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The conundrum of the notion of Permanent Establishment (PE) in Taxation of Tanzania's e-commerce

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A R T I C L E I N F O

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A B S T R A C T

Purpose: To understand how Tanzania taxes digital commerce transactions, this paper explores the complex terrain of Permanent Establishment (PE).

Design/Methodology/Approach: This study is analytical descriptive legal research. Secondary data sources encompass primary, secondary, and tertiary materials were used.

Findings: The review's outcome has revealed that this traditional notion of PE has historically worked well for taxing conventional businesses; however, the concept of PE, as defined by the Tanzanian Income Tax Act, has failed to address and cover e-commerce issues. Hence, the concept of PE requires substantial modifications to align with the contemporary and future challenges of e-commerce.

Research Limitations: The study's primary constraint is its restriction to a thorough review.

Managerial Application: This study's results are poised to provide significant guidance for reshaping tax legislation in Tanzania to align with modern challenges. Moreover, the study seeks to heighten public awareness regarding the Permanent Establishment and the taxation of digital commerce transactions while also serving as a valuable reference for future research ventures within the same domain.

Originality/Value: This study offers a novel perspective on Tanzanian taxes and the connection between online transactions and permanent establishments.

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Introduction

In earlier eras, economic activities followed a primarily linear trajectory, confined within a nation's geographical boundaries, leading to relatively straightforward taxation practices. However, with the advent of globalization, cross-border trade accelerated dramatically. This allowed companies to expand their operations to establish offshore entities swiftly. This whirlwind of activity marked the emergence of International Taxation. The League of Nations responded by introducing the theoretical concept of "economic allegiance." This rule suggests that the authority to impose taxes must be allocated based on where an individual's genuine economic interests are situated. Bruins et. Al. (1923). This laid the groundwork for the establishment of an international tax framework. Economic allegiance is based on metrics assessing the degree and kind of financial ties between a country and the income or person subject to taxes. The enforcement of rights to wealth or income, the source of wealth or income, the location of wealth or income, and the home or domicile of the person authorized to administer the wealth or income are the four components of economic allegiance that the League of Nations developed (Cowcher, 1923). Put differently, the League of Nations stipulated that, contingent upon the type of income, the responsibility for taxation should be shared between the nation where the income originates and the nation where the individual resides. This stands as one of the initial notions within international taxation and remains applicable in the present day.

Residence Vs Source: The Conflict

Typically, a nation's authority to impose taxes revolves around the taxation of its residents' global earnings, encompassing individuals and businesses, while also taxing non-residents on earnings generated within its territory. The dominant foundations for income taxation across most jurisdictions are residence jurisdiction and source jurisdiction. While these two concepts may have become common standards, there are differing opinions regarding whether they have the status of customary law (Kaufman, 1998).

Residency Jurisdiction

Residency jurisdiction hinges on the affiliation between a taxpayer and a specific jurisdiction, often referred to as the political allegiance principle (Kobetsky, 2011). This concept of residency jurisdiction is predominantly associated with the taxation of global income, as it considers a taxpayer's capacity to contribute based on their income worldwide (Sato & Bird, 1975). Unlike source-based taxation, which centers on the income itself, this type of taxation pertains to the individual or entity. To ascertain a taxpayer's residency, there are two primary criteria. The first criterion is evaluating a company's official connections to a jurisdiction, which are demonstrated by formation or registration following local laws.

The second examination pertains to companies established in foreign countries and involves the application of the "place of effective management" test. This test aims to establish whether there exists a business affiliation between the company and the jurisdiction. As a result of globalization facilitated by rapid and high-quality communication and information technologies, companies now can be directed from virtually any geographical location. In situations where a company is registered or incorporated in a jurisdiction with favorable tax conditions and crucial business decisions are made during these proceedings, it's improbable that any other country can assert the company's status as a resident taxpayer. Consequently, there might be challenges in objectively ascertaining the residency of international companies according to the criteria of the effective management test.

