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# TAXATION, E-COMMERCE AND DETERMINATION OF PERMANENT ESTABLISHMENT

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*E-commerce provides a new way of conducting commercial transactions in today's global market. E-commerce has made the world a one big marketplace. However, e-commerce also poses challenges to the existing tax rules in determining permanent establishment of businesses. Permanent establishment has been used as the criteria to determine whether a country has taxing rights on the business profits of a non-resident taxpayer. Most tax experts view the current concept of permanent establishment as insufficient to cope with e-commerce, as it is seen to be more suitable for traditional business transactions rather than internet trading.*

*This paper investigates the application of current tax laws in Malaysia on the determination of permanent establishment in an e-commerce environment. Implications of existing policy to establish the source of income in e-commerce are also explored. Interviews were conducted to solicit opinions of tax officers and tax professionals in Malaysia. The respondents agree that the criteria used to determine permanent establishment should be applicable to both types of transactions: conventional and e-commerce. However, the respondents perceived that additional criteria should be included to determine permanent establishment in e-commerce transactions and some modifications to its definition are necessary to suit the modern form of trading over the internet.*

## Introduction

Electronic commerce is defined as “commercial transactions, conducted through the processing and transmission of digitized data, in the form of text, sound as well as visual images, over the open networks, or close networks that have a gateway into an open-network” (Singh, 2003). Electronic commerce (e-commerce) was a revolution in conducting commercial transactions. E-commerce allows users to transact business in a number of ways such as ordering of goods online and making payments electronically. This form of trading has become

very popular globally due to the easy access to computers and Internet. Buyers of goods and services find it more convenient to shop online rather than having to face hassles in conventional shopping.

According to Lubbock and Krosch (2000) e-commerce has far-reaching economic and social implications. One key area of economy where e-commerce has far reaching implication is the field of taxation where it has made the task of taxing businesses become more daunting. The real challenge in taxing e-commerce is how to apply the existing tax laws and principles to e-commerce transactions. One other core issue in e-commerce taxation is how to determine the principles governing permanent establishment. This is because the traditional presumption of business operations, which requires a physical location as the concept of tax jurisdiction that has thus far been linked to a physical/geographical nexus, is difficult to be identified in an e-commerce environment. The use of domain names and web-based intermediary in e-commerce make it difficult to ascertain the physical location of a business. Nevertheless, there is a view that e-commerce transactions should not be outside the existing tax system. For example, Organization for Economic Cooperation and Development (OECD) states that the present tax system is suitable for both medium of business transactions, online or physical (Kasipillai and Razak, 2000).

Tax experts also recognise that tax rules were designed in an era where e-commerce was not present, thus the present tax rules are inadequate to deal with e-commerce transactions (Smith, 2002). There are presumptions that the application of present tax rules to e-commerce will cause tax loss to the government (Davis and Chan, 2000). Inevitably, this is a major concern by many governments because tax is essential revenue which contributes to at least 80% of the principal source of revenue for most governments (Jones and Basu, 2002). Tax loss as a result of e-commerce is a major concern for many tax authorities.

The objective of this paper is to study the perceptions of the tax practitioners and tax officers in Malaysia on the impact of e-commerce on tax collections to the tax regimes. This study contributes to the body of knowledge on e-commerce taxation. For example, this study contributes to the existing literature on tax issues related to e-commerce environment as very little research concentrates on this important area. In addition, the findings of this study will be useful to the Inland Revenue Board (IRB) to formulate guidelines on taxation of e-commerce in Malaysia.

## **Historical Development of Permanent Establishment**

The growth of the international trade and investment, just after the First World War, has created a vast expansion of business across border, and it also posed a new problem to the government in taxing business (Borkowski, 2002). Both countries where the business was established and the country where the business is conducted face the problem (which is also known as the double taxation problem) of taxing the same business activities (Cockfield, 1999). As this new problem (double taxation) undermines the expansion of international business, it is crucial to find a solution to the problem.

After a number of efforts, tax authorities finally decided that tax on profits should be based on the permanent establishment rule where the source country should tax profits derived from foreign business if the permanent establishment of the business exist in that country (Cockfield, 1999). In 1927 a draft convention on double taxation by the League of Nations defined permanent establishment as “real centres of management, mining and oil fields, factories, workshops, agencies, warehouse, office, and depots”, (Buchanan, 2001). Since then, permanent establishment has been used as a demarcation point to tax profits from business to overcome the problem of double taxation for non-resident taxpayers (Cockfield, 1999).

