International Taxation of E-commerce Business Income

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The rapid growth of cross-border e-commerce has challenged the existing international tax principles that are structured around national boundaries and State sovereignty. Most tax regimes generally assert jurisdiction to tax business income based on the principles of residence-based and source-based taxation. The residence-based system imposes taxes based on the taxpayer being a resident or domiciled in that jurisdiction. Source-based rules, on the other hand, focus on the location of the economic activity generating the income, and tax is levied on income derived from a particular jurisdiction irrespective of the residence of the income earner. Most international tax rules have been enshrined in bilateral agreements and model tax treaties. However, most developed countries have modelled their bilateral tax treaties around the Organisation for Economic Co-operation and Development's (OECD's) Model Tax Convention (MTC).[1] Though the MTC does not have any binding effect upon any State (as it is does not classify as an OECD decision under the OECD constitution), over eighty countries (both OECD Member States and non-members) have ratified it. The MTC has had a profound effect on international treaty practice, with many countries using it as a template for their bilateral agreements.

Principles governing international taxation of business income

The rules governing source-based taxation of business income is prescribed in Article 7 of the MTC. Article 7 relies on the Permanent Establishment (PE) concept as the central element for requiring a contracting State to tax non-resident companies on business profits derived from sales made within their jurisdiction. Article 5 defines a PE as a fixed place of business through which a company either wholly or partially carries out its activities. This definition includes both physical intermediaries such as an office or factory; agents who are under the control of the foreign company; as well as computer servers on which the foreign vendor's website is located.

Challenges to applying the PE concept to e-commerce taxation

E-retailers ability to operate in a borderless environment has enabled them to exploit loopholes within the international tax rules especially when it pertains to source-based taxation of foreign e-commerce firms. The key challenges concern the application of the PE concept to e-commerce transactions particularly with taxing physical intermediaries and servers.

1. *Taxing physical intermediaries*

The MTC's provision on source-based taxation that focuses on a company's physical presence in the host jurisdiction is centred on traditional foreign investment patterns. Multinationals investment strategies stemming from the 1960s were themed around consumer proximity, with the physical location of their activities being a key component of their business model. Such corporations would try to break into new markets by establishing foreign-owned subsidiaries to provide sales, advertising and promotion services to local consumers in those economies. However, the growth of e-commerce and digitized goods and services has promoted disintermediated business models whereby suppliers are able to bypass traditional intermediaries and directly connect with consumers. E-retailers are able to sell goods to consumers in different countries without the need to establish subsidiaries or contract local sales agents. At the same time, such retailers have the flexibility of linking their website domain names to any server across the world, thus making it hard to verity the location of the machine or its users. This lack of physical location, coupled with the lack of physical contact between international sellers and consumers has made it difficult for tax authorities to impose income taxes to e-commerce firms based on the PE principle.

- *Taxing computer servers*

The MTC recognises servers on which an e-retailers websites are stored can constitute a PE of the company so long as the server is fixed at a certain place for a sufficient period of time, and is utilised by the foreign vendor to perform comprehensive commercial activities. The MTC defines comprehensive commercial activities as activities that comprise of the company's core functions as distinguished from auxiliary functions (such as advertising and gathering market data).

However, taxation of profits generated by server PE's does raise certain difficulties that are attributable to the mobile and malleable nature of these devices. First, servers can be remotely operated without the need to be physically located in the same jurisdiction as its users. They further have the capacity to rapidly transfer their programs to other servers located in other jurisdictions. These factors allow e-retailers to avoid taxation in source countries by simply ensuring that the servers that perform all their essential services are operated from tax havens while utilising their servers located in the source country for auxiliary services. Second, servers have the ability to shift the processing to the end-users computers through the use of applets. Applets like *ActiveX* and *JavaScript* can be sent from a server to an end-user's computer to perform calculations or other simple actions in order to free up more resources for the server to accommodate more users. This would make it difficult for tax authorities to claim that a particular server in their jurisdiction is a PE if it fails to perform any core functions. Lastly, server arrays can be employed to avoid the PE definition under the MTC. Server arrays are linked servers situated in different jurisdictions that switch signals from one server to another depending on the shifts in traffic volumes. Server arrays could be used to fragment e-commerce transactions into different functions which independently would amount to auxiliary services, but when linked together via the internet create a core business function that is not discernible to tax in any of its host jurisdiction.

Revisions under the OECD BEPS Action Plan

On 5 October 2015 the OECD released its final report on an Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan).[2] The report aimed at curbing tax planning strategies that exploit gaps in tax rules by allowing corporations to artificially shift their profit generating assets and activities to low or no-tax jurisdiction. The BEPS Action Plan did devote some sections to identifying the challenges posed by the digital economy. Action 7 in particular proposes some changes to the PE rule in order to prevent its artificial circumvention.

The report widens the scope of agency PE under Art. 5(5) and (6) of the MTC to include commissionaire arrangements. Prior to this amendment the MTC definition of PE only covered dependent agents who were under the control of and transacted on the foreign company's name. This definition failed to cover arrangements whereby the foreign company could contract with agents in the source country who would sell their products and transact for their benefit while utilising their own (the agents) name, thereby creating the illusion of being independent. In such cases the relevant tax authority in the source state would be restricted to imposing taxes on the commission received by the agent for their services, but not the business profits on the sale of products they did not own. This modification only covers one aspect of e-commerce business model where physical intermediaries are contracted. It nonetheless fails to account for electronic intermediaries like intelligent software and online brokers who are frequently utilised to conduct sales for foreign companies in source jurisdictions.

Action 7 has further provided for a new anti-fragmentation rule to Article 5(4) of the MTC, when it comes to classifying the nature of transactions/activities that are exempted from the PE definition. The original provision had outlined a list of activities (e.g. storage, display or delivery of goods) which would not amount to a PE, even if they were carried out through a fixed place of business. The listed activities were generally considered to be non-value adding activities. However, the provision was subject to abuse with retailer using the blanket exemption to avoid taxation on activities that did in fact constitute an essential part of their business, with significant value addition. The new anti-fragmentation rule provides a superseding precondition to the listed activities requiring them to be preparatory or auxiliary in nature. It notes that the exemption will not apply where the overall activity resulting from the combination of activities of a company, or of two closely related companies (located at either the same jurisdiction or two separate jurisdictions), is not of a preparatory or auxiliary nature. Though the modification would have an impact on fragmentation activities that are carried out through a physical place of business, it does not extend to e-commerce fragmentation activities carried out through virtual presence through the use of electronic apps and software. Such e-tools could be used to perform specific logistics or advertising activities as part of a single cohesive e-commerce transaction, and in essence exceed what is considered to be preparatory of auxiliary.

Future outlook

It is evident that the problems facing the international taxation of e-commerce income still persist. As discussed above, the current international tax principles have failed to fully respond to the technological issues posed by cross-border e-commerce. Part of this failure is attributed to the insistence on maintaining aspects of the traditional principles of source-based taxation. Meaningful progress in this area may require a complete overhaul of the traditional principles and reformulation of new principles that are reflective of the current cyber-age of globalization.

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[1] OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital: Full Version* (OECD Publishing, 2014).

[2] OECD, *BEPS 2015 Final Reports* (2015) available at: http://www.oecd.org/ctp/beps-2015-final-reports.htm (accessed 21 Aug 2018).

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