Source Jurisdiction

The concept of 'source' in the context of ascertaining tax jurisdiction relies on the economic affiliation that a specific income stream has with a country. The leading developers of this idea were European nations with scheduled tax structures. The fundamental idea is that income should be considered as originating within the jurisdiction where it maintains a significant economic connection. Irrespective of whether the recipients are taxpayers residing within the jurisdiction or those from outside, taxation based on the source principle is levied on the movement of income. The source rule has not held sway over the international tax strategies of governments due to two main grounds. First, it's intricate to apportion the profits of a multinational enterprise to a specific geographical source. Second, the challenge lies in precisely defining the source principle within legislative frameworks (Riven, 2011).

Tussles in the Digital Economy Age

The ongoing process of globalizing world economies, coupled with advancements in information and communications technology, has intensified the debate on the viability of retaining existing international tax norms for regulating international transactions. When compared to traditional business models, the complexities introduced by contemporary digital trade are heightened due to the diminishing significance of national boundaries. Conducting business across countries where governmental influence is minimal or absent has led tax authorities to grapple with determining their jurisdictional rights to tax the proceeds derived from these transactions (Oguttu & Sebo, 2009). Thus, the conflict between residency-based and source-based taxation has roots that extend beyond the discourse on online commerce transactions. Presently, the majority of tax frameworks adhere exclusively to either the residency or the source rule. A careful balance or compromise between these two approaches is shown by the present international tax system, which permits corporate revenue to be taxed largely in the source country provided a Permanent Establishment (PE) is formed. Indeed, before imposing a tax on income, it's imperative to establish a connection or tax nexus between a country and the said income. For instance, there are two main types of nexus: the source nexus, which pertains to taxing individuals on income generated within a country's physical borders, and the residence nexus, which entails taxing residents on their global revenue. When a multinational corporation establishes a subsidiary abroad, the subsidiary is treated as an independent legal entity and is subject to local taxes. However, unless the earnings can be linked to a permanent establishment (PE) inside that jurisdiction, the business entity's income cannot be taxed by the country in which it operates if it is not recognized as a resident. The presence of a PE enables the source country – the nation where the non-resident earns the income – to levy taxes on the revenue earned (Oguttu & Sebo, 2009). The idea behind a PE is that a company needs to be physically present for the nation of origin to tax its profits. Determining a taxable presence inside a particular jurisdiction has become more challenging with the shift from conventional physical distribution to electronic delivery (e-commerce).While it is undisputed that e-commerce transactions must be subject to taxation, the question of the basis for taxing e-commerce remains complex (Tan & Teo, 2008). A significant theory pertaining to a country's taxation rights is the benefit theory. This theory posits that a state has the right to tax, considering the overall benefits and services provided to taxpayers. In this context, a state should be compensated for offering public services such as a supportive legal framework, consumer base, economic stability, and stable exchange rates, all contributing to income-generating e-commerce activities.

Tax System in Tanzania

The United Republic of Tanzania was formed via the union of two self-governing countries, Tanganyika and Zanzibar. On April 26, 1964, the leaders of these regions, Julius Kambarage Nyerere and Abeid Aman Karume, who were heading Tanganyika and Zanzibar, respectively, formally agreed to unify their territories by signing the Articles of Union. These articles outline the principles of cooperation between the two regions. Under this union, there exist two separate executive bodies, two distinct judicial systems, and two individual parliamentary assemblies.

Zanzibar functions as a partially self-governing entity within the larger Union framework. This arrangement signifies that any matters not related to the union are under the exclusive jurisdiction of Zanzibar, which operates according to its own Constitution. Consequently, Zanzibar possesses the authority to establish its laws and regulations about these non-union matters. Given the legal structure in Tanzania, there are two distinct categories of taxes: Union taxes and Non-union taxes. Union taxes encompass areas subject to taxation across Tanzania Mainland and Zanzibar. On the other hand, Non-union taxes apply individually to either the Mainland or Zanzibar. Union taxes encompass aspects like Customs duty, Income tax, and excise duty on locally produced goods. In contrast, Non-union taxes consist of taxes such as Value Added Tax (VAT), Property tax, and a levy on hotels. The Tanzania Revenue Authority (TRA) is in charge of the assessment, accounting, and collection of Union Taxes and Non-Union Taxes pertinent to Tanzania Mainland. The Zanzibar Revenue Board (ZRB) of Zanzibar is responsible for the assessment, accounting, and collection of only non-union taxes.