Another group of experts, known as the Chamber of Commerce and Economist Group disagreed with the source based taxation as a solution to the double taxation problem (Buchanan, 2001). They proposed a different solution to solve the double taxation problem where the full resident state taxation was proposed to overcome the problem. In this system “all income wherever earned, would be defined and taxed according to the laws of the taxpayers own country of residence” (Buchanan, 2001). However, the popularity of residence state taxation began to slip just after 1960. In this era, the people’s choice went to the source based taxation as residence state was seen to disturb the flow of capital where it discouraged new capital being invested abroad (Buchanan, 2001). The outcome of the conflicts between these two schools of thoughts resulted in the introduction of the OECD model in 1963. Since then, many countries have adopted the OECD model on the determination of permanent establishment in formulating their own guidelines.

Originally, the permanent establishment principle was introduced mainly to avoid conflicts between countries and to avoid companies doing business in another jurisdiction being imposed tax twice. The principle of permanent establishment has been used to justify the fact that a contracting country foregoes its right to charge income in its jurisdiction (Sweet, 1998) and to enable the other country to practice its right of taxing the profits attributable in its jurisdiction (Moran and Kummer, 2003). Permanent establishment is a long established international tax concept used as an indicator by legal authorities to tax transactions between two entities. Permanent establishment means businesses will be charged to tax on the business income and capital gains attributable to the country where permanence of the business exists.

## **Issues and Challenges of E-Commerce**

The advent of global electronic commerce has posed a challenge to the tax authorities, which has also become a major concern in many jurisdictions. E-commerce has disturbed the smoothness of tax rules and regulation designed by tax authority (Horn, 2003). E-commerce has raised the difficult issue of charging income based on physical presence (Merill, 2001, Cockfield, 1999) in that it makes the identification of sources of income ambiguous (Hong, 2002). The nature of e-commerce is such that it confounds the principle requirement of permanent establishment where the fixed place of business is an important element used as an indicator to establish taxing income.

Since e-commerce manifests itself in borderless business transactions, it can result in tax evasion and complications in tax collection (Hong, 2002, Kasipillai and Salleh, 2000). Borkowski (2002) claims that e-commerce can lead to several tax collection implications such as tax avoidance, double taxation and tax havens. Davis and Chan (2000) in their study identified five main potential tax problems created by Internet trading. These problems include double taxation, tax-free, tax avoidance, tax evasion and problems in tax administration. Their study found that tax avoidance is the most probable problem created by Internet trading, and a majority of the experienced tax advisers in their study agreed that Internet trading creates potential tax problems to the tax authorities.

## Models and Worldwide Practice

The new era of trading has placed the recognition of the fixed place of business concept used in establishing permanent establishment in need of review. How does one determine fixed place of business in an electronic commerce context where the permanence of a business is difficult to be identified? At present, there appears to be no definitive legislation to determine permanent establishment in an electronic environment although there are few definitions of permanent establishment used by a few countries as a basis in the determinants of establishing permanent establishment. Mexican Income Tax Law, for example, defines permanent establishment as ‘a place of business in which part or all of an entrepreneurial activity is happening as permanent establishment. Branches, agencies, offices, factories, workshops, installation, mines, quarries and other places of exploration, extraction or exploitation of natural resources shall inter-alia be deemed permanent establishment’ (Amante and Pena, 1999).

Most countries nevertheless rely on the OECD model in determining permanent establishment. Article 5 of OECD Model Income Tax Treaty states the criteria for determining permanent establishment. Fixed place of business is the main criteria to establish permanent establishment in a jurisdiction. This is the most fundamental basis used to recognize permanent establishment (Merill, 2001). Article 5 also concludes that a website by itself does not create a permanent establishment. This is because the nature of a website itself could not be considered as being a fixed place of business (Scally, 2002). However, the Article states that a server could be considered as having a permanent establishment if it fulfils the time and location of business requirement. In this sense, a server which has a sufficient time period in a jurisdiction and conducts a business activity although without a presence of personnel would constitute a permanent establishment, only if the business activities are not “preparatory and auxiliary” in nature (Merill, 2001). On the other hand, the United Kingdom does not consider servers and websites to have enough presence to establish a fixed place of business, and therefore they do not create a permanent establishment (Merill, 2001). The United States in its Model Convention on permanent establishment has defined permanent establishment as a physical presence of business (Sweet, 1998).

