, a small number of experts disagree that the present interpretation of PE need further review while the other remains neutral. Based on the qualitative findings, the expert who disagree believe that the present tax law of PE is sufficient therefore, do not require any further amendment or modification be made to suit e-commerce environment. Few other experts also believed that the sources such as ITA 1967, DTA are sufficient to cope with the new medium of transaction (e-commerce) therefore no amendment should be made to the PE definition.

Criteria used to determine PE in e-commerce

Based on the expertise and understanding of the experts in the subject matter, the results show that the experts refer to various sources to identify the criteria

in determining PE. Below are the various sources of authority referred by these experts in relation to the determinant of PE in e-commerce environment.

- i) OECD Model Tax Convention
- ii) Income Tax Act 1967
- iii) Double Tax Agreement

Below are the criteria solicited from the experts from the open ended question asked. The question was as follows:

“In the course of your work, how do you determine PE in e-commerce for tax purpose? Please specify the criteria used for this purpose”

The criteria pointed by the experts are as follows:

- i) Criteria as prescribed by DTA (fixed place of business)
- ii) Badges of trade
- iii) Computer equipment used by the proprietor to carry out the business
- iv) Location of server
- v) Substantial equipment test
- vi) Location test
- vii) Location of personnel
- viii) Location of management (where and who conduct the business where activities or profit generating activities are conducted)

A number of the experts believed that although the present basis used as demarcation point to establish PE is applicable to suit in e-commerce, some suggested that further review should be made to the present PE definition. When asked, “existing principles of PE should be adopted with further review”, majority (refer table 1) agreed that the existing principle on PE should be adopted with further review.

In order to avoid ambiguity and uncertainties in the application of present tax regime in the application of PE concept to charge taxable income, the expert’s recommended additional criteria such as listed below;

- i) Where the contract is concluded
- ii) Proper registration of website that conducts business to facilitate determination of taxing rights
- iii) Method of enforcement should be considered with PE issues
- iv) Location where the title of goods passes from seller to buyer
- v) Location of server
- vi) Where the main profits generating activities are carried out

Application of territorial concept in e-commerce

The following question was asked in order to gather the opinion of the experts in regards to the application of section 3 for e-commerce;

‘Subject to and in accordance with this Act, a tax to known as income tax shall be charged for each year assessment upon the income of any person accruing in derived from Malaysia or received in Malaysia from outside Malaysia’ Should this scope of charge be applied to e-commerce?”

In sum, the experts opine that the provision is currently sufficient, however, a specific provision is also required for e-commerce. Below are some of the opinions given by the experts;

“There should not be a difference in the basis of taxation for e-commerce because business conducted through the Internet is just another way of carrying out business”(expert no.2)

“Income from Malaysia thus should be charged in Malaysia to protect Malaysia revenue base” (expert no.4 and 9)

“Malaysia should not lose its right to tax income arising from e-commerce”(expert no.8)

“E-commerce can still be tax on territorial scope because at present this is the best conformation to know whether an income is derived from Malaysia” (expert no.16)

“As long as the business is carried out in Malaysia then section 3 applies” (expert no.7)

“Trading using e-commerce should be viewed the same way as normal trading activities” (expert no.7)

“Principle of scope and derivation would not change. Need only further guideline as to how scope shall be applied to eCommerce” (expert no.11)

“Absence of specific legislation in taxing e-commerce hence it is very important to apply and fall back on section 3 (expert no.9)

“As e-commerce belongs to one of the classes of income on which tax is chargeable under section 4(a) ITA 1967, hence the suitability of section 3 applies” (expert no. 13).

“Administration for charging e-commerce is difficult, therefore the present scope of charge used is a best solution available” (expert no.5)

Recommended guideline

There are few among the experts who do not agree to any guideline or amendment be made to the present PE definition. These experts view that the criteria used to identify PE is sufficient and therefore no guideline is needed. On the contrary, majority (n=17) of the experts suggested including various other criteria to top the present PE definition. Following

are the recommended guideline suggested by the experts;

- i) Where the main profit generating activities are carried out
- ii) Location of server and function of server
- iii) Location where the title of goods passed
- iv) Location where the company is incorporated
- v) Place of management of business
- vi) Special treatment such as allowing withholding tax
- vii) Existence of personnel
- viii) Place of concluding contract
- ix) Customer on basis that the advertisement are accessible in Malaysia
- x) Proper registration of website that conducts business to facilitate determination of taxing rights
- xi) Method of enforcement should be considered with PE issues

Tax problems arise from e-commerce

The study found that more than half of the experts (n=11) agreed that e-commerce would undermine conventional tax principle, whereas only a small number (n=3) thought otherwise. More than half of the experts (n=15) agreed that e-commerce would threaten the application of source-based taxation, and only small group of experts (3 disagree, while 2 experts remain neutral) perceived otherwise. The experts also agree (n=18) that income derived from e-commerce should fall under section 4 of ITA 1967, while only a small number thought otherwise (n=2).

Qualitative findings indicated that more than half of the experts agreed the present definition of PE would to some extent create tax problems. Among the tax problems raised by the experts are the tax loss, difficulty of tracking business activities, possibility of doubled taxation and tax evasion. E-commerce would create lesser physical presence because it manifested the virtual business where business can be conducted without the physical presence. Therefore, tax problems such as tax avoidance and evasion are bound to occur in e-commerce environment.

5.0 DISCUSSION AND CONCLUSION

In regards to the interpretation of PE, the experts interpreted PE as comprise of three elements, namely place of business, degree of permanence and carrying out business to be the indicator of identifying PE of a non resident taxpayer. However, there are a small number of experts who interpreted PE to be more than just a fixed place of business. They perceived the present PE definition as too wide and the concept of PE should be based on the treaty used by the respective tax jurisdiction and not strictly adhered to OECD concept of interpretation in order to provide a better interpretation of PE.

However, the overall findings indicated that majority of the experts agreed that the PE definition is still applicable for both the conventional and e-commerce business. Majority also agree that the use of PE concept as a demarcation point for source country taxation is sensible and suitable to be used in e-commerce although they also believed that e-commerce would to some extent threatens the concept of physical presence. Therefore, they suggest further amendment to cater for e-commerce in order to avoid situation such as tax avoidance and evasion.

The experts opine that sources of authority such as ITA 1967, DTA and OECD Model used as basis to charge taxable income for non resident taxpayer are to some extent adequate, however, they also suggested additional criteria should be included to the present criteria. This is because they believe that e-commerce would undermine the principle used to determine PE, which would create the opportunity for tax avoidance and evasion. Hence, they suggested that criteria such as proper registration of website to conduct business determining taxing rights should be highlighted as additional criteria to determine PE and proper method of enforcement should be considered.

The outcome of the findings indicated similar trends with the views of many tax authorities (United States, OECD) that the present tax system in regards to PE is applicable to be used for both medium of conducting business although some modifications are necessary. For example, US Treasury in its White Paper 1996 stated that the present tax systems do not need major changes and the European Commission stated that alternative tax system is not necessary (Davis and Chan, 2000).

Nonetheless, it is recommended that Malaysia should introduce a clear and simple guideline so that business, professional and perhaps tax authority can seek to treat income of e-commerce.

This study is exploratory in nature. It is recommended that future studies should employ other methods and includes subjects such as accountants in MNC's, academics and officers from the customs department.

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