Moreover, a multitude of organizations functioning within Tanzania are liable to pay several types of taxes. Direct taxes like withholding tax, employment taxes, and corporate income tax are a few examples. In addition, there are applicable indirect taxes including Value Added Tax (VAT), Stamp duty, and Excise Duty. Individuals must additionally pay presumptive tax (estimated based on their yearly income threshold), employment taxes (applied on individual salaries), stamp duty, and Value Added Tax (VAT). The precise application of these taxes, particularly regarding registration thresholds, varies according to the circumstances.

Tanzania's E-Commerce

The concept of 'e-commerce' carries multiple meanings (Doernberg et al., 2001). At times, it's synonymous with electronic commerce or digital trade transactions. It encompasses the transfer of business data through electronic data interchange, the World Wide Web, email, online bulletin boards, electronic funds transfer, and similar technological networks (Ganguly et al., 2016). This form of digital trade not only automates manual tasks and paper-based transactions but also facilitates the transition of businesses into a fully electronic realm, fundamentally altering their operational methods.

Scope of E-Commerce

It covers a diverse array of business activities conducted digitally, extending well beyond just buying goods and services online. This includes electronic banking, such as digital currency; digital procurement and inventory systems; online payment mechanisms; any business deals conducted over the internet, phone, or fax; and all types of trade involving digitalized products and services. A significant portion of Tanzanian citizens engage in online purchases through social media platforms, where businesses showcase their offerings and customers communicate with sellers for delivery arrangements. Payment can be settled either upon receipt of the goods or through mobile money services. While e-commerce is still in its infancy in Tanzania, its potential for quick growth is significant, owing to the recent emergence of mobile payment options such as Hallo-Pesa, M-Pesa, Azam-Pesa, Tigo-Pesa, and Airtel Money. Tanzania is home to Africa's fourth-largest e-commerce customer base, according to the UNCTAD B2C E-Commerce Index 2020. The fact that 1,593 million people purchase online, or 21% of all internet users and 5.3% of the global population, attests to this (UNCTAD, 2021). Based on UNCTAD's B2C E-Commerce Index, Tanzania is ranked second in East Africa, 16th in Africa, and 110th worldwide (UNCTAD, 2018).

- Despite the expansion of e-commerce within Tanzania, data from the Income Tax database indicates that in the mainland of Tanzania, the count of corporate taxpayers stands at around 106,000, while the number of individual taxpayers surpasses 3.5 million, constituting approximately 6% of the mainland's population. In Zanzibar, the tally of corporate taxpayers is nearly 5,000, accompanied by roughly 20,000 individual taxpayers, which equates to approximately 1% of the population in Zanzibar, as per the tax database records.

Methodology

The approach used for this study was doctrinal research. The primary areas of issue were Tanzanian e-commerce taxes and legal theories about Permanent Establishment. The study located and reviewed the sources to analyse the legal principles using descriptive, comparative, and analytical methodologies. After finding and examining the materials, the researcher used reasoning and logic to synthesize the concepts in the study's context and match them to the targets. This study conducted a qualitative analysis of the doctrines. Nonetheless, some assertions were supported by scant statistical data. Moreover, this study utilizes secondary data, encompassing primary, secondary, and legal documents. Consequently, the examination encompasses the analysis of existing domestic and international tax laws, pertinent case law, and authoritative sources about the concept of Permanent Establishment and the taxation of e-commerce.

Review of Literature

- Commonly, electronic commerce refers to the process of conducting business transactions using electronic platforms. This encompasses various commercial endeavors facilitated by computers, such as online buying and selling of products and services, digital money transfers, trading financial assets on the Internet, and exchanging electronic data

> Gopalakrishnan & Kanthi, (2001) argue that potential purchasers can efficiently explore manufacturers' and traders' websites from their location using the internet. This enables them to quickly browse through available products, and their prices, and make selections for placing orders. Likewise, they can opt for specific services they desire. In essence, E-commerce can be described as any business deal carried out, either entirely or partially, through Internet utilization.