Similar to the OECD model, where time and location of a business server would constitute permanent establishment, Germany too share the same views as the OECD. The Second

Chamber of German Supreme Tax Court has ruled that the presence of personnel is not considered to be significant in establishing “PE”. As long as any equipment used fulfilled the criteria of carrying on or operating a business in a jurisdiction, then it would be considered as having a permanent establishment in that jurisdiction (Scally, 2002).

Facts of the case:

*“[T]he pressure for the transportation of the oil was supplied from the Netherlands, from which all the oil transportation within German was regulated by remote control through a computer. The Dutch company had no employees in Germany, and all its technical and marketing personnel were situated in the Netherlands. Independent contractors did all maintenance and repair of the pipelines in Germany. The court held that the Dutch corporation did have a PE in Germany. The court interpreted the term ‘PE’ to include any fixed place of business that served the business activities of the taxpayer...with a fixed nexus with the earth’s surface of a certain duration...and over which...the taxpayer has more than only temporary dominion and control. The court explained that in the case of fully automated equipment, a PE can exist even in the absence of a human presence. The courts’ broad interpretation would favour a finding of a PE in the above example” (Sweet, 1998).*

In India, on the other hand, the view is that the application of present tax rules, the resident and source basis, cannot be applied to e-commerce transactions. The Indian authorities recognized that the present tax rules lead to loss of tax revenue (Moran and Kummer, 2003). Malaysia, a fast developing country in the region has adopted the principles prescribed by the OECD on permanent establishment. However, Malaysian tax authority to-date has yet to introduce any guideline on the application of e-commerce in relation to PE. In Malaysia, permanent establishment is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on or a dependent agent who has, and habitually exercises authority to conclude contracts in the name of a non-resident (Malaysian Master Tax Guide, 2005). Therefore, if a foreign company sets up a branch or has a place of management, an office, a factory, a workshop or a mine, an oil or gas well, a quarry or any other place of extraction of natural resources in Malaysia then that would be deemed a permanent establishment. Any profit attributable to such an establishment would be liable under Section 4 of Income Tax Act 1967.

## Method

### Procedure

This study solicited opinions from tax experts and tax officers on the determination of permanent establishment in an e-commerce environment. Twenty tax experts participated as respondents in the study. Among them were directors and senior managers of the Big Four accounting firms as well as senior tax officers from the Malaysian Inland Revenue Board (IRB). A questionnaire was used to solicit the opinions of these tax experts. The

questionnaire contained both open-ended and close-ended questions. The questions were aimed at gathering the experts' opinions about problems related to the determination of permanent establishment in an e-commerce environment and its implication on taxation. Data were collected through personal interviews. Close-ended questions were analyzed using descriptive statistics. Open-ended questions were analyzed by examining the themes of responses to the key questions identified earlier in the study. Through the themes, the key concepts are used to explain the findings of the study.

## Findings

Table 1 shows the descriptive findings of the data gathered from the tax experts (n = 20). The close-ended questions were primarily concerned with the permanent establishment problems on taxation of e-commerce. The results of the study are summarized in the table below. The tax experts were asked to indicate whether they agreed with the statement as depicted below.

Table 1: Problems Related to Permanent Establishment and E-commerce

Problems	Strongly Agree		Agree		Strongly Disagree		Disagree		Neutral	
	%	n	%	n	%	n	%	n	%	n
Permanent establishment creates problem in taxing business	5.0	1	45.0	9	-	-	15.0	3	35.0	7
E-commerce undermine conventional tax principle	5.0	1	50.0	10	5.0	1	10.0	2	30.0	6
Present principle of permanent establishment will expose e-commerce business tax liabilities to more than one jurisdiction	10.5	2	31.6	6	-	-	5.3	1	52.6	10
E-commerce threatens the applicability of source based-taxation	10.0	2	65.0	13	-	-	15.0	3	10.0	2
E-commerce undermines principle of permanent establishment	10.5	2	57.9	11	-	-	15.8	3	15.8	3
E-commerce threatens the tax threshold physical presence	11.7	2	58.8	10	-	-	17.7	3	11.8	2
E-commerce creates problem for tax avoidance and evasion	21.1	4	47.4	9	5.2	1	21.1	4	5.2	1

