SOURCE-BASED TAXATION OF E-COMMERCE: ISSUES FOR DEBATE

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Structure of Presentation

OUTLINE

- Concept of Permanent Establishment (PE) and challenges surrounding application of PE rule to e-commerce income
- OECD recognition of servers as PE’s and its criticisms
- Professor Dale Pinto’s Refundable Withholding Approach
- Criticisms to Pinto’s model
- Conclusion
Non-resident companies are generally taxed on profits attributable to a PE in the source country.

Rationale is that foreign businesses ought to pay taxes equivalent to benefits they derive from the host market.

PE articulated in Art’s. 5 OECD & UN Model Tax Convention

- PE is a fixed place of business through which business of an enterprise is partially or wholly carried out
- Includes tangible places e.g. office & building site;
- Also dependent agents in certain circumstances
- Business carried out in PE must be essential and not preparatory or auxiliary
The main roles of EOCD model are summarised in the following diagram.

Source: Angharad Miller & Lynne Oats, Principles of International Taxation (Bloomsbury (Professional, 3rd Ed, 2012)) p. 180
Significance of PE

- Ensures that foreign companies have established sufficient economic allegiance with the source country to warrant taxation.

- PE provides avenue for tax authorities to seize assets of noncompliant foreign companies.
Application of PE Rule to E-commerce

- Disruption of physical intermediaries
  - Online businesses are able to realize their sales through websites which are cost effective

- Reduced need for human intermediaries
  - Websites can perform administrative tasks traditionally performed by dependent agents and employees
  - Web conferencing software has promoted contracting of independent agents
OECD Approach to Servers as PE

- In 2000 OECD Commentary on Art. 5
- Extended PE to cover computer servers but not websites
- Servers located in source country would constitute a fixed place of business if:
  - They perform a core function and not preparatory function
  - They are owned & operated by foreign enterprise. Excludes Websites hosted by ISPs.
Servers are highly mobile and flexible

- Can be located in tax havens while websites operate in source country
- Main servers can be located in headquarters while mirror servers performing auxiliary services are maintained in the source country

Difficulty monitoring millions of servers that could create PE

Use of applets can shift processing to end-users computers
Pinto argues for a system where source countries would apply a uniform rate of withholding to all international e-commerce transactions, which would be refundable if total gross sale over a relevant period does not exceed a *de minimis* threshold.

Approach relies on 3 elements

- Setting of *de minimis* threshold that would determine level of economic presence that would warrant taxation
- Use of digital certificates to confirm source jurisdiction of consumers
- Contracting of online intermediary (Visa or MasterCard) to withhold a portion of sales amount on behalf of source jurisdiction
1. Order of $100 placed

2. Online intermediary informed

3. Digital certificate details and location of customer checked

4(a). $95 (net of refundable withholding tax) sent to the foreign seller

4(b). Refundable withholding tax of $4 ($5 less $1 to cover cost) remitted to the tax authority
A key benefit of the refundable withholding approach is that it proposes the use of a numerical threshold – i.e. total gross sales – as a proxy for determining taxable nexus in source countries.

Application of numerical threshold avoids challenges of applying PE to e-commerce taxation.
Criticisms to Pinto’s Approach

- Anomaly with digital certificates
  - Digital certificates generally state the residence of the holder but this may not necessarily be the tax residence

- Possibility of tax avoidance through capped sales
  - Foreign e-commerce firms could avoid taxation by ensuring that their sales in source countries does not exceed the relevant *de minimis* threshold

- Challenge posed by digital currencies/crypto-currencies
  - The online intermediaries in Pinto’s approach (Visa and MasterCard) would not be able to detect transactions involving digital currencies
Conclusion

Thank you