Additionally, it is crucial to grasp the distinctions among the three variations of electronic commerce: e-commerce involving physical items, e-commerce centered on intangible products, and e-commerce revolving around services. Johnson & Post, (1996) assert that all categories of electronic commerce share a global nature, operating across the world without strict adherence to national borders. E-commerce effectively transcends or even eradicates geographical boundaries. All manifestations of e-commerce also exhibit a virtual character, existing predominantly within the realm of the internet and possessing limited physical presence beyond it. The definitive response to the query about e-commerce's location is "on the internet." Attempting to pinpoint its geographical position outside the internet is notably contrived. Another common trait among all forms of e-commerce is their element of anonymity, wherein transactional parties and details are at least partially concealed. Nevertheless, the varying degrees to which global, virtual, and anonymous attributes are present distinguish the three e-commerce types from one another. Generally, e-commerce involving tangible goods displays lesser global and virtual attributes than e-commerce involving intangible items, with e-commerce focused on services falling somewhere in between. This divergence has taxation implications; the higher the global or virtual component of e-commerce, the more intricate the associated tax challenges become. Similarly, a degree of anonymity is universally present but varies across e-commerce types based on internet architecture and accessible location technologies. Consequently, heightened anonymity escalates the complexity of tax-related difficulties. This adaptive quality has facilitated the development of diverse digital technologies, leading to enhanced computational capabilities through increasingly sophisticated software algorithms.

Notwithstanding this trend, numerous Multinational Enterprises might opt to establish a direct connection with significant clients, provided they possess the necessary infrastructure to support local assets. Crivelli et al. (2016), explore that, it is worth noting that in certain nations, taxes are levied based on an individual's residency within the country for a specific duration. In contrast, in other countries, taxes are imposed on income generated within those nations or received from sources outside of them. However, electronic commerce has transformed this dynamic, as a taxpayer is no longer restricted to operating within a particular country for conducting activities like sales, purchases, distribution, or supply. Such a taxpayer can engage in numerous business transactions while remaining mobile. They can execute transactions across various states simultaneously by traversing the digital space they have established, enabling continuous business operations. Nicholas et. al. (2018) state that, the residency examination, determined by physical presence, enables untaxed income to be retained. This implies that the interpretation of Permanent Establishment (PE) is being questioned, as numerous non-resident companies can avoid obligations despite lacking a fixed business location or relying on an agent to finalize contracts within a country. Many businesses can complete contracts autonomously through offshore technological methods, without needing personnel or agents. Consequently, the existing definition of PE leads to diverse tax complications, giving way to significant concerns about Base Erosion and Profit Shifting (BEPS). Therefore, it is anticipated that digital business transactions will result in gaps in sales tax, customs, excise duty, and indirect tax collections. The fundamental principles of income tax addressing foreign businesses, source, and residence rules become ambiguous, and the concept of PE fades into obscurity. Monitoring online transactions may be extremely challenging, even inside a single country.

Further Oduntan, (2000) , underscores the challenges associated with taxing e-commerce within the Nigerian context. Despite the effects of globalization and the increasing automation of commercial dealings in Nigeria, the digital economy presents a significant potential as a substantial revenue source for the government. The unique obstacles of inadequate infrastructure, outdated legal frameworks, inconsistent enforcement of existing regulations, pervasive corruption, and widespread lack of education contribute to making the taxation of the digital economy an even more captivating issue in Nigeria. Additionally, the intricate and complex technological aspects involved in these transactions further compound the matter. The author draws a comparison between Nigeria and Tanzania, acknowledging that the conditions prevailing a decade ago in Nigeria differ from those in Tanzania.