\* n = less than 20 because a few did not give any comment

One half of the respondents (n = 10) perceived that the present permanent establishment principle would create problems in taxing e-commerce business. 15% (n = 3) opined that the present permanent establishment concept would not create a problem in taxing business, and 35% (n = 7) did not have any opinion on this matter. Furthermore, eight (42.1%) of the experts agreed that the principle of permanent establishment would expose e-commerce tax liabilities to more than one jurisdiction whereas 5.3% (n = 1) of the experts perceived otherwise and 52.6% (n = 10) remained neutral. This is an interesting finding as the same views were given by a group of economist in the early 20<sup>th</sup> century (Buchanan, 2001) where the concept of permanent establishment was first established as a demarcation point to tax profits from business, and to overcome problems of double taxation. Double taxation occurred because the country where the business was conducted by a non-resident and the domicile country of the said resident both claims rights to the income. Thus, the concept of permanent establishment solved the problem relating to legitimate rights of the taxable income. However, the virtual nature of e-commerce and the multiplicity of jurisdictions of the tax payer and conflicts of law between countries have created tax issues. Probably, based on these assumptions, majority of the experts in this study also opined that e-commerce would create tax problems.

The findings further indicated that majority 68.4% (n = 13) of the experts agreed that e-commerce undermined the principle of permanent establishment although 15.5% (n = 3) believed otherwise. This could be because the experts believed that the present definition used to establish permanent establishment was not appropriate where transactions were done through electronic communication. Thus, the experts opined that e-commerce had undermined the traditional concept of permanent establishment due to the difficulty in identifying the fixed place in an electronic environment. The permanent establishment concept relies on the degree of physical presence in a treaty state for a permanent establishment to exist. The physical presence sets an observable threshold for the physical presence. However, applying the present definition of permanent establishment (fixed place of business) would raise a troublesome issue as the nature of e-commerce does not encourage establishment of physical presence, let alone identification of a fixed place of business.

The results also revealed that majority 75% (n = 15) of the experts agreed that e-commerce threatened the application of the source-based taxation. Only 15% (n = 3) of them disagreed that e-commerce did not follow the principles of source-based taxation. The study found that 70.5% (n = 12) of the experts believed that e-commerce threatened the tax threshold physical presence, which contributed to the implication on taxing e-commerce business while only 17.7% (n = 3) believed otherwise. The results indicated that 68.5% (n = 13) of the experts agreed that e-commerce created opportunity for tax avoidance and evasion while 26.3% (n = 5) disagreed. Generally, the findings suggest that the tax experts are concerned about the manner permanent establishment is defined, which would lead to tax avoidance and evasion by the taxpayers.

Table 2 shows the results of the analysis of the open-ended questions regarding the implications on taxation related to the application of present permanent establishment definition. Tax loss, difficulty in tracking business activities, tax evasion, lesser physical



Table 2: E-Commerce and Tax Implication

	Experts	Number of experts
Tax loss	1, 4, 5, 8, 11	n = 5
Tracking of business activities	3, 6, 18, 19	n = 5
Tax evasion	9, 11	n = 2
Lesser physical presence	2	n = 1
Possibility of doubled taxation	7	n = 1

presence and possibility of double taxation are perceived by the respondents to have an impact on e-commerce taxation.

Tax loss is unavoidable if the present definition of permanent establishment in taxing e-commerce income is used. Among the total number of the experts who responded to the question (what are the implications of using the present definition of permanent establishment to establish source of income derived from Malaysia on e-commerce transactions), five (n = 5) believed that the current principle of determining permanent establishment to establish source of income derived from Malaysia on e-commerce would lead to tax loss. As said by expert no.11 “many e-commerce enterprises would not be caught under the permanent establishment net”. This is probably because potential taxpayer would prefer to have their server registered in a tax free zone but conduct business in another jurisdiction. Expert no. 8 emphasized that “Malaysia will lose its right to tax the income as business is carried on in Malaysia by non-residents without the need to set up a fixed base in Malaysia”. This is a serious and potential challenge faced by the Malaysian IRB. Unlike conventional business, the location of physical presence of an e-commerce business is not easily recognized, and eventually leading to loss of tax revenue to the authorities.

The findings further indicated that four (n = 4) of the experts perceived that the permanent establishment principle used to establish the source of income might not be able to trace the business activities done via e-commerce. As said by expert no. 18 “it is difficult to establish where the business operation in substance is actually carried out”. This is because e-commerce operates without frontiers and without any physical location. If the present permanent establishment definition is applied to tax e-commerce, then the issue of identification of physical location remains uncertain. Therefore, the difficulty of tracking trading activities done via e-commerce indicates that the fixed place of business as the determinant of permanent establishment needs further review. Expert no. 3 for example, said that “based on the OECD concept, the tracking of e-commerce activities is difficult. Furthermore, there are no guidelines or tax policy in Malaysia to ‘catch’ these transactions”.

The findings further indicated that tax evasion will be another implication for e-commerce taxation if the present definition of permanent establishment is used. E-Commerce creates an environment of virtual business where business can be conducted without its physical presence. As said by expert no. 9 “location of the server can lead to abuse or shopping by the entrepreneur and can lead to leakage of tax and the entrepreneur himself may not be

liable to any taxes”. One of the experts (expert no. 2) perceived that there would be lesser need for physical presence of a business in an e-commerce environment. According to the expert, “with e-commerce, there will be a lesser need for foreign businesses to set up physical presence to carry out their business especially those relating to sales and distribution of consumer products”. Therefore, this virtual reality world of conducting business will be an advantage for foreign companies to set up business in the preferred jurisdiction (tax free zone) without having to worry about the tax liability. Also, the tendency for e-commerce companies to move operation to a lower tax zone is highly possible.

One other expert also contended that double taxation would be a common problem in an e-commerce environment. Expert no.7 stated that “income may be taxed twice in two jurisdictions and difficult to determine the source of the income as trading is done in cyberspace”. Determining the profits attributable to a certain jurisdiction via e-commerce is not an easy task especially when countries differ on how to assign the source of income. The difficulty in determining the location where the profits is generated could lead to conflicting and contradictory income classification by countries as e-commerce transactions would result in income taxed twice. However, a number of experts (n = 7) did not give any opinions when asked about the implication of the present definition of permanent establishment to tax e-commerce income. This may be because these experts view that the present principle used to define permanent establishment as sufficient to cover all transactions including that of e-commerce, or it may be because their companies are not involved in e-commerce transactions.

## **Summary, Conclusion and Recommendations**

The innovative and continuous improvement in information and communication technology poses a challenge to tax regimes worldwide. Tax laws and regulations must keep pace with the technological advances. Evaluation of tax rules should be continuously reviewed so that it keeps abreast with the latest forms of conducting business. Otherwise, governments would face great difficulties in collecting tax revenues from companies conducting e-commerce transactions and activities. It is inevitable that e-commerce will continue as a significant form of trading. A review of tax rules and principles is necessary in order to overcome taxing equity and revenue loss implications to the tax regime in the future.

The findings of this study reveal similar results with previous studies in that e-commerce would give rise to double taxation, tax loss, lesser physical presence and tax evasion. The findings also indicate that the basis in determining permanent establishment for taxing e-commerce needs further review in governing e-commerce. Malaysian IRB should issue a set of guidelines on taxation of e-commerce to assist businesses in understanding the tax treatment on e-commerce better.

A majority of the tax experts in the study recommended that the existing definition of permanent establishment be amended to cater for e-commerce trading. A few believe that the present definition of permanent establishment needs to be amended to include other

criteria to suit the e-commerce environment. Criteria such as the place where the contract is concluded, proper registration of website that conducts business to facilitate determination of taxing rights, method of enforcement, location where the title of the goods passes from the seller to the buyer, where the main profits generating activities are carried out and location of server should be considered in determining permanent establishment.

This study being a first of its kind in Malaysia is exploratory in nature. It is recommended that future studies should adopt other methods such as a field survey of wider groups of practitioners such as tax agents, tax accountants from multinational companies and e-commerce operators. The Malaysian tax authority could incorporate recommendations from these studies in the formulation of a guideline on e-commerce taxation for tax professionals and accountants. A guideline in e-commerce taxation should be drafted soon and issued to all professional accountants by the Malaysian IRB.

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