Navigating Taxation Challenges

Over the past decade, there has been a notable surge in the utilization of advanced information and communications technology systems in Tanzania, including widespread internet usage. This has facilitated a surge in cross-jurisdictional sales conducted remotely, bypassing the necessity for economic and physical presence. Furthermore, because of their capacity to advertise, sell, and buy items and services from a distance, online merchants are challenging and displacing traditional brick-and-mortar establishments. Over the past ten years, Tanzania has seen an increase in the percentage of e-commerce in retail sales. Presently, customers can effortlessly book affordable accommodations through online B&B apps, replacing the conventional methods that require phone calls or in-person visits. Similarly, Tanzanian users can access NETFLIX channels by making online payments, enabling them to enjoy current movies on their TV sets or communication devices. Henceforth, a discrepancy or gap arises between where value is generated and tax is collected. This disparity leads to an inequality where conventional businesses bear a heavier tax burden than their digital counterparts. Companies like eBay, Amazon, Netflix, and Alibaba, operating in the digital realm, often encounter minimal tax rates and in certain instances, almost no taxation, particularly in markets with significant market share. The existing tax framework in Tanzania considers a company's residency within the country as the primary criterion for imposing taxes, defining Permanent Establishment (PE) within the source nation. While this traditional PE concept has historically worked well for taxing conventional businesses, the development of the digital economy raises the pertinent issue of whether this conventional PE concept, or an alternative form of source-based taxation, requires expansion or reconsideration to guarantee clarity, certainty, and effective enforcement. Although the definition of PE has undergone adjustments with the introduction of the "agent of non-resident" term and a broadly defined concept of business connection in the Income Tax Act through the Finance Act of 2021, these revisions seem to address the rapidly evolving technological landscape reactively. These revisions appear to be based on the traditional interpretation of Permanent Establishment, which states that for the source country to exercise its taxation power over the revenues of multinational firms, it must have some degree of physical presence there.

An entity having a local or foreign permanent establishment is subject to income tax liability under Section 70 of the Tanzania Income Tax Act, which states that the entity and the permanent establishment must be treated as distinct but related entities and both must be residents of the nation where the permanent establishment is located. This section plainly states that the emergence of the digital economy, such as e-commerce, has put pressure on the conventional idea of PE, which relies on a fixed physical presence as a prerequisite for a government's authority to charge taxes. As a result, it's imperative to redefine and explore avenues for taxing e-commerce, potentially by reimagining the notion of PE, to bolster government revenue.

In this context, the proliferation of digital commercial transactions has complicated efforts to trace distant sellers catering to local customers. The issue is that domestic tax laws do not require e-businesses to register with the market jurisdiction. Additionally, in the absence of data from offshore sellers, it becomes challenging to estimate the number of sales or other activities since there could not be any available sales or accounting records within the jurisdiction's purview. Consequently, income tax and Value Added Tax (VAT) collections suffer due to outdated and insufficient source-based taxation rights in e-commerce.

Role of Judiciary

Moreover, Tanzania's judiciary lacks broad guidance in defining PE and handling e-commerce taxes. Judiciaries throughout the world have a propensity to interpret and evolve international notions differently. In India, for example, courts have refined and interpreted the idea of PE, distinguishing it from the notion of Business Connection and clarifying taxation rules for PE in digital business transactions. As highlighted in this paper, a gap now exists in Tanzania's tax regulations concerning the taxation of e-commerce, primarily owing to the challenges posed by the concept of PE. The existing tax laws, formulated during the era of conventional commerce, require substantial modifications to align with the contemporary and future challenges posed by e-commerce. Consequently, the researcher puts forth recommendations and provides a strategic path forward. Thus, this study serves as a catalyst and an urgent call for Tanzania's legislative bodies to formulate clear tax regulations to effectively manage taxation in the realm of digital commercial transactions.

Path Forward

The rapid expansion of digital commercial transactions has revolutionized the business landscape on the Internet. This study proposes the following recommendations to address the tax complexities associated with digital commercial transactions:

I) Revision of the Permanent Establishment (PE) Definition

Amendments in the Income Tax Act to broaden the definition of PE to encompass Significant Digital Presence or operations within Tanzania, or interactions with Tanzanian residents, as a nexus for constituting a PE for tax purposes. This revision should also incorporate the recommendations outlined in the Base Erosion and Profit Shifting (BEPS) Action Plan. Additionally, amendments to the Value Added Tax Act, of 2014 should be considered to inflate the meaning of goods to encompass virtual goods.

II) Introduction of Digital Services Tax

Introduce a Digital Services Tax to address the inadequacies of the current Income Tax Act in handling the complexities of digital commercial transactions, as evidenced earlier. This approach recognizes the inherent shortcomings and establishes the necessity for dedicated legislation aimed at resolving these issues. The new legislation should address matters such as digital PE, customer engagement, source rules, value creation, assessment procedures, return processes, data collection, enforcement mechanisms, and other tax-related procedures.

III) Enhancement of Technical Infrastructures

The technical infrastructure in many African nations requires significant improvements to accommodate the digital economy's emergence and to ensure effective revenue collection. Collaboration among regulatory bodies, service providers, suppliers, and consumers is essential to develop technology-driven approaches for acquiring transactional and business data from online platforms. Tools like software for recording e-transactions and online business data can substantially aid tax administrations. Furthermore, initiatives such as system integration and enhanced information exchange between tax authorities, central banks, communications regulatory bodies, and other stakeholders are crucial. This underscores the need for strategic technological investments.

IV) Capacity Building and Stakeholder Awareness

Equipping tax administration personnel with a profound understanding of digital economy challenges and their taxation implications is crucial. Comprehensive training and courses on this subject should be mandatory for all tax officers. Enhanced vigilance and proactive monitoring of e-commerce transactions and business activities are imperative. Establishing a dedicated unit or section within the revenue authority responsible for identifying and registering small digital enterprises can be beneficial among other tasks.

V) Inclusion of Nexus Rules in Tax Treaties

A sustainable solution for taxing digital commercial transactions involves integrating nexus rules into tax treaties. This can be achieved through two approaches. First, through negotiations to modify treaty clauses with partner countries. However, this process is time-consuming. As an interim solution, priority negotiations should be initiated with countries significantly engaged in digital commercial transactions involving Tanzanian nationals. These renegotiations should encompass changes to the PE definition. Second, the adoption of a Multilateral Instrument (MLI) can introduce nexus rules, but it's important to acknowledge that treaties are the outcome of complex negotiations reflecting the economic and fiscal policies of the contracting parties. The introduction of an MLI might not adequately address the nuanced relationships between contracting states, potentially leading to varying degrees of acceptance among the parties.

Reflection and Discourse

Globalization and liberalization have resulted in a steady rise in cross-border transactions and foreign commerce in the international arena. This study conducted a textual examination of the term 'PE' as defined in Model Tax Treaties, and the Tanzania Income Tax Act. The formulation of the PE definition within both the Model Conventions, while bearing resemblances, reflects diverse ideological standpoints. The United Nations Model Convention (UN-MC) predominantly governs relations between developed and developing nations, serving as the foundation for Tanzania's treaty framework. However, the current provisions within these Model Conventions do not adequately address the legal intricacies associated with e-commerce taxation within the scope of PE. Consequently, the discourse based on the existing tax treaty models underscores a conspicuous misalignment between e-commerce transactions and the conventional prerequisites for a permanent establishment. This observation is evident not only within the Model Conventions but also within the Tanzania Income Tax Act. The PE definition contained therein appears outdated, failing to encompass the challenges posed by digital commercial transactions in Tanzania. Thus, the existing tax regulations are ill-suited for the dynamics of digital commerce. Consequently, novel tax legislation is imperative to address the pressing taxation requirements associated with e-commerce effectively.

Conclusion

As evinced by the preceding discourse, interpreting the term 'Permanent Establishment' has sparked considerable debate within international and national tax litigation. Nevertheless, tax models like the OECD and UN Models have evolved and refined the notion. Despite the absence of enforcement, these Model Treaties serve as guiding principles for interpreting tax treaties and formulating tax law. Despite the vital role tax treaties play in the country's economic policy and legislative framework, there have been no concerted efforts to assess their effectiveness and impacts on e-commerce in Tanzania. Although preventing fiscal evasion is a crucial objective of tax treaties, no Tanzanian treaties incorporate measures to combat this concern, especially within the scope of the Permanent Establishment definition. As a result, it is clear from the current Income Tax Act that e-commerce transactions would not meet the conventional requirements of the PE requirement. Tanzanian tax legislation currently taxes business income only when the businesses possess a physical presence to which profits can be attributed, as stipulated by Section 6 of the Income Tax Act. Multinational corporations with a PE in Tanzania fall under the purview of the Income Tax Act. Section 3 of this Act outlines various factors for determining a permanent establishment, including the physical location of the business, substantial business equipment, or the duration of business activities conducted in Tanzania. However, this concept falls short of encompassing online retail operations that involve the exchange of physical and intangible goods between Tanzania and other nations.

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